

2015

Stronger and better, today and tomorrow



Principality

Building Society
Cymdeithas Adeiladu

2015 Highlights

Record customer satisfaction scores of 86.9% (2014: 86.8%)

Supported 3,500 first-time buyers onto the housing ladder

Underlying profit of £57.8m (2014: £51.9m)

Retail mortgage balances of £5.2bn (2014: £4.8bn)

Strong capital ratios with a Common Equity Tier 1 ratio of 20.97% (2014: 18.20%)

Launched a ten year partnership with the WRU to invest in rugby at all levels, which has also seen the national stadium of Wales renamed Principality Stadium

Raised a record £90,000 for Mind Cymru, our Charity of the Year for 2015

Entered into more than 100 local branch sponsorships

Net interest margin 1.81% (2014: 1.87%)

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Chairman's statement for the year ended 31 December 2015

It has been another successful year for Principality and I am proud that we have continued to deliver growth in this business whilst supporting our Members, our savers and borrowers, in more ways than ever before.

As a mutual Building Society, which prioritises the delivery of value for our Members, we have continued to grow. This year profits were £49.0m and assets grew to £7.6bn, which will enable us to invest in our business for the future. Profit is vital to our mutual model as unlike banks, profit is one of the few ways we can create more capital for the Society. This capital can then be used to support future growth, invest in this business for the long term and meet regulatory capital requirements to protect the business against market volatility.

Since 1860, Principality has helped people to find a home that is right for them and kept our Members' money safe so that they can build the life that they want. This continues to be our focus and this year we have supported even more first-time buyers, Members and communities and we will continue to invest in these areas to make a difference to people, particularly in our heartland of Wales and the Borders.

The world is changing

Since we launched our growth strategy in 2012 the Society has come a long way, implementing significant change and growing this business to become the sixth largest Building Society in the UK.

However, the pace of change is accelerating and we must transform our business even further to ensure that we provide our Members with the service and products they need to prosper both now and in the future.

New entrants are starting to make an impact on financial services markets. With increasing competition and several online-only financial services providers emerging, there is an increasing need for us to differentiate ourselves from our competitors to ensure we can compete in a continually challenging marketplace.

With the life expectancy of the UK population increasing and technological advancements being made on a regular basis, the needs of consumers are changing. We are acutely aware of this and we recognise that we will need to adapt our business if we are to continue to remain focussed on meeting our Members' needs.

Responding to changing customer needs

Many of our Members value the convenience and support offered by our branch and agency network and we have 71 outlets as well as our Welsh and English language contact centres to support them. We continue to see an important role for our branches and agencies in the future to help our Members around Wales and the Borders.

However, businesses in all industries have to adapt to technological advances and our Members frequently want to interact with us through digital channels.

Being able to interact with your financial services provider via the internet is no longer a 'nice to have', it is now seen as a minimum requirement and we must invest in technology so that we keep pace with our competitors and ensure the continued development of our business for the future.

We also recognise that the demographics of the UK are changing. There are already 11.6 million people over the age of 65* in the UK, and by 2034 it is estimated that around a quarter of the population will be 65 or older. We exist to help people prosper in their homes and we are already supporting these people in many ways. We know that there is now increasing demand for borrowing into, and in, retirement from both older borrowers who need assistance now and the younger generations who expect to need a mortgage until later in life.

Risk management

The weight of regulatory change is ever increasing and the past year has continued to be a busy period of regulatory reform requiring financial services organisations to operate to higher prudential and conduct standards.

In 2014 the biggest change to the mortgage market since 2004, the Mortgage Market Review, was introduced in the UK and in March 2016 new rules from our European regulators known as the European Mortgage Credit Directive (MCD) will be introduced. Our teams worked very hard on this and I am delighted that Principality was ahead of plan and was compliant with the new MCD rules in November 2015, which will help our Members to have a better experience and service when getting a mortgage.

Our team strives to keep our Members and their money safe and we remain supportive of our regulators as they seek to raise standards and support consumers across the industry.

Supporting our communities

At Principality our Members and their communities are at the heart of everything we do. We have always tried to add value to the communities in which we live and work and this year we have expanded our community support programme to support even more people than before.

We do this in a number of ways, including volunteer projects, our Charity of the Year support and helping build homes for people where they are needed. A detailed update on all of our work in our communities can be found in the Member, Colleague and Community section of the report, but here are some of the highlights from 2015:

* Source: BBA, World of Change Report 2015

2015 HIGHLIGHTS

- Named Wales' Responsible Large Business of the Year 2015 by Business in the Community Wales.
- Given 1,241 volunteer hours to projects around Wales and the Borders.
- Raised £90,000 for Mind Cymru, our 2015 Charity of the Year.

Your Board of Directors

Along with a strong management team and skilled workforce the strength of any business's Board is vital to its success and at Principality that is no different. We ensure that we have Directors of the highest calibre to represent the Society from a variety of different backgrounds.

This year we have seen a number of changes to your Board. Gordon MacLean, Joanne Kenrick and Menna Richards have stepped down and we are immensely grateful to the three former Directors who have done an excellent job in keeping the Society safe during some difficult economic conditions.

We are delighted that Non-Executive Director Derek Howell has taken on the role of Senior Independent Director and we have two new Non-Executive Directors, Sally Jones-Evans and David Rigney, who bring a wealth of experience to Principality. I am sure that they will help the Society to meet the challenges to come.

Closing statement

I would like to take this opportunity to thank the Board, the leadership team and most importantly all of the hard-working colleagues in our branches, agencies and head office who work tirelessly to serve our Members. Without them Principality would not be the business it is today.

After 155 years supporting our Members, with all of the factors set out above and others impacting the market it is now more important than ever for us to invest in our business to ensure that the Society continues to prosper and support its Members for many years to come.



Laurence Philip Adams
Chairman
9 February 2016



Group Chief Executive's review for the year ended 31 December 2015

Creating a strong platform

I am delighted to say that our Member-focussed mutual model continues to be successful and we have had another strong 12 months. We have seen continued good performance with net retail mortgage growth of £1.6bn since we launched our growth strategy in 2012. We have a solid balance sheet with total assets of £7.6bn, and generated statutory profit before tax for the year of £49.0m (2014: £53.5m). Underlying profit, adjusting for one-off items not reflective of the underlying performance of the business, has increased to £57.8m (2014: £51.9m). Details of the adjustments made in arriving at underlying profit are set out in the Strategic Report on page 10.

For the first time in our history our mortgage lending to homeowners has grown to over £5bn and we have increased our support to first-time buyers, helping 3,500 more people get a foot onto the property ladder. In 2012 we set out on our journey to achieve balance sheet growth and enhance our Member proposition and our 2015 results show that our strategy is clearly delivering. Our profitability has reinforced the security of the Society through the generation of capital, and our growth ensures that more people enjoy the benefits of membership.

We are however conscious that the likely changes to the economic landscape over the coming years, including rising costs of funding and increasing competition in lending markets, will put downward pressure on margins

across the financial services industry. We cannot therefore expect profitability to continue at the levels generated in the last few years. Despite these external pressures, we will continue to build on the capital base of our business to ensure we remain a safe and secure home for our Members' savings well into the future.

KEY PERFORMANCE HIGHLIGHTS

- Record customer satisfaction scores of 86.9% (2014: 86.8%)
- Net retail mortgage balances of £5.2bn (2014: £4.8bn)
- Strong capital ratios with a Common Equity Tier 1 ratio of 20.97% (2014: 18.20%)
- Net interest margin 1.81% (2014: 1.87%)
- Launched a ten year partnership with the WRU to invest in rugby at all levels, which also saw the national stadium of Wales renamed Principality Stadium

Our customer satisfaction scores have continued to rise, which is testament to the excellent levels of service that can be seen right across the business. In 2015 we have also launched new partnerships with trusted organisations that will support the future growth of this business.

We've further strengthened our capital position and improved our balance sheet alongside our strong profit. This profit enables us to build a solid platform to increase investment in our people, systems, processes and technology so that we can meet the demands of our Members into the future and provide excellent service when and how they want it.

The benefit of having no shareholder interests to satisfy enables us to focus on long-term value for Principality and our Members rather than short-term gains.

The need for change

Consumers' needs are changing and we are seeing our Members demand our services in new ways – asking for more accessibility, more interaction online and service that is seamless across our branches, contact centre and website. We are witnessing a period of change that is happening quicker than anyone could have predicted with new and innovative service and product offerings constantly emerging in the marketplace.

We are committed to providing financial products and services to our Members and customers that meet their needs and this involves proactively reviewing our processes and procedures to ensure that we continually improve. Our Members should be able to deal with us in the way that they want, when they need it the most. Whether that's in branch, online or on the telephone, we want them to be able to move between the options whilst still receiving the standards of service that they have come to expect from Principality.

During 2015 we started to work on a number of measures to ensure that we are supporting the needs of our Members, including rolling out mortgage interviews through Skype™ and developing online appointment booking, but we know that there is a lot more to be done.

Future-proofing our business is critical to ensure its stability over the long term and we must invest further to ensure the continued success of this business for our current and future Members.

We need to transform the Society at a rate not experienced before. This will include investment in a wider range of products that will meet our Members' needs, in updating branches and offices, in marketing and in new technology. We have launched an extensive investment programme to ensure that we have the right foundations to achieve our growth aspirations and meet the needs of our Members both now and in the future. Further information on this investment programme can be found in the Strategic Report.

The changes set out above will not alter our core business values. We know we have a strong platform to build upon

and I believe that our business model will enable us to meet the challenges of the new world and ensure the future is as successful as the past.

Helping you prosper in your home

In 2015 we reassessed what Principality stands for and as part of that work we confirmed that helping people prosper in their homes is our core purpose. For 155 years we have been doing this for our Members and we want to continue helping them to manage their money and get the most out of their life at home.

We know that home matters to our Members and during 2015 we have continued to help more people own their own home than ever before.

Buying a home is not an option for everyone and we have supported a range of housing schemes to provide other solutions for our Members. Through funding a range of house building schemes, supporting housing associations and looking at new ways to supply more homes where there is demand for them, we have been supporting the UK housing market for people who are renting as well as buying.

We have continued to support the buy-to-let market as another way to provide homes, as we know that renting is an important alternative for people, regardless of their situation.

The mortgage market is increasingly competitive and it is important that we have a diversified funding model in order to remain competitive. Our business model continues to rely heavily on savers with 85.9% of the money we lend coming from them. Whilst savers continue to be the principal funders of our lending programme, we have to take advantage of alternative, cost effective funding to help us grow the business. We have previously, and will continue, to take advantage of wholesale funding to ensure that our business grows for the good of our Members.

We know savers have had a difficult time in this low interest rate environment and we aim to pay savers competitive interest rates to support them as much as we can. We will continue to do our best for our savers against a backdrop of falling interest rates but we cannot operate in isolation from the market. For some time providers have been reducing rates and whilst we've tried to protect our savers against reductions, we made the difficult decision to reduce the rates on our Promise Saver and Promise ISA in 2015 as we couldn't sustain our position any longer. Even after these changes we remained in the top three high street providers in Wales and will continue to support savers as much as we can.

In 2015 we also simplified our range of savings products, reducing the number of products by 35%, to make it easier for our Members to compare their rates against other products and providers. We moved some of our older accounts, which are no longer on sale, to products in our on-sale range to make saving more straightforward and easier to understand. Under the changes 98% of the relevant customers were moved to the same or higher rate and we paid £300,000 of additional interest to customers who were moved to new accounts.

We have also recently launched a new general insurance offering with our partner Legal & General to keep people safe in their homes in the knowledge that they are insured should the worst happen.

Group businesses

After some challenging years in the commercial sector the market is now more buoyant and a number of larger players have started to re-enter these markets. This positivity is something that is certainly reflected in the performance of our commercial arm, Principality Commercial, which has seen a strengthened balance sheet and improvements in both asset quality and profitability, with profits of £6.2m in 2015 (2014: £1.2m). The team has been working on some exciting projects this year, including student accommodation in Cardiff, a new pharmacy and office buildings to regenerate a derelict area at Baglan Energy Park in Port Talbot and a nursing home for people with dementia at a former hospital site in Pontcanna. Additionally, we have supported a number of housing association schemes, given support to developers that are small and medium-sized enterprises,

and work at Ely Mill has begun: this is a fantastic project which will see much-needed affordable homes brought to Cardiff to meet the increasing demand as the capital continues to grow. Principality Commercial continues to support our mutual ethos and goals of helping people into a home that is right for them and I am delighted with the performance of this business in 2015.

To ensure that we continue to deliver value for our Members, we regularly review our operating model and over the last 12 months we undertook a thorough strategic review of our secured loans subsidiary Nemo.

Nemo has had a very positive year with profits of £14.0m (2014: £13.9m) and a strong balance sheet reflected in reduced levels of impairment charges. Competition in the market has remained high. However, Nemo has defended its market share well and concentrated on providing excellent customer service and putting customer outcomes at the heart of its business.

However the second charge market continues to develop and expand away from its traditional base. We have carefully managed this business but, as a result of these developments, we do not want to increase our exposure to this market.

The Board has therefore taken the decision to cease new lending at Nemo and focus the Group's investment on the core retail and commercial businesses. Nemo will continue to be a meaningful contributor to our Group as a refocused business which provides excellent service to its customers.



Principality staff went to St Michael's R.C. Primary school in Newport to promote healthy eating as part of the Give and Gain day.

Supporting our communities

We take our responsibility to our local communities seriously and we aim to play a supportive role within society in Wales. This year we won Wales' Responsible Large Business 2015' at the Business in the Community Cymru awards for our work in communities around Wales and the Borders.

We have raised £90,000 for our Charity of the Year, Mind Cymru, and introduced a new corporate social responsibility policy to focus on what we think are the most important areas of citizenship for our business.

We have entered into 121 local branch sponsorships, supporting young football teams, lifesaving groups, cricket teams and much more. We have teamed up with Tonypany Community College and other schools around Wales, to support future generations and improve financial education amongst young people. This work builds upon our longstanding relationships with Glyn Derw and Llanishen High School which we continue to support in a number of ways.

Many competitors invest large sums of money in advertising on television or other mass media. We have instead built upon our partnership with the WRU to invest in a ten year deal to encourage, develop and grow Welsh rugby at all levels. As part of this deal the national stadium of Wales has been renamed Principality Stadium. This is a strategic decision that will provide mutual benefits for both parties. It will help us to enhance Member value, with a range of Member-exclusive special offers, discounts and competitions for this multi-purpose venue, whilst putting our brand onto a worldwide stage.

This allows us to achieve a better balance for our marketing budget, by supporting community rugby and other events and providing additional benefits for our Members and colleagues, whilst also giving our brand wider exposure. The incremental cost to the organisation, compared with our existing marketing budget, will be very small, as the sponsorship will be the lynchpin of much of our marketing and brand awareness activity over the next ten years as we refocus our marketing efforts.

Outlook

Growth in the UK economy has continued positively in 2015 albeit at slightly lower levels than originally expected, being fuelled by consumer spending and business investment. We have seen employment growth and modest wage inflation in the UK alongside rising house prices and increased consumer confidence and borrowing.

However, there are a number of economic headwinds as we enter 2016 including slowing growth in China, falling oil prices and volatile worldwide equity markets, together

with ongoing pressures on domestic public spending. These factors suggest that any rise in the official Bank of England base rate is not likely to occur until 2017 and when it does it is likely to be modest.

Whilst the potential for rising interest rates might seem like good news for savers, the connectivity between the Bank of England base rate and savings rates has been well and truly broken. The difference between the two has to be managed by lenders to ensure that they can remain competitive and keep their business secure. This difference has been increasingly narrowing throughout a sustained low interest rate period and it will take a number of years of increasing interest rates to restore the balance. Disappointingly for savers, savings rates are likely to lag behind base rate rises. In order to keep their businesses secure, lenders like us may not be able to pass on interest rate rises as this would damage the strength of our business and our ability to support savers and homeowners in the long term.

Homeowners also need to bear in mind the impact of any future interest rate rises on their mortgage or other longer-term loans. At Principality we continue to test a borrower's ability to pay their mortgage not only at the point of borrowing but also in a rising interest rate scenario. This prudent approach should help to ensure people are able to cope with increasing interest rates and remain in their home, which will always be one of our core principles.

Despite the economic challenges we expect the UK economy to grow further in 2016 and to see another rise in house prices in most areas of the UK in the next 12 months, although we expect the housing market to remain stable. We will remain alert to the economic factors but will continue to focus on growth in our business to ensure its long-term success. We will invest in our products, services, people and systems to ensure that we can retain and attract Members for many years to come and have a successful business of which our Members and colleagues can be proud.



Graeme H. Yorston
Group Chief Executive
 9 February 2016

STRATEGIC REPORT for the year ended 31 December 2015



A Principality Commercial development at St. David's Court, Laleston

Our strategy

Principality is Wales' largest Building Society and the sixth largest in the UK. The Group has over £7.5bn in assets and accounts for 4.8% of the Welsh residential mortgage market and 12.6% of the total Welsh retail savings balances. The Group also operates commercial lending and secured personal 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 Member base of over 500,000 who trust us with their savings and mortgages, and we employ over 1,000 colleagues.

Our principal strategy is to focus on growing our Members' Society, through increasing our retail mortgage lending and enhancing our overall proposition. In order to achieve this, we strive to provide our Members with exceptional service, and we are committed to becoming 'The most recommended financial services provider in Wales' and supporting people to prosper in their homes.

A key aspect of this strategy is the financial stability of the Society, and our growth strategy is underpinned by a clearly defined risk appetite. Financial stability is achieved through sustainable financial performance, which in turn relies on the following:

- Strong capital generation achieved through ongoing profitability
- Effective liquidity management to ensure the Society maintains a sufficient buffer of available funds
- A diverse and cost effective funding base
- Operational efficiency achieved through a culture of continuous improvement within the Society
- Fit for the future technology and processes
- The right culture and values amongst our people.

Being a mutual Building Society

Members consistently tell us 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 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. As we do not have any shareholder interests to satisfy, all our profits are put back into the 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. Further, it is important that we continue to invest in our business to ensure our future can be as successful as our past.

Our business model

The Group has three primary business units within its business model: retail financial services and commercial lending, both conducted through the Society, and secured personal lending, conducted through the subsidiary company Nemo Personal Finance Limited (“Nemo”).

Strategic review of Nemo



During the year the Group undertook a comprehensive review of the options for the future of Nemo. The secured lending market continues to develop and expand away from its traditional base, characterised by product diversification and increased loan size. Given the Group’s risk appetite, the Board considered that ongoing participation in the secured lending market was not in line with the Group’s strategic objectives.

The Board undertook an extensive process to identify other potential owners who would be able to take the business forward. Having undertaken this process, the Board were satisfied that there was no such transaction which represented value for Members. The Board has therefore taken the decision to cease new lending at Nemo and focus the Group’s investment on the core retail and commercial businesses.

The Group will continue to maintain and service its existing secured lending customers through a reshaped Nemo business, which will provide excellent service to its customers.

Retail financial services and commercial lending

A summary of the products offered through the retail financial services and commercial lending business units is set out below:

		LOANS	SAVINGS	OTHER	CHANNEL				
					BROKER	ONLINE	PHONE	FACE-TO-FACE	
PRINCIPALITY GROUP	 Principality <small>Principality Personal Finance</small>	RESIDENTIAL MORTGAGES			✓		✓	✓	
		BTL MORTGAGES			✓		✓	✓	
			FIXED RATE SAVINGS				✓	✓	✓
			VARIABLE RATE SAVINGS				✓	✓	✓
				FINANCIAL PLANNING					✓
				LIFE INSURANCE				✓	✓
			HOME INSURANCE			✓	✓	✓	
		 Principality <small>Commercial</small>	COMMERCIAL LOANS					✓	

Investment programme

The Group's robust financial performance has delivered a strong platform from which to invest for the future. In response to the fast changing financial services landscape, with well publicised innovation through mobile applications, devices and other internet linked technologies, the Group has embarked on an ambitious programme of investment to ensure it has the right foundations to achieve its growth aspirations and remain relevant and successful in an ever-changing marketplace.

We have a clear view of the business we are trying to build and this will see significant investment in our people, processes, brand and our technology capability.

Technology will be critical to meeting this challenge, in particular to be able to provide a seamless experience

across branch, internet, broker and our contact centre so that the Society is easy to do business with, which means simple processes with minimal effort and maximum convenience for our customers.

The programme has plans to deliver a secure, responsive website, which optimises the viewing and interaction experience across all devices (desktop PC, tablet and phone). The Society will be rolling out a programme of Skype™ in branch in order to facilitate virtual face-to-face appointments, helping to serve customers at their convenience.

Key Performance Indicators

The Group monitors a number of Key Performance Indicators (KPIs) to measure progress towards its strategic objectives. The table below details these KPIs:

	2015	2014
	£m	£m
Member Experience		
Net Promoter Score – Savings (Wales) ¹	3rd	1st
Customer Satisfaction ²	86.9%	86.8%
Financial Performance		
Group profit before tax from continuing operations ³	£49.0m	£53.5m
Retail mortgage balances	£5,244.9m	£4,783.9m
Group net interest margin	1.81%	1.87%
Management expense ratio (underlying cost basis) ⁴	1.07%	1.05%
Financial Stability		
Common Equity Tier 1 Ratio	20.97%	18.20%
Liquidity Ratio	13.9%	15.7%
Colleague Engagement	80%	84%

1 Source: GfK NOP Financial Research Survey (FRS), 12 months ended December 2015

2 Source: The Leadership Factor (TLF) Customer Satisfaction Survey, 12 months ended December 2015

3 Group profit before tax on continuing operations in 2014 excludes the gain on the disposal of the Peter Alan estate agency business

4 Further details contained under the heading 'Operating expenses' opposite

Member experience

The Society's Customer Satisfaction scores increased in the year to 86.9%, demonstrating the continuing high level of service provided to customers. However despite this, the Society's savings Net Promoter Score in Wales has fallen over the past year from 1st to 3rd. This is evidence of the improvement in service levels in the financial services industry as a whole, and demonstrates the importance of the investment programme to ensure the Society is fit for the future.

Financial performance

Income statement overview

Continuing operations:	2011*	2012*	2013	2014	2015
	£m	£m	£m	£m	£m
Net interest income	105.0	99.1	116.4	133.8	134.1
Other income	20.6	24.3	13.2	8.1	6.8
Fair value gains/(losses)	(0.1)	0.2	(1.2)	(1.5)	0.9
Operating expenses	(66.2)	(71.2)	(65.3)	(64.7)	(83.7)
Impairment provisions	(24.6)	(16.3)	(22.4)	(13.5)	(4.8)
Other provisions	(11.2)	(11.9)	(12.5)	(8.7)	(4.3)
Other gains	1.0	1.5	-	-	-
Profit before tax from continuing operations	24.5	25.7	28.2	53.5	49.0

* Not adjusted for the impact of the sale of the Peter Alan estate agency business in 2014.

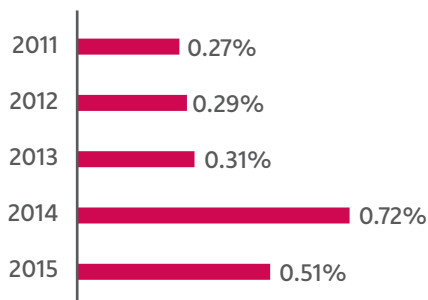
The Group recorded another year of strong financial performance, with pre-tax profit from continuing operations of £49.0m (2014: £53.5m). Included within the prior year profit is an exceptional credit of £10.1m in relation to the Group's defined benefit pension scheme, details of which are set out in the 2014 Annual Report and Accounts.

Underlying profit, which adjusts for one-off factors not reflective of current trading performance, increased to £57.8m (2014: £51.9m). Both measures demonstrate the continued robust financial performance of the Group which supports the long-term financial sustainability of the Society.

	2015	2014
	£m	£m
Statutory profit before tax from continuing operations	49.0	53.5
Pension inflation assumption change	-	(10.1)
Gain on the sale of Gilts	-	(0.2)
Nemo strategic review and restructuring costs	4.5	-
Provisions for other liabilities and charges	4.3	8.7
Underlying profit	57.8	51.9

The Group's return on assets, calculated as statutory profit after tax (including one-off items such as the pension gain and profit from discontinued operations in the prior year) divided by average total assets, was as follows:

Return on assets (%)



Net interest margin

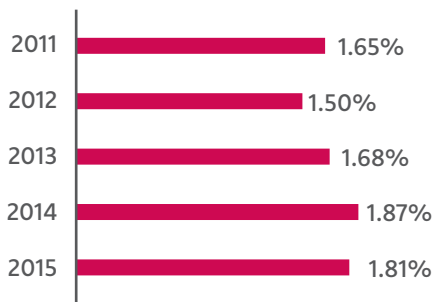
Group net interest margin (the ratio of net interest income to mean assets) remains strong at 1.81%, albeit lower than the previous year's ratio of 1.87%.

Residential mortgage rates continued to fall in the year to record lows for some products, and the markets for both commercial lending and second charge mortgage lending became more competitive during 2015. This meant that the new loans the Group has written during 2015 have been at lower rates, which has contributed to a decrease in interest receivable in the year.

Retail savings rates in the market continued to fall in 2015. Whilst the Society continued to offer better than industry average rates, this led to a reduction in the Group's retail funding costs. The Society aims to support savers in the current low interest rate environment, but it must do so in a secure and sustainable way, and balance the needs of savers against the long-term financial security of the Group.

The Group's lending continues to be primarily funded by Members' retail savings, with 85.9% of loans and advances to customers funded in this way. In order to ensure the Group can continue to offer competitive rates in challenging markets, the Group also utilises lower cost wholesale funding. This diverse funding mix allows the Society to compete effectively in lending markets, and ensures the funding position is robust.

Net interest margin (%)



Other income

Other income at £6.8m (2014: £8.1m) is lower than the prior year. The primary reasons for the decrease is a reduction in income generated from general insurance and financial planning products, reflecting the competitiveness and changing nature of the insurance market. The Group has recently entered into a new partnership with Legal & General with the aim of providing a broader range of competitive insurance products.

Fair value movements

Fair value movements represent the change in value of certain assets and liabilities to reflect underlying market rates. These movements are primarily timing differences, which will reverse as the asset or liability approaches maturity. During the year the Group recognised a gain of £0.9m in the income statement (2014: £1.5m loss) in relation to these movements in fair value.

Operating expenses

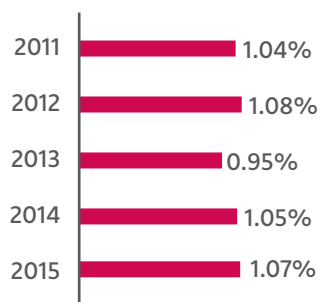
Operating expenses remain a key focus for the Group. The Group has incurred exceptional costs of £4.5m in the year in respect of the strategic review of Nemo described above. This related to costs of the process to market the business and identify potential buyers, together with the restructuring cost associated with the decision to cease origination of new business. Included within the prior year operating expenses is a one-off credit of £10.1m in relation to the Group's defined benefit pension scheme, details of which are set out in the 2014 Annual Report and Accounts.

Excluding these items, the underlying operating expenses comparison is set out in the table below:

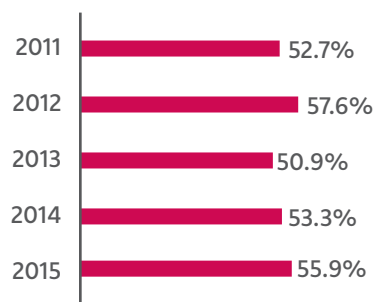
		2015	2014
		£m	£m
Retail financial services		62.2	60.3
Commercial lending		4.0	4.0
Secured personal lending		13.0	11.9
Consolidation adjustments		-	(1.4)
Underlying operating expenses		79.2	74.8
Pension inflation assumption change		-	(10.1)
Nemo strategic review and restructuring costs		4.5	-
Total operating expenses		83.7	64.7
Management expense ratio	Underlying cost basis	1.07%	1.05%
	Statutory cost basis	1.13%	0.90%
Cost/Income ratio	Underlying cost basis	55.9%	53.3%
	Statutory cost basis	59.0%	46.1%

On the basis of underlying cost, the Group's cost to income ratio for the year was 55.9% (2014: 53.3%), and the management expense ratio (cost as a proportion of mean assets) was 1.07% (2014: 1.05%). The increase in underlying cost was driven by expenditure on strategic programmes, including the Group's investment programme.

Management expense ratio (%)*



Cost/Income ratio (%)*



*Stated on an underlying cost basis

Impairment provisions for losses on loans and advances

The Group charge for impairment provisions of £4.8m (2014: £13.5m) was £8.7m lower than last year.

		2015	2014
		£m	£m
Retail mortgage lending		1.2	2.1
Commercial lending		5.0	9.2
Secured personal lending		(1.4)	2.2
Total		4.8	13.5

Improved economic conditions, continued low levels of arrears and increasing house prices have acted to reduce impairment charges against both first and second charge mortgage loans in the year. The low overall levels reflect the Group's prudent approach to lending and robust affordability, credit quality and underwriting standards. The Group is, however, mindful of the potential impact on borrowers of increased mortgage rates should the Bank of England's Monetary Policy Committee choose to raise interest rates.

For a number of years the Group has been reviewing at application stage customers' ability to repay their loans at higher interest rates, in order to mitigate against the

impact of an incremental increase in interest rates over the coming years.

Impairment charges against commercial loans have also decreased in the year, reflecting the stronger position of the commercial lending market together with the resolution during 2015 of a significant proportion of the remaining impaired or lower credit quality loans.

For the same reasons, the total balance sheet impairment provision has decreased from the previous year. The total impairment provisions held on the statement of financial position were as follows:

	2015	2014
	£m	£m
Retail mortgage lending	6.3	6.1
Commercial lending	24.7	31.1
Secured personal lending	18.2	25.5
Total	49.2	62.7

Provisions for other liabilities and charges

The Group made an additional provision of £1.0m (2014: £0.5m) during the year in relation to previous sales of Payment Protection Insurance. No further provisions (2014: £0.5m) have been made in respect of other customer claims. The Group notes that the FCA is expected to finalise rules and guidance in respect of the handling of Payment Protection Insurance complaints in relation to the 2014 Supreme Court decision in Plevin vs Paragon Personal Finance Ltd ('Plevin'), and will monitor the developments on these proposed rules and guidance.

The Group has recognised a Financial Services Compensation Scheme (FSCS) interest charge of £1.7m in respect of scheme year April 2015 to March 2016 and the third instalment of the capital repayment of £1.6m.

Further information on the level of the provisions and the uncertainties therein can be found in notes 2 and 30 to the financial statements.

Taxation

The statutory rate of corporation tax was reduced to 20.0% from 1 April 2015. The Group was subject to corporation tax at a rate of 21.0% for the period 1 January to 31 March 2015, and 20.0% for the period 1 April to 31 December 2015, resulting in an effective statutory rate of corporation tax of 20.3% for the full year in 2015.

The actual effective tax rate from continuing operations for the Group was 23.0% (2014: 21.9%) compared with the statutory rate of tax of 20.3% (2014: 21.5%). 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 12.

Balance sheet

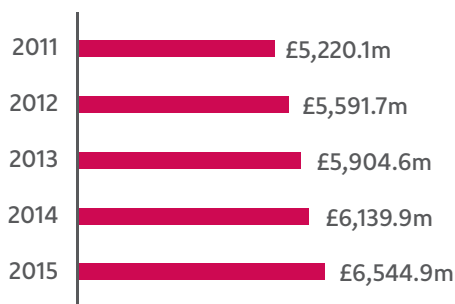
Total balance sheet assets increased by £319.4m to a total of £7,584.4m.

	2011	2012	2013	2014	2015
	£m	£m	£m	£m	£m
Liquid assets	1,114.7	1,074.3	1,042.1	1,037.4	962.0
Loans and advances to customers	5,220.1	5,591.7	5,904.6	6,139.9	6,544.9
Other assets	114.9	118.3	111.4	87.7	77.5
Total assets	6,449.7	6,784.3	7,058.1	7,265.0	7,584.4
Retail savings	5,013.8	5,467.0	5,562.6	5,613.0	5,621.8
Wholesale funding	808.6	710.5	902.8	1,001.7	1,287.5
Other liabilities	300.6	266.5	238.0	239.0	226.1
Total liabilities	6,123.0	6,444.0	6,703.4	6,853.7	7,135.4
Reserves	326.7	340.3	354.7	411.3	449.0
Total liabilities and equity	6,449.7	6,784.3	7,058.1	7,265.0	7,584.4

Loans and advances to customers

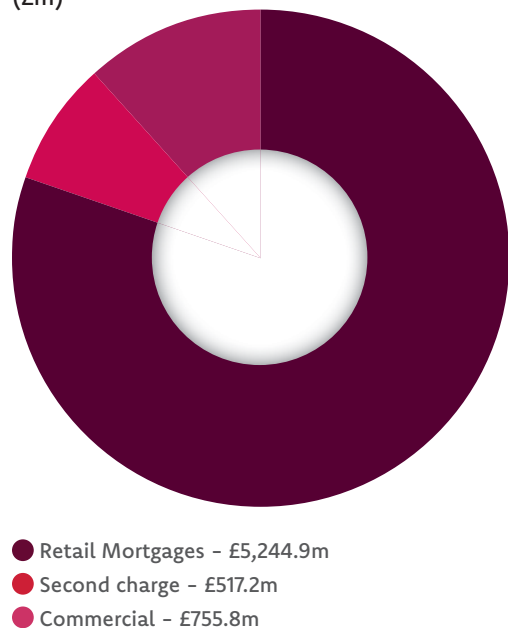
Loans and advances to customers increased by £405.0m in the year (2014: £235.3m) to £6,544.9m (2014: £6,139.9m), driven by net retail mortgage lending of £461.0m (2014: £278.0m), delivering against the Group's strategic objective of growing retail mortgages. The Group continues to focus on the quality of business written, concentrating on affordability and credit risk in underwriting loans and mortgages.

Loans and advances to customers (£m)



The Group's largest portfolio, at £5,244.9m, is its retail mortgage portfolio. This is prime lending against first charge residential property, and includes a high quality buy-to-let portfolio of £1,300.2m (2014: £1,140.4m). The Group continues to support the buy-to-let market, recognising the need for diversity in the housing market to provide different options to individuals and families. All buy-to-let lending is assessed against stringent interest cover and loan-to-value criteria. The Group also holds a portfolio of £517.2m of loans secured against residential property by a second charge, typically for home improvements or debt consolidation.

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



* Figures in the graph above exclude fair value adjustments.

The Group's first and second charge mortgage portfolios reflect the prudent nature of the Group's lending policies, with 70% (2014: 69%) of exposures having a loan to indexed valuation of less than 70% and 85% (2014: 84%) less than 80%.

The Group's exposures are well spread by geographical area within the UK, albeit with a larger share of lending in Wales, which by value makes up 27.5% of lending (2014: 28.5%) in the first and second charge residential lending portfolios.

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 of more than three months is 0.62% (2014: 0.75%) which compares favourably with the industry average of 1.17%*. The number of properties taken into possession during the year was 86 (2014: 109).

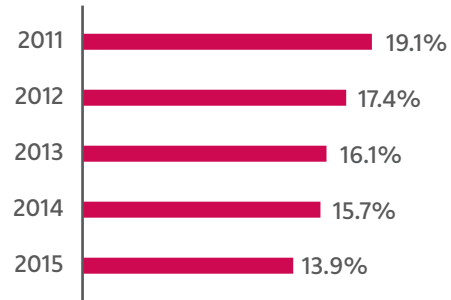
The percentage of secured personal loans currently in arrears of two months or more by number is 6.87% (2014: 8.44%), which by value is 7.14% (2014: 10.14%). The Group's commercial lending portfolio is made up of commercial property exposures representing 41.4% of balances, and lending against residential property and to registered social landlords of 58.6%. The Group provides loans secured on commercial property across England and Wales, with 49.9% of lending situated in Wales.

The commercial lending portfolio had no exposures greater than three months in arrears at the year-end (2014: two). 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 13.9% (2014: 15.7%) as a proportion of shares, deposits and loans (SDL). The Group has also secured access to alternative funding sources.

Liquidity ratio (%)



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 available liquidity which was buffer eligible was 67.2% (2014: 74.1%), and the total was well above the buffer liquidity requirement set by the PRA. Of the total liquid assets, 1.7% (2014: none) are less than A rated under Fitch credit ratings.

The Group holds no direct exposure outside the UK, other than £51.0m (2014: £79.1m) of AAA rated Supranational Bonds, issued by the European Investment Bank and the International Bank for Reconstruction and Development and backed by member governments of those organisations.

Two new regulatory measures of liquidity have been introduced as part of the recent CRD IV regulatory changes, 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 must 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 requires that all financial institutions in the UK hold a minimum of 80% from 1 October 2015. 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 still subject to change so there remains uncertainty over its final form. However, based on the Group's own internal monitoring, its NSFR is in excess of 100%, and the Group holds sufficient stable funding to meet the new requirement.

*CML arrears and possession data at 30 September 2015.

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

	2015	2014
	£m	£m
Cash and balances with the Bank of England	357.6	432.6
Securities issued by the UK Government and Multilateral Development Banks:		
On balance sheet	400.9	379.6
Off balance sheet	77.0	131.3
Total Buffer Eligible Assets	835.5	943.5
Loans and advances to credit institutions and other debt securities	203.5	225.2
Contingent liquidity facilities ¹	-	38.2
Total	1,039.0	1,206.9

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 £912.4m (2014: £525.7m) which have been approved for use in accessing Bank of England liquidity facilities.

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 £5,621.8m (2014: £5,613.0m) represent 85.9% (2014: 91.4%) of all mortgage and loan balances. Retail savings balances have increased by £8.8m in the year (2014: £50.4m), reflecting the continued focus on offering attractive products to Members despite the challenging interest rate environment. Members' savings are, and will remain, the most important part of the Group's funding base; however, given the highly competitive nature of the mortgage market and the lower relative cost of wholesale funding sources, it is important that the Group maintains an appropriate balance between retail and wholesale funding.

The Group remains a member of the Funding for Lending Scheme (FLS), with £207.0m (2014: £207.0m) of Treasury bills outstanding at the year end. Funding is obtained by using these Treasury bills as collateral in a repurchase transaction for cash. The Group does not intend to draw any further funding from the FLS scheme. The Group also has two residential mortgage backed security (RMBS) issuances, with the total value of RMBS funding of £451.9m at the end of the year (2014: £562.0m).

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 Bank of England funding schemes. At the end of the year, 21.1% (2014: 19.0%) of the Group's assets were encumbered, representing £1,457.7m (2014: £1,247.5m) of residential mortgage assets and £143.4m (2014: £133.9m) of other assets.

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, or PIBS) and subordinated debt, adjusted in line with regulatory rules.

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 amortise 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

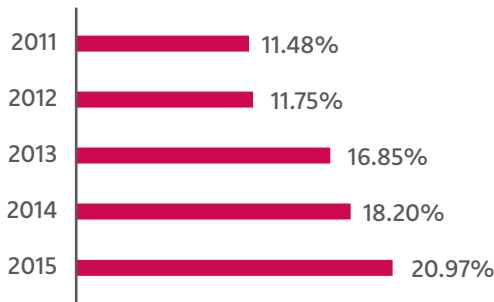
Group. The risk weighting for each asset is calculated either through the use of internal models or through standardised calculations dependent on regulatory permissions for each portfolio of assets.

The Group's CET1 ratio at 20.97% (2014: 18.20%) 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.

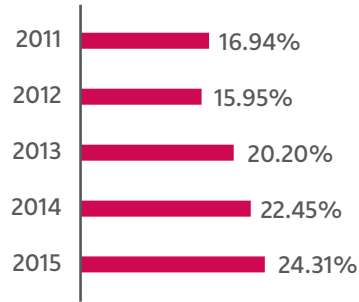
Another measure of capital strength is the Solvency ratio, calculated as the ratio of total capital to risk weighted assets. The Solvency ratio has increased to 24.31% (2014: 22.45%).

The Group received approval to adopt the IRB approach in 2013. Currently the IRB approach is applied to Retail and Commercial assets, and second charge mortgage assets continue to use the standardised approach. The adoption of the IRB approach for the second charge mortgage assets is expected to lead to higher risk weights for that portfolio than on the standardised basis with a consequent impact on both CET1 and Solvency ratios. However the Group would still comfortably meet all regulatory requirements for capital adequacy.

Common Equity Tier 1 capital ratio (%)



Solvency ratio (%)



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-balance sheet commitments. At the end of the year the Group's leverage ratio was 5.47% (2014: 5.02%), which is significantly above the minimum as proposed by the Bank of England Financial Policy Committee of 3%.

Member, Colleague and Community

Member, Colleague and Community are the subject of a separate report on pages 18 to 26.

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 27 to 40.

Stephen Hughes
Group Finance Director
 9 February 2016

MEMBER, COLLEAGUE AND COMMUNITY

for the year ended 31 December 2015



Principality staff with confUSION Youth Disability Dance group

Member

Throughout this Report you will have seen that since 1860 our core principles have been to provide a secure home for people's savings and to help people buy homes and these continue to underpin our business activities. During the last 155 years we have become the sixth largest Building Society in the UK, grown to a Member base of over 500,000 and we now employ over 1,000 colleagues.

By opening up a savings account of £100 or more (and providing you are 18 years old or over) or taking out a mortgage with us, you become a Member of the Society. As a Member, this entitles you to certain rights and benefits. You will be able to have your voice heard by the people that run the business.

Member benefits

As an organisation run for the benefit of our Members we want to give as much back to you as we can, whilst keeping the business secure for the future. We do this by

working to give you competitive rates on our products, offering a personalised service and giving you extra benefits wherever we can.

This year we have had 447 Best Buy Table mentions for our savings and mortgage products, helping to keep our rates at the top of the Welsh high street wherever we can.

For many years we have attended the Royal Welsh Show, National Eisteddfod and other events to give you a chance to meet our colleagues and show our support for the cultural events that mean a lot to you. Whilst there, we always offer a cup of coffee, tea and a Welsh cake or two, to make you feel at home.

Our Community section on pages 23 to 26 highlights the work that we do in our communities to support the organisations and activities that need support where our Members live and work. Many of these are put forward by our Members because they are close to their hearts.

This year we also embarked on a ten year partnership with the Welsh Rugby Union. This historic partnership will not only support Welsh rugby at all levels but will also deliver unrivalled benefits for our Members. By signing up to our online hub, www.principality.co.uk/getmore or speaking to staff in our branches, Members could access:

- Priority ticket access to selected events at Principality Stadium
- The chance of ‘money can’t buy’ behind the scenes Stadium tours on match day
- 15% discount off merchandise online at the WRU store
- The chance to win complimentary match tickets for each 6 Nations home game
- Principality Stadium tour tickets

Our Members help to shape and strengthen our strategy for the future. By using your feedback we are able to identify areas of improvement in order to grow our business and offer an unrivalled personalised service. We know from the feedback that we have gathered over recent years that to offer real value we need to continue to modernise our Member offering and we are committed to updating what we offer without losing the friendly and personal feel that our Members tell us is so important.

Providing a leading multi-channel service for Members

Over the last few years we have been working hard to provide a seamless cross-channel service offering across our website, branches, agencies and on the telephone. Our website continues to be our “largest branch” being used by over 500,000 Members and customers. We are continuously making improvements to our technology and we will be launching a new responsive website that ensures that Members have an optimal viewing and interaction experience when they contact us online. We will also be rolling out online appointments via our Skype™ service so that people are able to speak to us from the comfort of their home.

Technology is becoming increasingly important in the marketplace and is now a common way for consumers to interact with businesses. We know, however, that face-to-face contact is still vital for many and we continue to understand the value to our Members of our high street presence through our 53 branches and 18 agencies in Wales and the Borders.

Throughout 2016 we will continue to make improvements in our cross-channel service to ensure that our Members are able to interact with us in the way that they want, when they want.



The official unveiling of Principality Stadium

Working better for our Members

Providing exceptional service for our Members is of paramount importance to us and we want to offer a stand-out experience and smart solutions to our customers to make a real difference to them.

In doing these things we aim to be the most recommended financial services provider in Wales. To understand how well we are performing against this objective we use the industry-wide Net Promoter Score to measure loyalty based on a single question: 'How likely are you to recommend Principality's products or services?'

In order to improve our service further, last year we introduced a new scheme for gathering Member feedback following appointments with us; within 48 hours of attending an appointment, email requests are sent to Members to ask them about their interaction. This real-time feedback helps our colleagues to get an immediate insight into how the Member felt after attending the appointment, giving them the chance to repeat what they liked and change what they didn't at their very next and all future appointments.

Since we launched the scheme it has proven to be invaluable in allowing us to improve the service we provide to Members. Its success has meant that during 2015 we extended the scheme to cover appointments held at our Agencies, enabling us to obtain feedback from Members visiting any of our 71 locations. This feedback continually helps us identify ways in which we can make changes to reflect Member needs. For example:

- Members felt our home insurance product could be improved and as a result, in 2015 we launched a brand new home insurance product which is competitive in the marketplace, has an improved claims process and makes the entire process easier for our customers.
- Feedback told us that there were occasions when Members were unable to converse with a Welsh speaker in our contact centre. To put this right, this year we launched a Welsh-language telephone service, to increase our ability to service customers that choose to interact with us through the Welsh language.
- Numerous customer responses mentioned that there was too much background noise when talking to advisors in our contact centre. As a result we reviewed the seating arrangements and made changes to ensure that future calls would not be impacted by excessive noise.
- Customer comments have helped us to make several in-branch changes to improve the experience for our Members, ranging from installation of new printers to replacement of chairs.

- Members told us we should continue to invest in Welsh culture and sport. We launched the ground-breaking ten year partnership with the Welsh Rugby Union to grow rugby at all levels and support the national stadium of Wales.

Colleagues have welcomed the chance to use their own feedback to share experiences with other colleagues, celebrate successes and utilise examples of stand-out service that can be replicated. Doing so means that we are continually making small improvements to ensure we meet Members' needs and display our expertise through our interactions with all customers.

Customer satisfaction

Ensuring our customers are satisfied is of paramount importance to us. We continually monitor how satisfied our customers are with our offering in order to improve our service, products and proposition. We track this by running a monthly customer satisfaction survey, contacting a random sample of at least 160 customers. This survey provides us with an insight into satisfaction on a wider scale and we are very proud that for 2015 our Members rated customer satisfaction at 86.9%.

Talking directly to Members

Our Annual General Meeting (AGM) gives Members the chance to meet Principality staff and Directors, hear about our achievements over the past year and discover how we are planning to develop our Society. It also provides Members with the opportunity of holding the Board to account by asking questions and getting to meet them face-to-face.

We invite all our eligible Members to register their vote at every year's AGM. Most importantly, you can also vote on the election of Directors and resolutions which are fundamental to our continued success.

Our regular Talkback events provide the opportunity for direct engagement with our Members. Throughout the year our senior leadership team holds regular Talkback events, at various locations across Wales. These sessions give people the chance to ask our senior leadership team questions about the way we run our business and also give Members the opportunity to hear about our performance as a business and the different ways in which we support our local communities. The Talkback sessions are not only a great opportunity for us to find out what our Members like about us, but they also offer the chance for us to find out what you would like us to change. In 2015, we have held events in Blackwood, Swansea, Caernarfon and Cardiff.

Member Forum

Our Member Forum is made up of six Members, who act as a collective voice for all our Members. They attend meetings on a quarterly basis to share their thoughts with our team and tell us what they think of our products, Society initiatives and help us make the right decisions for all Members. Each meeting is hosted by a Non-Executive Director and attended by other Directors and senior managers from across the business. Forum Members are asked to commit to a minimum of three years' membership and our current Members come from various locations across Wales. During 2015 we have invested time in revamping the forum to ensure that it continues to evolve and offer the best possible value for all attendees. In 2015, we have tested a number of new product and marketing opportunities with the Forum, to gain their valuable insight and challenge our executive team on their thinking. In addition, we have recruited three new Forum Members and launched a dedicated page on our website to explain what the Forum is for and who our current customer Members are. We always welcome contact from any Society Members interested in becoming part of the Forum and taking advantage of the opportunity to voice their opinions in a small group setting.

Research Panel

To gather alternative forms of feedback we regularly utilise our Customer Research Panel which consists of 7,000 of our Member and customers. Through the use of online surveys our Panel helps us to understand the customer view on different elements of our business and Panel feedback is particularly helpful to us in determining Member views when we do something new. For example, when we produce new product information leaflets we ask Panel Members to read them and answer product related questions to identify if we have presented the information in a clear way. We then use their feedback to determine if there is anything else we can do to incorporate their views and make the literature easier to understand.

Our Research Panel also helps us assess which new products and services our Members would like us to provide in the future, enabling us to map out the directions in which Members would like us to take the business and keep their views at the heart of our decision-making processes.

All the insight tools that we use provide us with an in-depth understanding of our Members to ensure their interests are always at the heart of every decision



One of our Members asks the Board a question at 2015's AGM

we make and we achieve the best outcome for them. The insight that we gather and analyse has helped us to shape our growth strategy and we will continue to gather and utilise feedback as we work towards realising our vision. This is an exciting time for Principality, as we invest in changes that will make a real difference for both our current and future Members, and ensure that we offer real Member value through everything that we do.

Colleague

To support our growth strategy we must have the right people in our business. To achieve this we have a clear people strategy in place to deliver our aspiration of being the employer of choice for Wales – attracting, retaining, developing and inspiring colleagues who are passionate about delivering our growth strategy and plans through excellent customer service. 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. The key elements of this people strategy are:

Creating the right culture

Our people strategy seeks to promote a high performing organisation through colleagues living our values throughout their everyday interactions with one another. 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 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. This year we carried out a culture survey across the Group to get a better understanding of what it is really like to work in our business. To build on the good aspects of our culture, we agreed to refresh our values. With input from colleagues at all levels, we now have five values:

- Being courageous;
- Doing the right thing;
- Making it straightforward;
- Delivering with passion; and
- Taking ownership.

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

Promoting diversity

Our people strategy 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.

A breakdown of colleagues in the Society by gender is presented below:

	Female (%)	Male (%)
Directors (including Non-Executive Directors)	22.0	78.0
Senior managers	27.0	73.0
Colleagues	64.0	36.0

Staff turnover, which measures how many of our colleagues are leaving of their own choice, is 13.0%. 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 colleagues have grown with us and the average length of service is approximately six years.

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 people strategy seeks to ensure all employees feel connected to the business and understand the strategic direction and purpose in their everyday roles. Our annual colleague 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 86% (2014: 87%), we get a clear insight into how colleagues feel about working with us, especially through their individual comments.

Our recent survey showed that 85% of our colleagues are satisfied with the Group as their employer and 90% 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
- 91% 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 82% in the Society compared to the financial services industry average of 72%.

We appreciate 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. During 2015 we conducted a review of our internal communication to see how effective it was and if it was meeting the needs of our colleagues. As a result we have refreshed our approach to internal communications, introducing new tools and approaches to share news and gain feedback. Besides the annual colleague conference we have held more local team road shows; in addition to “meet the executive” sessions the CEO completes a monthly blog; we also have monthly newsletters and business briefings and we are using videos and leadership cascades to improve the communication with our colleagues further. Our recent colleague survey showed much improved scores in the area of communication as a consequence of this increased focus.

Rewarding colleagues fairly

Our people strategy seeks to put in place reward, recognition and benefit frameworks that allow the business to attract, retain great people and fairly reward them for high performance and great teamwork in support of our business strategy. As you will see in the separate Remuneration Report we have made huge progress in our journey to simplify and streamline our reward schemes and have now launched a new Rewarding Excellence Award which rewards all colleagues for contributing to the successful growth of the Society and improving service to customers, thus aligning the efforts of everyone with Members’ interests.

Investing in talent to realise potential

Our people strategy seeks to build strong leadership and management capability whilst ensuring operational competence across the organisation to enable us to manage both day-to-day operations and business change.

Learning and development helps our leaders and colleagues to develop their ability to provide the best customer service for our Members. Both the Society and colleagues benefit from maximising 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.

The Society also partnered with Acorn Recruitment to create a bespoke apprenticeship programme. Following a great deal of hard work over 18 months, six of our managers achieved the Higher Apprenticeship in Banking – Level 4; the first in the UK.

We continue to work towards achievement of our long-term people strategy and delivered a range of new management development programmes which focused on benchmarking and improving the leadership capabilities of our managers using a combination of assessment and observation measures.

Community

Since we were formed in 1860 we have been passionate about the communities in which we live and work. We recognise the importance of being a responsible business for our Members, colleagues and wider society and try to support them in as many ways as possible.

We have a wide-reaching corporate sponsorship programme that includes WRU sponsorship, cultural events like the National Eisteddfod and the Royal Welsh Show, Only Boys Aloud, and Wales Millennium Centre, as well as colleague volunteering, local sponsorships and support for charity.

Getting to the heart of our communities

With branches and agencies across Wales and the Borders, we are committed to making a positive difference to local communities and further building on our community-focused reputation as a responsible business.

Our community support programme begins in high streets across Wales and the Borders, with our branches and agencies continuing to play an important role in their local communities.

This year our Prestatyn branch was nominated by people in its local community for the High Street Hero awards from Welsh Government. The branch finished as semi-finalists in the professional and financial services category after supporting flood victims, helping a local anti-bullying initiative and supporting other events in the town.



Maindy Corries under 15's, sponsored by Whitchurch branch, in their new Principality kit

In the last 12 months we expanded our community outreach programme even further, giving 1,241 volunteer hours and investing £30,000 in 121 local community sponsorships throughout Wales and the Borders.

We supported the Business in the Community (BITC) Give & Gain Day 2015 with 40 staff helping out across Wales, including conservation work in the Brecon Beacons, improving a school tuck shop and a nature reserve, facilitating a tag rugby festival, along with supporting a school's healthy eating initiative.

We have long supported fitness initiatives as we know that they can provide huge benefits not just in health and wellbeing terms but also by improving teamwork and other life skills. This year we launched a Kit of the Month competition where a different sports organisation or group could win kit up to the value of £500 each month. Through this we have helped a surf lifesaving group, a cricket team, a hockey team and a multi-use sports kit for a primary school. Five colleagues have completed the FAW Football Leaders coaching qualification with Swansea City Community Foundation and we created our own staff touch rugby team, known as the Principality Puffins, which won the WRU Cardiff Summer League (Men's Division 5).

In recognition of all the work our colleagues do to support the communities around us every day we were

awarded Responsible Large Business of the Year 2015 at the Business in the Community Awards 2015. This is a fantastic achievement for everyone in our business and our Members who continue to support these initiatives.

Supporting Welsh heritage and culture

Our support of Welsh heritage extends to our continued attendance at events like the Royal Welsh Show and the National Eisteddfod. Not only do we give financial support to these important Welsh events, but we also use them as an opportunity to meet our customers face-to-face outside our branches.

Principality has been a key supporter of Only Boys Aloud since 2010 when we joined Only Men Aloud founder Tim Rhys-Evans to search for the next generation of male choral singers in the Valleys, an area that often attracts negative press for having a lack of opportunities for young people. This year as the group celebrates its fifth birthday it has expanded to North Wales to help even more young men reach their potential. In recognition of our support we were awarded the Arts, Business & Brand Identity Award, sponsored by Rightacres Property, at the Arts and Business Cymru Awards 2015.

Of course, our community and culture support would not be complete without rugby – Wales' national sport. In 2015 we celebrated ten years of the Principality Premiership and we are now in our 11th season of

support. Working with the Welsh Rugby Union, this support continues to invest in grass roots sport and develop the future stars of Welsh rugby. Over the years our partnership has gone from strength to strength and earlier this year we announced a new ten year partnership with the WRU to nurture and develop Welsh rugby talent even further, and will see our name on the national stadium of Wales.

Helping future generations

Part of our work in communities includes supporting future generations. This year we have launched more educational workshops and support schemes to support young people and their needs.

Our close working relationships with Glyn Derw and Llanishen High Schools in Cardiff have continued for a third year with our colleagues providing reading, mentoring and employability workshops as well as other support to the pupils and teachers. We have also joined the Business Class programme and have already started new programmes at Tonypandy Community College.

We have provided further support to students at Neath Port Talbot College with attendance at career fairs and financial crime talks as well as sponsorship of their Centreprise Interns, who are young people who are thinking of starting their own business. The Centreprise

scheme gives the students help and advice in their journey.

Our Shrewsbury branch engaged over 480 pupils at a BITC Your Future, Your Choice event, carrying out a customer service workshop. We have run Dragons' Den events with our partners Legal & General and have attended a range of careers fairs to give employability advice to people who need it. We also supported the School of Hard Knocks Careers Fair, a charity initiative that uses the well-established benefits of sport to tackle the issues surrounding education, unemployment, crime and health. The group works with disadvantaged children and adults to help them take responsibility and make positive changes in their lives.

Additionally, this year we have had our first intake of Network 75 students that sees us partner with the University of South Wales to give undergraduates a five year placement in Principality as a combined work and study route to a degree. We have also continued to be part of Wales' pioneering Financial Services Graduate scheme working alongside Atradius, Admiral, GMAC UK PLC and Composite Legal Expenses offering graduates the chance to experience a professional career in financial services first hand. The scheme gives young people two year paid placements across the businesses in order to support the growing financial services sector in Wales.



Harriet Lewis, Tonypandy Branch Manager, launches the Business Class programme at Tonypandy Community College



Llandeilo branch staff on a sponsored hike to Carreg Cennen Castle

Supporting people experiencing a mental health problem with Mind Cymru

We have been helping charities for a number of years through our Charity of the Year relationships, each year striving to raise as much money as possible to support good causes. Every year our colleagues nominate, vote and raise money for a chosen Welsh charity that is close to their hearts. We rely on their goodwill, enthusiasm and inventiveness to come up with new ways of fundraising and they never disappoint.

This year our colleagues chose mental health charity Mind Cymru. Through bake sales, half marathons, charity dinners and much more, our colleagues have raised thousands of pounds for this worthy cause. The charity provides advice and support to anyone experiencing a mental health problem. It campaigns to improve services, raise awareness and ensure that the one in four of us who experience mental health problems each year get both support and respect. Colleagues on two occasions also took over Mind charity shops in Newport, Monmouth and Llandudno to work as volunteers.

Through all of their activities in 2015 colleagues raised a record £90,000 for Mind Cymru.

On top of this, ten of our staff were also trained as mental health first aiders. This will enable them to spot the early signs of a mental health problem, feel confident in helping someone experiencing a problem and provide help on a first aid basis to anyone who needs it.

Encouraging the use of the Welsh language

Our Welsh heritage is central to the Society and we recognise the importance of the Welsh language and its impact on our Members, customers, colleagues and wider society. We want to see the Welsh language thrive and encourage those who speak Welsh alongside English to use it in their day-to-day dealings with us.

Our aim is to ensure that our customers and Members get the same high standard of service with Principality, whether they deal with us in the Welsh or English language. This year we have launched a number of measures in support of the Welsh language, including a new Welsh Language Policy which can be found on our website.

We have also launched Welsh lessons in our branches for Members and colleagues, and new Welsh language literature in addition to our new Welsh language contact centre. The contact centre is based at our branch in Bangor and will be open from 9am until 5pm Monday to Friday.

Taking further steps forward

We have recently launched a new Corporate Social Responsibility Policy which outlines the way we operate responsibly towards our Members, the way we engage staff, our support given to communities, and how we intend to reduce the impact our operations have on the natural environment. This Policy has three main areas of focus: getting and staying in a home, health and wellbeing, and financial education. These themes will help us to frame our support to communities for the next few years and ensure we continue to support more people and communities in Wales and the Borders.

RISK MANAGEMENT REPORT for the year ended 31 December 2015

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 principal risks that arise from its activities and believes that its culture and risk management philosophy reflects a strong awareness of the current and emerging risks which could affect delivery of the Group's strategy. The Group addresses these risks by:

- Operating a single integrated business model underpinned by strong risk governance;
- Adopting a risk management framework which covers all risks and is supported by a clearly defined three lines of defence model;
- Managing risks within risk appetite as set by the Board; and
- Operating a business model where the Group's capital and liquidity would enable it to survive severe but plausible market and specific stresses.

The three lines of defence

The Group operates a 'three lines of defence' model ensuring clear independence of responsibilities for risk control, oversight and governance. This is summarised below:

FIRST LINE OF DEFENCE

Day-to-day risk management

Every Group employee is responsible for managing the risks which fall within their day-to-day activities. The first line of defence ensures all key risks within their operations are identified, mitigated and monitored by appropriate controls within an overall control environment.

SECOND LINE OF DEFENCE

Risk oversight and compliance

Independent functions within Group Risk and Compliance are responsible for providing independent oversight and challenge of activities conducted in the first line.

THIRD LINE OF DEFENCE

Audit

Group Internal Audit provides independent assurance over both the first and second lines of defence.

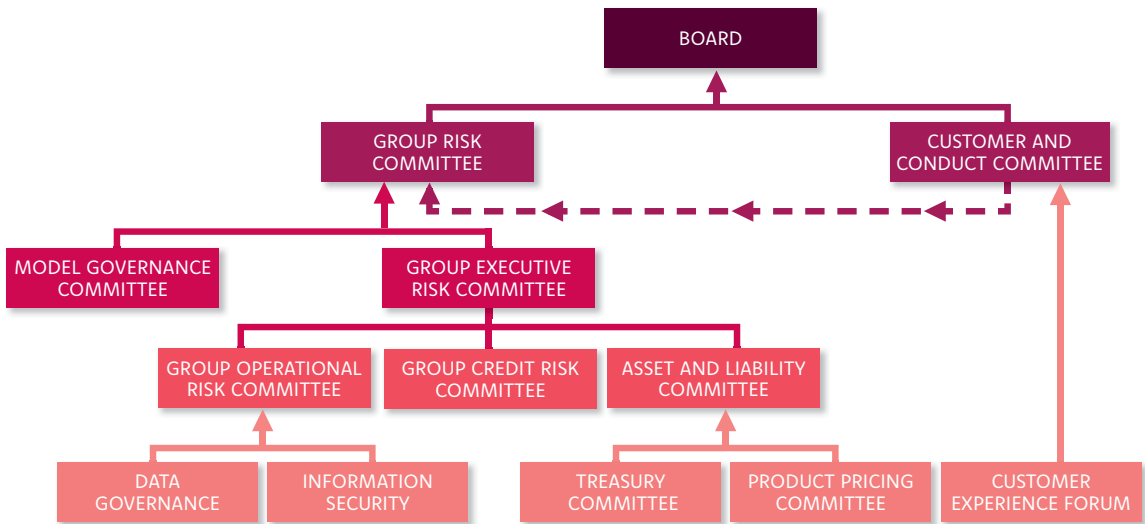
Risk management and governance

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. 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 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 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.



During the year, a Group Executive Risk Committee was established to exercise responsibility for controlling risks across the business and to monitor and review risk exposures. This is chaired by the Chief Executive.

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 Compliance and 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.

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.

Risk appetite

The Board sets a high-level risk appetite to enable the Group to:

- Identify and define the types and levels of risks it is willing to accept both qualitatively and quantitatively in pursuit of strategic goals

- Establish a framework for business decision making.

The Board risk appetite statements are linked to the Group's strategy and are supported by a broad suite of Board risk metrics, limits and triggers, designed to cover the Group's exposure to key prudential and conduct related risks. Reporting, limits and controls are set in a hierarchy that links the Board's tolerance for risk to its strategic goals, medium-term plans and 'business as usual' activities.

Risk culture

The Group operates a simple business model and senior management places significant emphasis on ensuring a high level of engagement is maintained between individual business functions and staff at all levels of the organisation with regard to the awareness and effective management of risk. The 'three lines of defence' model is key in ensuring that risk management is embedded across the Group, encouraging staff to take ownership for the identification and management of risk falling within their respective areas of operation. A key element of the Group's risk culture is a genuine emphasis on putting Members' needs first and this is reflected in the absence of sales-related incentives for any staff.

Stress testing and planning

The Group engages in thorough stress testing, scenario analysis and contingency planning programmes, allowing it to understand the impact of remote but potentially severe risks and to ensure that it remains resilient. This includes a range of Group-wide, multi-risk category stress tests, reverse stress tests and operational risk scenario analyses. Stress testing is an integral part of the annual planning process, the adequacy assessment processes for liquidity and capital, and the annual review of the Group's risk appetite. Outputs from stress testing are used to inform capital and liquidity planning, articulate potential

management actions within contingency plans, and further improve the management of the Group's risk profile.

The Internal Capital Adequacy Assessment Process (ICAAP) is the Group's evaluation of its capital position and requirements, assessed under the Capital Requirements Regulation and Capital Requirements Directive (CRD IV) framework. The ICAAP provides details of the current approaches used to manage risk across the Group. As part of that assessment, the ICAAP assesses capital requirements both against the Group's current position and during severe but plausible stresses. In addition, other more severe stresses are considered in support of the overall capital assessment.

The Individual Liquidity Adequacy Assessment (ILAA) is the Group's evaluation of its liquidity position and requirements, assessed against regulatory requirements and risk tolerance. An integral component of the approach to liquidity risk management is stress testing, some of which is prescriptive, using very detailed rules and guidance issued within prudential regulations. In addition to the regulatory prescribed stress testing, the Group undertakes its own stress tests and sets limits on these which tend to extend beyond minimum regulatory requirements.

Reverse stress testing (RST) is a key component of the Group's existing stress testing framework considering extreme events that could result in failure of the Group. As such it complements the existing ICAAP and ILAA processes, helping to improve risk identification and risk management more generally. A qualitative approach is used to explore potential scenarios which, if crystallised, could have the capacity to result in failure of the Group. This is supplemented with a quantitative assessment of the risks which explores the level of capital or liquidity utilised in these scenarios. A key outcome from the process is to consider whether any of the scenarios considered are sufficiently plausible to necessitate a change to the Group's risk strategy or underlying controls.

Recovery and resolution plans

The UK and European regulatory authorities require all banks and building societies to formulate plans to minimise or eliminate the risk of failure. The recovery plan outlines the steps the Group can take to prevent failure whilst the resolution plan provides the data required by the Bank of England to establish an orderly resolution of the Group's affairs, in the event that recovery cannot be achieved. The process of preparation for such extreme events enables the Board to plan actions it would take to recover from adverse conditions which would otherwise lead to failure. The recovery plan represents a 'menu of options' for the Group to deal with firm-specific or market-wide stresses and which can be incorporated into a credible and executable plan.

Assessment of current threats

The Group's exposure to current and emerging risks is closely tracked through the formal risk governance structure. The Group continues to keep these risks under close observation through risk reporting and measuring performance against key risk indicators. The Group conducts regular horizon scanning activity to identify any new or emerging risks which could impact delivery of the Board's strategy, or threaten the long-term viability of the business. The Group considers its exposure to principal current and emerging risks by reference to these themes: macroeconomic and market uncertainty, business resilience, innovation to support the digital proposition, and conduct challenges.

Macroeconomic and market uncertainty

The Group's financial position continues to strengthen, through increased profitability and continued deleveraging of the highest risk lending assets. However, economic and political uncertainty in both the UK and the Eurozone present three main threats that could affect the Group's exposure to financial and operational risks:

- The slowdown in the pace of growth in the Chinese economy continues to dominate financial headlines and this, coupled with ongoing political uncertainty in the Eurozone, could adversely affect the stability of the UK economy and the operating environment of the Group. A loss of confidence may potentially lead to an increase in funding costs
- A reversal in the UK economy accompanied by deterioration in the housing market could increase credit losses. Government policies particularly in relation to Buy-to-let mortgage lending, the low interest rate environment, and the relative attractiveness of the UK to overseas buyers have stimulated the housing market. There is a risk that these conditions may reverse, increasing credit losses in the Group's mortgage portfolios and depressing the wider economy
- Rising competition could compress core margins in the industry. The margin earned on the Group's core products may be reduced through further intensification of an already competitive market. Improvement in market conditions could lead to a loosening of industry credit policies or an increase in funding costs.

Innovation and business resilience

The pace of technological development is creating a period of significant change in the financial services sector. The Group must explore the possibility of adopting new and existing technology to deliver a service that Members and customers expect and value. In line with the wider financial services market, the following key areas pose risks to achieving its goals:

- In an increasingly digitalised world, customer expectations are rising with a significantly lower tolerance and

acceptance of service disruption. The Group must ensure it manages its service provision to maintain high levels of customer satisfaction. Furthermore, in the event that the Group decides to invest in technology to support the delivery of new products or services, then appropriate steps will need to be taken to ensure that the transition from existing to new systems is carefully managed. In a fast-paced environment there is the potential for new technologies to become outdated before the end of their expected lives

- The scale and pace of required change may outstrip the Group's capacity to achieve its transformation programme. This could create delivery challenges and may lead to disruption of the Group's operating environment and distribution strategy or require process enhancements on legacy systems. The Group continues to deploy experienced change management and IT resource to ensure that these risks are managed and mitigated
- The ever-increasing sophistication of cyber-criminal activity raises the likelihood and severity of cyber-attacks and money laundering. Security controls need to keep pace to prevent, detect and respond to any threats or attacks. In recognition of the cyber risk facing both the Group and the financial sector in general, the Group continues to focus its efforts on investing in appropriate technology and processes
- The pace of transformation may require enhancements to existing processes and legacy systems with potential impacts on service experience.

Regulatory conduct risks

The Group's business model and strong member focus leaves it well placed to meet current and emerging regulatory conduct requirements. However, the following matters pose potential risks to the achievement of the Group's goals:

- Unknown legacy conduct issues may emerge. Regulation relating to the fair treatment of Members and customers continues to be a focus for the industry. It is possible that in consideration of how past business was conducted, the Group may be judged as not having complied fully with regulations or be regarded as not having delivered fair or reasonable outcomes in the treatment of Members and customers. In addition, unforeseen conduct issues may arise in existing products
- The regulatory landscape is changing and may lead to increased risks. As a consumer-focused business operating in highly regulated markets the Group is subject to complaints and threatened or actual legal proceedings in the ordinary course of business. In addition, at a sector level, the incidence of regulatory reviews, challenges and investigations is increasing. Regulatory expectations in respect of conduct standards increase the risk of future sanctions, fines or customer redress

- A firm's ability to identify vulnerable customers and those in financial difficulty continues to have a high degree of regulatory focus, particularly given the predictions around likely Bank base rate increases. The Group is mindful of the need to exercise an appropriate degree of forbearance in relevant circumstances.

Principal risks

The key risks to which the Group is exposed are outlined below:

CREDIT RISK

Credit risk is the risk that borrowers or counterparties do not meet their financial obligations to the Group as they fall due.

MARKET RISK

Market risk is the risk that the value of income derived from the Group's assets and liabilities may change adversely as a result of changes in interest rates.

LIQUIDITY AND FUNDING RISK

Liquidity risk is the risk that the Group has insufficient funds to meet its obligations as and when they fall due. Funding risk is the inability to access funding markets or to do so only at excessive cost.

CONDUCT RISK

Conduct risk is the risk that the Group does not treat its customers fairly resulting in inappropriate or unfair outcomes.

OPERATIONAL RISK

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

BUSINESS RISK

Business risk is the risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geographical, regulatory or other factors.

PENSION RISK

Pension risk is the risk that the value of the Scheme's assets will be insufficient to meet the liabilities of the Fund.

In addition to the principal risks, the Group is also exposed to model risk which is defined as the risk that an adverse outcome (incorrect or unintended decision or financial loss) occurs as a result of weaknesses or failures in the design or use of a model. Given that

internal models are frequently used by the Group model, risk could potentially arise in assessing and managing exposure to a number of the principal risks outlined on page 30. The Group uses a variety of techniques to mitigate model risk, including sensitivity analysis to key assumptions and applying shock stresses. The MGC is dedicated to the oversight of the Internal Ratings Based (IRB) model supporting the management of credit risk.

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 and uncertainties

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 volatile global outlook, and continued risk of recession across Europe. This, together with any future Bank of England base rate rises, could 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, the ability to refinance at maturity, a sustained deterioration in the macro-economic environment and consequential increases in unemployment.

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 Group's strategy. 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.

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 new lending ensuring that the mix of overall portfolio exposures is within the prudent limits and risk appetite set by the Board. 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. The Group assesses affordability using a stressed, higher interest rate to protect the borrower from entering into a mortgage commitment which could prove unsustainable in a higher interest rate environment.

Lending is secured against properties in the UK.

This concentration in the UK market could then be exacerbated by overexposure to one geographical location or reliance on particular product types within the portfolio. The Group manages this risk by monitoring the geographical distribution of lending, the distribution of gross lending by channel of acquisition and by setting new lending risk limits in specific segments of the mortgage market.

Regular stress testing is undertaken which seeks to establish the extent to which losses may emerge under a range of macroeconomic and specific stress scenarios and to ensure that the Group continues to remain within its retail credit risk appetite. These stress tests primarily consider the impact of economic events on the probability of default and on house price movements.

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. Customers in financial difficulties need support at what may be a difficult time so careful consideration is given to the most appropriate strategy likely to result in the best outcome for the Group and the customer. Repossession of a property is only sought where all reasonable efforts to regularise matters have failed or the mortgage is unsustainable in the longer term.

Regular reviews of the Group's arrears management function and processes are independently undertaken to ensure that borrowers are being treated fairly, appropriately and sympathetically and in line with established policies, procedures and regulatory guidance.

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 exit strategy where the Society will engage in a detailed review of the options. In particular the Commercial Lending division will engage in extensive dialogue with customers and advisors but enlist external professional support where required to ensure that the optimal approach is chosen taking account of the needs of all stakeholders.

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 and funding 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. Funding risk is the inability to access funding markets or to do so only at excessive cost.

Determining the appropriate mix and amount of liquidity to hold is a key decision for the Board, which recognises the Group must remain a safe and attractive home for Members' retail deposits. However, the more assets that are held in liquid form, the less that are available for the Group to lend to borrowing Members. The more liquidity that is held, the lower the profitability of the Group and the less capital it generates. If capital is reduced then the capacity for new mortgage lending is restricted. Therefore, it is in the best interests of the Group as a whole for it to hold sufficient but not excessive levels of liquid assets to cover cash flow imbalances and fluctuations in funding.

Market background and uncertainties

The Society has demonstrated a strong track record of being able to attract and retain retail funding before and since the financial crisis began. The external credit ratings held by the Society support access to wholesale markets giving further potential availability of funding sources. The Society continues to monitor regulatory changes in relation to bail-in requirements and Minimum Requirements for Own Funds and Eligible Liabilities (MREL) which could have an impact on pricing within the unsecured wholesale markets.

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.

During the year, the PRA published a Policy Statement PS11/15 'CRD IV: Liquidity' which implements the Liquidity Coverage Ratio (LCR) at 80% from October 2015 rising to 90% in January 2017 and 100% from January 2018. The Net Stable Funding Ratio (NSFR) is expected to be implemented at a minimum of 100% from January 2018. PS11/15 also revoked the liquidity standards contained in Chapter 12 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU 12) and the withdrawal of existing firm-specific guidance on liquid assets buffer contained in firms' individual liquidity guidance (ILG) from October 2015. Under the new rules which were implemented on 1 January 2016, firms will

be required to carry out an Internal Liquidity Adequacy Assessment Process (ILAAP).

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 weekly reports on current and projected liquidity positions.

The Board determines the level of liquid resources required to support the Group's strategy through undertaking an annual ILAA as part of the development of the Group's Corporate Plan. Stress tests consider a range of severe but plausible scenarios and their impact on the Group, particularly with respect to retail saving outflows. The most recent ILAA was approved by the Board in May 2015. Under PS11/15, the ILAA will be revoked and replaced with the ILAAP for the Board's review in 2016.

Based on current interpretations of regulatory requirements, as at 31 December 2015 the Group held LCR and NSFR ratios well in excess of the full 100% ratio requirement due for implementation in January 2018.

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. 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 repricing of assets and liabilities.

Another significant form of interest rate risk arises from the imperfect correlation between repricing 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.

The Group continues to ensure that it maintains a significant proportion of discretionary variable rate savings and mortgages on its balance sheet, which provides flexibility to manage a prolonged low interest rate environment, or the possible impacts from a change in Bank of England base rate.

The Group has a series of Board approved limits that ensure the impact of a change in general interest rates has limited effects on both the net interest income generated and the present value (PV) of its statement of financial position.

Market background and uncertainties

The potential for rate rises along with an increase in the provision of mortgage advice following the Mortgage Market Review has influenced customer demand for fixed rate mortgage products. In contrast, savers are choosing to take advantage of variable rate products where there are expectations that an increase in base rate would result in relatively higher returns.

Interest earned on fixed rate mortgages will not increase; however, interest payable on variable rate savings is likely to increase and plans take due account of the need to mitigate this potential risk to interest margin. The Board is confident that it has the necessary tools to manage a protracted low rate environment, and the Group's balance sheet is positioned to respond positively in a rising rate environment.

Base rates have remained unchanged during the year. The Board anticipates that whilst there may be increases in the Bank of England base rate in the next 12 months, rates will remain at comparatively low levels.

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, and 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 considering both earnings and value measures. In addition ALCO and GRC review the Group’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.

Use of derivatives

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

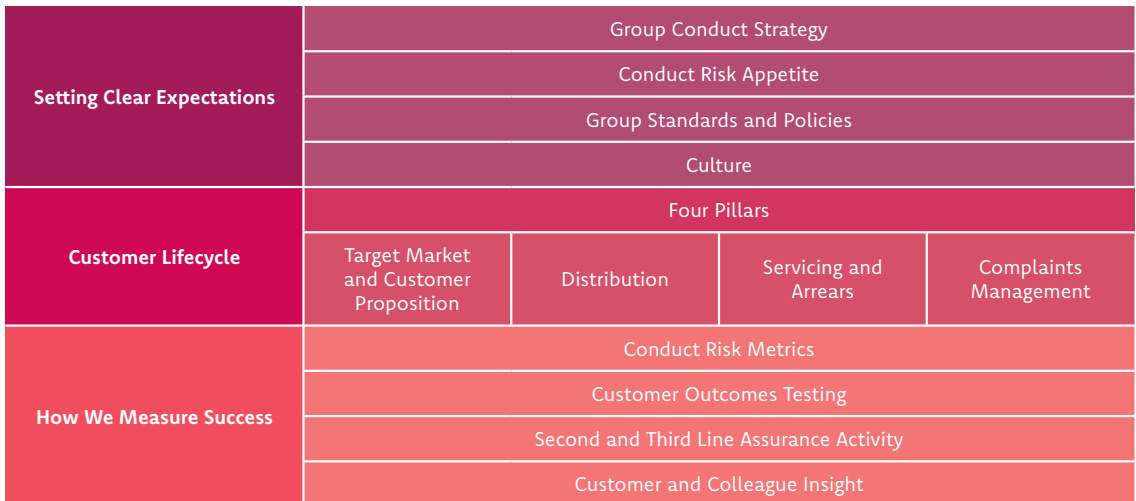
Conduct risk is the risk of the Group treating its customers unfairly resulting in the delivery of inappropriate outcomes.

Market background and uncertainties

The sustainability of the Group’s business model and achievement of its longer-term strategy are dependent upon the consistent and fair treatment of Members and customers. The Group has always been committed to ensuring that Members and 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. In 2014, the Group reappraised its framework and approach to managing conduct risks and will continue to make appropriate investment and adjustments to ensure the ongoing ability to meet its conduct obligations.

Risk mitigation

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



The Group’s conduct strategy was updated and approved by the Board in December 2015. This sets out the Group’s strategy for managing conduct risk and also articulates the Board’s risk appetite in relation to conduct risk.

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. 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.

The Group’s conduct risk appetite is defined against each of the four pillars of the conduct strategy:

Pillar	Desired Outcome
Target Market and Customer Proposition	• Business plans and incentive schemes are developed, and reviewed, by senior managers in accordance with the Group Conduct Strategy.
	• We only offer products and services which clearly meet the needs and circumstances of the target market.
	• We offer straight-forward products with clear, fair and not misleading literature.
	• We regularly review the performance of our products to ensure that they function and deliver fair outcomes for our customers.
Distribution	• We lend responsibly ensuring the loans we make are affordable at the point of purchase.
	• For non-advised sales, we provide customers with clear information, enabling them to make an informed decision about the products they purchase.
	• Where customers receive advice, the advice will be suitable.
Servicing and Arrears	• Customers will be provided with information that is clear, fair and not misleading and kept appropriately informed throughout the lifetime of their product or service.
	• We take all reasonable steps to ensure that our financial crime, information security and business continuity risks, associated with products or services provided to our customers, are appropriately managed.
	• We will work with borrowers in financial difficulty towards an appropriate resolution and all appropriate forbearance options will be considered. In addition, we will treat our customers sympathetically. We will only repossess our customers’ homes when this is the fair outcome.
Complaints Management	• Customers will not face unreasonable barriers to make a complaint.
	• All complaints will be resolved in a timely manner and fairly based on review of the customer’s individual circumstances.
	• We will undertake root cause analysis and where appropriate act on any lessons learnt to enable us to improve the outcomes we are achieving for our customers.

The management of conduct risk is measured 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, outcome testing enables

an assessment of the extent to which the Group is achieving its aim of consistently delivering fair outcomes for Members and customers. Regular feedback from Members and customers is also obtained.

Operational risk

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

The Group assesses its exposure to and management of operational risks by reference to 12 principal categories:

Risk category	Brief definition
Business continuity management	The risk of loss arising from an inability to service customers and key stakeholders due to a failure of the operational infrastructure including people, premises and IT systems.
Customer experience	The risk of loss to the business from a failure to provide best practice customer service, including the level of service required to meet retention and new lending growth targets, and from failing to ensure that the level of service offered is key to differentiating the business in the future.
Change management	The risk of non-delivery of the strategic change programme objectives or disruption to business as usual activity resulting from the implementation of change.
Financial crime	The risk of loss to the business arising from activities which circumvent controls, the unauthorised use of assets or services or illegal activities.
Financial management	The risk of losses arising from the failure to set and monitor budgets, reconcile accounts, price appropriately and monitor compliance with exposure limits. Failure to design and produce adequate, timely and accurate MI for decision-making purposes.
Information security	The risk of loss arising from a failure to protect information from unauthorised access, use, disclosure, modification or destruction.
IT	The risk of loss to the business arising from an inability to service customers, counterparties and other stakeholders due to the failure of the integrity or performance of the IT infrastructure and critical systems and/or an inappropriate IT strategy and/or inadequate use of the Group's information technology.
Legal and regulatory	The risk of loss, penalties and consequential disciplinary action, restitution costs, restrictions on business or missed opportunities arising from a failure to identify, understand, interpret and comply with UK and European regulatory rules/laws/codes of conduct.
People	The risk of failure to maintain and develop the appropriate level of skilled resource, maintain employee relations, provide a safe environment in line with legislative requirements and comply with ethical, diversity and discrimination laws.
Process	The risk of loss arising from the failure in the design, documentation or performance of an operational process.
Premises and facilities	The risk of loss arising from the ownership, management and security of and threats to, the property and facilities used in the Group.
Third party	The risk of loss arising from the failure of a key supplier or outsourcing arrangements or in failing to meet agreed target levels from the use of outsourcing or third party service providers.

Market background and uncertainties

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 cyber-crime require the adoption of increasingly sophisticated anti-fraud controls. The Group recognises that the cyber threat remains a key industry concern and will continue to adopt additional controls in line with industry best practice. Notwithstanding recent and substantial investments by financial institutions in

technological solutions aimed at combatting the more sophisticated financial crime threats, there is an increasing trend of financial deception targeting consumers directly. The Group continues to strengthen its control environment to protect those who are most vulnerable to financial abuse, and continues to work collaboratively with industry partners to further improve controls and enhance customer education. In addition, the Society is conducting a strategic review of its IT capabilities, including the identification of improvements to enhance Members' experience when interacting with the Society.

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 achieve its strategy while protecting its reputation. The Group manages its exposure to operational risk by considering risk events analysed by the operational risk categories described above. In addition to any direct loss attributable to risks in these categories, the reputational impact of such an event may damage the Group leading to secondary impacts.

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 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.

Business risk

Business risk is the risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geopolitical, regulatory or other factors. The Group

considers strategic risk, the risk to delivering the Group's Corporate Plan, to be the principal business risk. Whilst all business areas are responsible for managing their own risks, management of strategic risk is primarily the responsibility of the Board and the Group Risk Committee whose remit encompasses all risk categories on a Group-wide basis.

The management of strategic risk is intrinsically linked to the corporate planning and stress testing processes, and is further supported by the regular provision of consolidated business performance and risk reporting data to the Board and senior risk committees. In addition, a risk to reputation is inherent in all risk categories where actions and incidents can affect the extent to which people trust, and wish to do business with the Group. Reputation risk is assessed via incident reporting, media monitoring, business performance, complaints monitoring and both internal and external benchmarking.

A number of the current and emerging principal risks have the potential to affect more than one specific risk category and could have a significant impact on the business model if these were to crystallise concurrently. In particular, increased regulatory demands could significantly change capital or liquidity requirements which could, in extreme circumstances, threaten the viability of the Group's business model.

Market background and uncertainties

The Group recognises the potential for increasing competition in its core savings and lending markets through the emergence of 'challenger banks' and from mainstream UK banks as they focus on service delivery and non-investment activities. Whilst the Group will continue to focus on efficiency and cost control through its Continuous Improvement Programme, cost pressures within the business will continue to arise from the pace and complexity of regulatory change, required levels of investment in technology and organic growth.

Risk mitigation

The management of strategic risk is intrinsically linked to and is supported by the provision of consolidated business performance and risk reporting data to the Board and senior risk committees whose remit encompasses all risk categories.

The Group will continue to carefully manage its reputational risk and invest significant resources in enhancing the robustness of its systems and controls, governance, product set and ongoing monitoring.

Pension obligation risk

Pension risk is the risk that the value of the Scheme's assets will be insufficient to meet the estimated liabilities of the Fund. Pension risk can adversely impact the

Group's capital position and/or result in increased cash funding obligations to the Scheme.

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.

Market background and uncertainties

Investment returns from assets and the value of liabilities cause volatility. Key risk factors which include interest rates, credit spreads, inflation and asset performance are closely linked to economic performance. The other key risk factor is life expectancy as pension benefits are paid for life. Changes in these factors can have positive and negative impacts on the deficit.

The Scheme is also exposed to possible changes in pension legislation.

Risk mitigation

During the year analysis, insight and monitoring of pension risk was further enhanced by the Group to support and facilitate appropriate risk management and anticipate any early management actions required to mitigate exposure.

The Group actively engages with the Pension Scheme Trustees to ensure broad alignment on investment objectives and implementation. This is supported by the sharing of management information between the Group and the Trustees. The Group and the Trustees of the Scheme regularly review reports prepared by the Scheme's independent actuaries and take appropriate action which may, for example, include adjusting the investment strategy and/or contribution levels.

The Scheme will be subject to a triennial valuation in 2016 where a new schedule of contributions will be agreed.

Solvency risk and capital management

The Group holds capital to protect its Members by ensuring that there are sufficient assets to repay liabilities even in the face of unexpected losses. When assessing the adequacy of its capital, the Group considers the material inherent risks to which it is exposed and also the need for capital to be available to support the development of the business. The Group manages its capital to ensure it continues to meet minimum regulatory requirements, as well as meeting the expectations of other key stakeholders.

The Group employs a number of tools to support the management of solvency risk. The Board is responsible for setting a risk appetite with respect to solvency risk, which is articulated through its risk appetite statement, defining minimum capital ratios and thresholds, including

leverage, within which it is willing to operate. These are supported by specific limits and triggers, against which performance is monitored by GRC, ALCO and other relevant internal management committees. With general reserves forming the majority of the Group's capital resources, profitability is an important factor when considering the ability to meet ongoing capital requirements.

The Group undertakes a regular ICAAP, which considers the minimum amount of capital to be held in order to cover credit risks, operational risks, interest rate risks and pension risks, and also considers an additional buffer to ensure that the impact of a severe but plausible stress can be absorbed. The most recent ICAAP was approved by the Board in May 2015.

In 2013, the PRA gave the Society permission to use the Internal Ratings Based (IRB) approach to calculating capital requirements which has been applied to the first charge retail and commercial lending portfolios. This approach allows the Society to calculate capital requirements using internally developed models that reflect the credit quality of the Society's mortgage book. This permission reflects the Society's detailed understanding of its customer base and credit risk profile. For other exposures and risk areas the Society follows the standardised approach which uses capital risk weighting percentages set by the PRA.

Regulatory developments

Basel III was implemented through CRD IV which came into force on 1 January 2014. It is supervised in the UK, together with local implementation rules and guidance, by the PRA. The objective of CRD IV is to improve the banking sector's ability to absorb shocks arising from financial and/or economic stress, thus reducing the risk that a stress in the financial sector damages the wider economy.

One of the consequences of CRD IV is to reduce the Group's capital resources primarily through restricting the eligibility of Permanent Interest Bearing Shares and subordinated debt on a phased basis under transitional rules which extend to 31 December 2021.

Additionally, CRD IV also introduces a non-risk based leverage ratio that is supplementary to the risk-based capital requirement. The Financial Policy Committee has proposed the minimum requirement for this measure to be 3%, applicable immediately to the largest global banks, and domestically significant banks and building societies. It is unlikely that the Group will be classified as domestically significant, therefore the minimum requirement will become binding no later than 2018.

CRD IV sets a minimum for Tier 1 capital of 6% of risk weighted assets (RWAs) of which Common Equity Tier 1 (CET 1) is required to be a minimum of 4.5% of RWAs. The total of Tier 1 and Tier 2 capital must be a minimum of 8% RWAs and this is referred to as the Pillar 1 requirement. The PRA announced in December 2013 that the total Pillar 2A capital requirement (capital held against risks not fully captured by Pillar 1) should be met with a minimum of 56% of CET 1, up to 44% of Additional Tier 1 (AT 1) capital, and a maximum of 25% of Tier 2 capital.

To promote the conservation of capital and the build-up of adequate buffers that can be drawn down in periods of stress, CRD IV implements the use of supplementary common equity capital buffers. These comprise a capital conservation buffer of 2.5% of RWAs to be built up from 2016 to 2019; a systemic risk buffer applied to institutions judged to be systemically important; and macro-prudential countercyclical buffers (CCyB) and sectorial capital requirements (SCR). The FPC published a Policy Statement in January 2014 explaining the circumstances in which the SCR and CCyB may be applied, to counter emerging threats to financial stability. The SCR can be applied by amending the Group's 'risk weights' which affect RWAs and minimum capital requirements or via capital buffers (within Pillar 2A) which apply over and above minimum capital requirements.

Capital utilised in meeting the firm-specific Pillar 1 and Pillar 2A capital requirements, which may include a firm-specific buffer, may not be used in meeting the additional CRD IV supplementary buffers.

The Group is obliged to implement the European Mortgage Credit Directive (MCD) with effect from 21 March 2016. The MCD is European legislation designed to foster a single market for mortgages and to protect consumers. The European Commission published the final MCD text in February 2014 and the requirements will be implemented in the UK through rules set by the FCA. The impact of MCD on first charge lenders will be relatively negligible as the requirements are largely met through existing FCA requirements. However, for second charge lenders such as Nemo, the impact will be significant with wide-ranging changes required in the training of staff, the sales process and product disclosure.

The Payment Services Directive (PSD) was adopted in 2007. This legislation provides the legal foundation for an EU single market for payments, to establish safer and more innovative payment services across the EU. The objective is to make cross-border payments as easy, efficient and secure as 'national' payments within a Member State. In 2013, the European commission proposed to revise the directive (PSD2). The PSD2 updates and complements the EU rules put in place by the

Payment Services Directive. Its main objectives are to:

- Contribute to a more integrated and efficient European payments market
- Improve the level playing field for payment service providers (including new players)
- Make payments safer and more secure
- Protect consumers
- Encourage lower prices for payments

The Group will implement the requirements of PSD by 13 January 2018 in line with the regulatory implementation timescales.

Leverage

The components of the leverage ratio requirement are a minimum ratio of 3%, of which 25% may be met using high quality AT 1 capital, and two additional buffers that are to be met using CET 1 capital: a supplementary leverage buffer, which will apply to the largest UK banks and building societies and be implemented from 2019 (from 2016 for firms deemed globally significant), and a countercyclical leverage buffer ("CCyB") that will apply to all firms. The levels of these buffers will be set to 35% of the corresponding risk weighted systemic risk buffer and CCyB. The CCyB is set by the FPC and is currently zero (maximum 0.9% leverage impact). Given the size of the Group, it is not anticipated it will qualify for a supplementary buffer.

The FPC has indicated it will provide up to 24 months' notice for any increase in the CCyB and therefore the minimum requirement currently proposed for the Group is 3% but could increase to 3.8% from 1 January 2019. The Board is confident that the Group will continue to exceed the minimum requirement.

Future uncertainties

Whilst CRD IV and the PRA's policy statement have been published, a number of the technical standards being published by the European Banking Authority have not been finalised and the Basel Committee is still consulting on a number of topics including the calculation of credit risk capital requirements under the Standardised and IRB approaches. A further full review of the leverage ratio requirements is due to be undertaken in 2017. During 2014 further details were provided on initiatives designed to address issues associated with financial institutions that were perceived to be 'too big to fail'. This is likely to have implications for creditor hierarchy in the event of insolvency and requirements will be imposed on firms to maintain minimum amounts of funding (loss absorbing capacity) that could be 'bailed-in' at the point of failure. This is to reduce the likelihood of taxpayer support being required. These changes are still subject to legislation within the UK and the extent to which the Group will

be affected by the new requirements is not yet clear. Consequently the final capital requirements remain unclear and the Group continues to monitor regulatory changes at a UK, European and global level.

Based on the Board's current understanding of the reforms, the Board is confident the Group is well positioned to maintain its overall capital strength and meet minimum ratios as the regulatory framework continues to evolve.

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 2016.

A handwritten signature in black ink, appearing to read 'R. Michael Jones', is written over a light grey rectangular background.

R. Michael Jones
Group Risk Director
9 February 2016

BOARD OF DIRECTORS for the year ended 31 December 2015



Laurence Philip Adams
MA
Chairman, Non-Executive Director
Age: 59

I was appointed a Non-Executive Director of the Society in August 2013 and was elected Chairman in April 2014. I am also a member of the Remuneration and Nominations Committees.

I have more than 25 years' experience in the banking industry, to help advise and guide the Society through the increasingly demanding and complex regulatory environment in which it now operates. Most recently I have been involved as a Non-Executive Director helping to rescue the troubled Northern Rock PLC in 2007 where I headed the Risk Committee.

I am a qualified solicitor and previously served as Managing Director and Global Head of Legal and Compliance for the investment banking wholesale division of ABN Amro Bank and had a similar role for Citibank.

Born in 1956, I lived in Neath until I was five before moving to Barry where I went to school. I currently live in London with my wife and two children. I am a Non-Executive Director of Novae Group PLC and of Exane Limited. I also enjoy singing and gardening and I am a member of the London Welsh Male Voice Choir.



Derek Anthony Howell
BSc (Hons), FCA
Non-Executive Director
Age: 61

I was appointed a Director of the Society in April 2014 and have subsequently been appointed to the role of Senior Independent Director. I also serve as Chairman of the Audit Committee and as a member of the Board Group Risk and Nominations Committees. As Senior Independent Director I act as a sounding board for the Chairman, serve as an intermediary for other Directors, and am responsible for leading the annual review of the Chairman's performance. I am also available to Members if they have concerns which they have not been able to resolve through the normal channels of the Chairman, Chief Executive or other Executive Directors or for which such contact is inappropriate.

I hold a degree in mathematics and qualified as a chartered accountant with Price Waterhouse – subsequently Pricewaterhouse Coopers (PwC). During my time with that firm I worked originally in the audit team and eventually specialised in corporate recovery and insolvency work, becoming a partner in 1988. I retired from the PwC partnership in April 2013 and have been engaged on a part-time basis since as a consultant, working on the Lehman insolvency.

I am proud to have the continuing opportunity to serve as a Non-Executive Director of Principality and to contribute to the Society's ongoing success. I believe the Society holds a unique place in the fabric of Wales through supporting the local communities which it serves.

I am also Treasurer of St John Cymru Wales and a trustee of both the National Botanic Garden of Wales and Artes Mundi.

Born in 1954, I am married with two grown up children and live close to the centre of Cardiff. I am a keen golfer, an enthusiastic rugby supporter and have an interest in theatre and the arts. I keep promising my wife that I will find some more time to travel with her in our classic car, particularly in the UK and near continental Europe.



Graeme Howes Vorston
FCIB MBA
Group Chief Executive
Age: 58

I joined the Society as Chief Operating Officer in July 2006 and was appointed to the main Board in October 2007. As Chief Operating Officer I was responsible for all of the Building Society's functions including distribution, marketing, IT and operations. I became Group Chief Executive in October 2012. I am Chairman of Nemo Personal Finance and Loan Link and Chairman of the Group Management and Group Executive Risk Committee. In addition I am a member of the Asset and Liability and Commercial Asset and Liability Committees and attend meetings of the Board Audit, Group Risk, Customer and Conduct and Remuneration Committees.

During my time in financial services I have worked for Abbey National where I carried out a number of senior roles including Regional Director for branches, Director of Sales for the call centres and CIO for the retail bank. I have led a number of significant strategic change programmes including one of the largest CRM implementations in Europe.

In addition to my role at the Principality, I am a member of the Board of Governors at Cardiff Metropolitan University, I am on the Wales Council for the CBI as well as sitting on the Executive Committee for the CML, one of the leading industry trade bodies. I am also a Fellow of the Chartered Institute of Bankers and hold an MBA from Warwick Business School.

I was born in 1957 and now live close to Cardiff in the Vale of Glamorgan with my wife. I have three grown up children.



Natalie Cecilia Elphicke OBE
LLB (Hons)
Non-Executive Director
Age: 45

I was appointed to the Society's Board as a Non-Executive Director in July 2012.

I am the Chief Executive of The Housing & Finance Institute, a national not-for-profit organisation which works to deliver more homes and better housing services by working across the public and private sectors. I am a qualified barrister and solicitor, and started my legal career in the government legal service becoming a leading law firm partner in an international law firm. I am a national expert in my field of housing and property finance and a regular adviser to the UK Government. I have worked on over £4bn of complex finance transactions across debt, equity, residential regulated and investment markets, major infrastructure, and large regeneration and development projects. I was appointed an OBE in the Queen's Birthday Honours 2015 for services to housing.

At Principality, I chair the Board's Group Risk Committee. I also sit on the Audit Committee and Nominations Committee. Prior to joining the Society, I led the structuring team for the Ely Mill project which Principality jointly founded with the Welsh Government and which is on track to deliver 800 new affordable homes in Cardiff.

I am 45, married with two children and my family home is in Kent.



Stephen James Hughes
ACMA
Group Finance Director
Age: 43

I was appointed Group Deputy Finance Director in December 2011 and was appointed to the Society's Board in March 2013 as Group Finance Director with responsibility for Finance, IT and Business Change. I chair the Society's Asset and Liability Committee and Model Governance Committee and I am also a member of the Group Management Committee. I have particular responsibility for ensuring that the Society retains a strong capital base and has high quality and sufficient levels of liquidity.

I am a qualified accountant and bring over 20 years' experience in finance to my role. Prior to joining the Society I held a number of finance roles across a range of industries including manufacturing, retail and insurance. Prior to joining the Society I performed the role of Finance Director of the Lloyds Banking Group General Insurance business.

I am Chairman of the Wales Advisory Board for Business in the Community (BITC) and I am passionate about our community work and the difference it can make to people's lives in our heartland.

I was born in Swansea in 1972 and continue to live close to that city with my wife and three sons who share my passion for sport with our weekends taken up by both watching and playing football and rugby.



Robert Michael Jones
BA (Hons) MBA, ACIB
Group Risk Director
Age: 57

I joined the Society's Board in February 2013 and was subsequently elected to the Board for the first time in April 2014. Having worked for the Society since 1997, I was appointed Head of Group Risk in 2005 and promoted to the role of Director of Group Risk in 2009. I have attended full Board meetings since September 2009 and attend all meetings of the Board Audit, Group Risk, Customer and Conduct and Remuneration Committees. I also chair the Group Credit Risk Committee and Group Operational Risk Committee and I am a member of the Group Management Committee, Group Executive Risk Committee and the Asset and Liability Committee.

I have spent over 35 years working in financial services, starting my career at Midland Bank and subsequently at HSBC, undertaking a number of managerial roles in both the retail and corporate banking divisions. I hold a degree in Economics, an MBA from Henley Management College, and I am an Associate Member of the Chartered Institute of Bankers. Together with the Group Finance Director, I have particular responsibility for ensuring that the Society maintains a strong capital base which will enable it to continue to grow and compete successfully over the long-term.

Born and educated in Denbigh, North Wales, I now live just outside Cardiff and am married with two children. Outside of work I play tennis, and when time permits I very much enjoy hillwalking and climbing in Snowdonia, which also gives me the opportunity to visit friends and family in the Vale of Clwyd.

BOARD OF DIRECTORS for the year ended 31 December 2015



Nigel Charles Annett CBE
MSC, MA (Hons), DSC Econ
 Non-Executive Director
 Age: 57

I joined the Board of Principality as a Non-Executive Director in October 2013 and was subsequently elected to the Society's Board as a Non-Executive Director in April 2014. I now serve as Chairman of the Board's Customer and Conduct Committee and also serve as a member of the Remuneration, Nominations and the Group Risk Committees. As Chair of the Customer and Conduct Committee I am responsible for making sure that the fair treatment of Members and customers is central to the Society's culture and operations.

I used to work in investment banking, but after ten years I decided on a change of career and joined the Board of Welsh Water, initially as Planning Director. I was one of the founding Directors of Glas Cymru, the not-for-profit company that took over the ownership of Welsh Water in 2001. I believe strongly that mutual business models can do a great deal of good for the people and the communities that they serve.

Born in 1958, I have lived in Wales for more than 20 years and I have two grown up boys both of whom recently graduated from university.



Sally Jones-Evans
FCIB, MBA
 Non-Executive Director
 Age: 49

I was appointed to the Society's Board in February 2015 and I am delighted to be able to stand for election for the first time at the Society's 2016 Annual General Meeting. Since joining the Board I have become Chair of the Remuneration Committee and also serve as a member of the Customer and Conduct and Nominations Committees. As Chair of the Remuneration Committee I am responsible for ensuring that the Group's remuneration and reward strategy, policy and procedures follow best practice, support the strategy approved by the Board, and reflect the best interests of Members.

I have 30 years' experience in retail banking and general insurance during which I gained a wide range of experience in leading change initiatives, mainly in customer facing areas including the branch network, telephone centres, internet banking and operations centres which will help me to contribute to the Society's ongoing change programme. During my time with Principality I have already been impressed by the dedication and skills of colleagues at Principality which is essential to the provision of good quality service to our Members.

I also sit on an advisory panel to the Welsh Government which seeks to stimulate the financial and professional services sector in Wales to create employment and economic growth, and I was formerly a Non-Executive Director at Welsh Athletics.

I and my husband Alun were both born and educated in Cardiff, and lived in the Vale of Glamorgan until ten years ago when work commitments moved us to Wiltshire. We love Welsh rugby, music of many kinds, and I also have a deep interest in strategies to lift people out of poverty in the developing countries of the world, especially Africa.



David James Rigney
ACMA, MBA, MA
 Non-Executive Director
 Age: 52

I was appointed to the Society's Board in March 2015 and am very pleased to be able to stand for election for the first time at the Society's 2016 Annual General Meeting. In addition to my Board responsibilities I also serve as a member of the Audit, Group Risk and Nominations Committees.

I am a Chartered Accountant and during my career I have performed a broad range of roles across the Post Office, BT and as a Board Director at Nationwide Building Society. I believe this experience leaves me well placed to contribute to the Society's ongoing change programme and to have the opportunity to contribute to the Society's continuing success. I passionately believe in the mutual business model and everything that I have seen so far at Principality demonstrates that the customer is truly at the heart of the business.

I am also Chairman of BACS Payment Schemes Limited, Non-Executive Director and Senior Independent Director of Elexon Limited and Non-Executive Director of Sports Resolutions.

Born in 1963, I now live in Bristol. Outside of work and family I have just completed a Masters Degree in Sports History focusing particularly on the positive impact of sport on communities and society. The work that Principality continues to do via sport will create a stronger Wales and a stronger business. It makes me proud to be part of it.

CORPORATE GOVERNANCE REPORT

for the year ended 31 December 2015

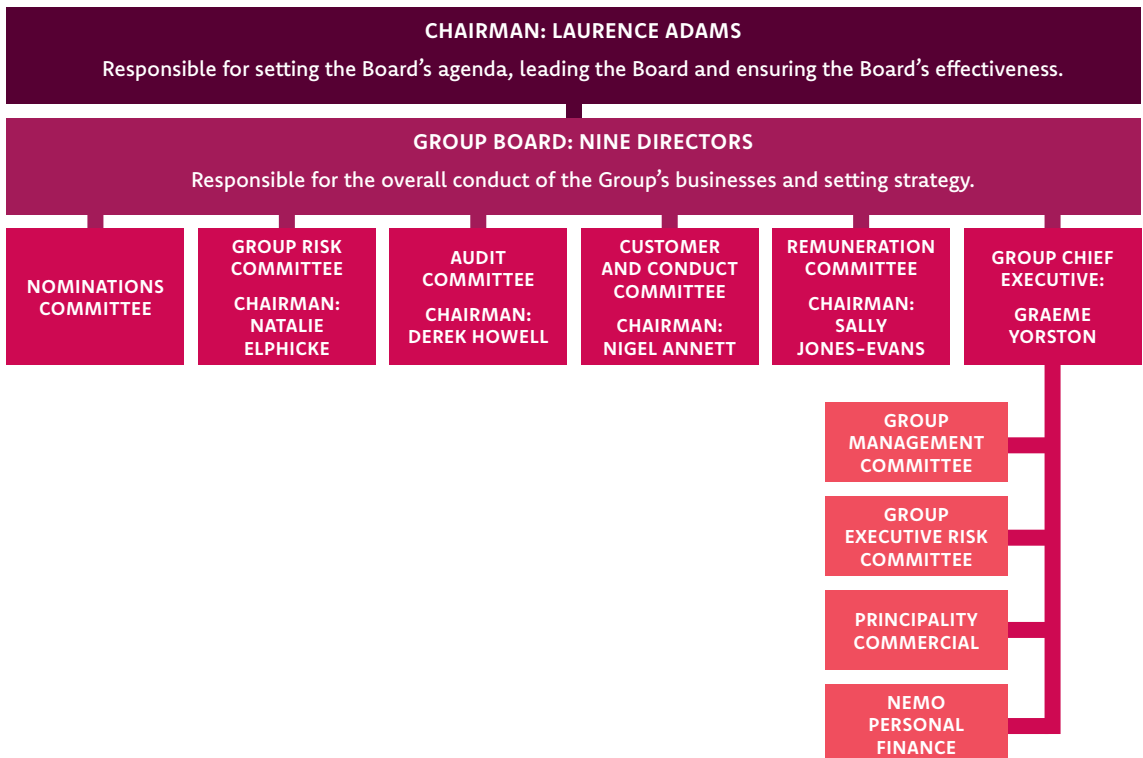
The Board is responsible for the overall conduct of the Society and its subsidiary businesses and is accountable to the Society's Members for the proper conduct of those businesses. It works to balance Member interests with those of other stakeholder groups including the regulatory authorities, the communities which the Society aims to serve, suppliers and employees.

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 apply primarily 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 the Society now reports against that version of the Code. The Code also provides guidance in relation to audit, 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 2015, the Board comprised of three Executive Directors and six 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 election in 2015 and were duly elected (including Derek Howell who stood for election for the first time). All Directors will again stand for election at the 2016 Annual General Meeting, including Sally Jones-Evans and David Rigney who will stand for election for the first time.

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 and Group Executive Risk Committees. He maintains a close working relationship with the Society's Chairman.

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 expected to have a broad range of business knowledge 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
- Assess whether current and future resources are commensurate with future plans
- Determine the broad policy for executive remuneration and the remuneration packages for Executive Directors and the Chairman

- Be satisfied that an appropriate culture is in place across all Group businesses.

The Board focuses its work on strategic issues, control of the business, reviewing operational and management performance, oversight of subsidiary companies and committees, 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
- 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.

The Board operates through its regular meetings and five committees – Audit, Customer and Conduct, Group Risk, Nominations and Remuneration – all of which have written terms of reference. Matters considered at all Board meetings include: the Group Chief Executive's report including strategic and business KPIs; 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; the Customer Director's operations report and, where applicable, reports from the Chairs of each of the Board's Committees. A forward Board agenda has been developed setting out the main issues to be considered in the year ahead and this is augmented by topical issues requiring Board consideration as necessary.

Membership of Board Committees is reserved to Non-Executive Directors; however, 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.

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

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.

Group Executive Risk Committee

The Group Executive Risk Committee is the principal management committee with responsibility for controlling risks across the business, and monitoring and reviewing risk exposures. It reports directly to the Group Risk Committee.

Board and Committee Membership and Attendance Record

	Board	Audit	Customer and Conduct	Group Risk	Nominations	Remuneration
Gordon MacLean	4/4	2/2	-	-	-	-
Joanne Kenrick	6/7	-	2/4	-	1/1	-
Menna Richards	7/7	-	4/4	-	1/1	5/5
Natalie Elphicke	11/11	5/5	-	6/6	-	-
Nigel Annett	11/11	-	7/7	6/6	2/2	8/8
Laurence Adams	11/11	-	-	-	2/2	8/8
Derek Howell	11/11	5/5	-	6/6	2/2	-
Graeme Yorston	11/11	-	-	-	-	-
Michael Jones	11/11	-	-	-	-	-
Stephen Hughes	11/11	-	-	-	-	-
Sally Jones-Evans	9/9	-	6/6	-	1/1	4/4
David Rigney	9/9	4/4	-	5/5	1/1	-

There have been a number of changes to the Board during the year and consequently Sally Jones-Evans and David Rigney will both stand for election for the first time in accordance with the Society's Rules at the 2016 Annual General Meeting.

Tenure and appointment 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 2015 AGM	Considered to be independent by the Board
Natalie Elphicke	April 2013	2	Yes
Nigel Annett	April 2014	1	Yes
Laurence Adams	April 2014	1	Yes
Derek Howell	April 2015	N/A	Yes
Sally Jones-Evans	N/A	N/A	Yes
David Rigney	N/A	N/A	Yes

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.

A copy of the letter of appointment for a Non-Executive Directors can be obtained on request from the Group Secretary.

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 conflicts 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. All Directors must meet the fitness and propriety tests prescribed by the PRA and FCA and must be registered as an "approved person" in order to discharge their controlled function role. Looking ahead the present "approved person" regime will be replaced in March 2016 with a new "Senior Managers Regime". Under that regime, Directors will be subject to regulatory approval for their allocated responsibilities. Directors must also continue to follow the regulatory code of conduct.

Directors' time commitment

The amount of time Non-Executive Directors are expected to commit to the affairs of the Society is largely dependent upon their responsibilities and increases significantly for those members of the Board who also act as the chair of a Board Committee. As part of the recruitment process for Non-Executive Directors, the individual time commitment is communicated and agreed. The usual minimum commitment is 30 days per annum.

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 training he or she needs tailored to their own specific requirements and the subsequent on-going training he or she requires. This year induction training was provided for Sally Jones-Evans and David Rigney on joining the Board. As part of that process new Non-Executive Directors meet individually with each of the members of the Group Management Committee and other senior managers to hear about the aspects of the Society's affairs for which they are responsible. 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 industry specialists, 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
- Providing Board members with access to external training sources.

As part of the Board's review of its effectiveness in 2015, Board members were asked to assess whether they had enough opportunities for training and development. This information will help to inform the provision of training to Board members during 2016.

Performance evaluation

The effectiveness of the Board is subject to an external evaluation every three years. The next external review is due to be completed in 2016. During interim years the Board carries out a formal annual evaluation of its own

performance with the aim of improving effectiveness. 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.

On an annual basis the Board undertakes an evaluation of the performance of the Chairman and of its own performance. Members of the Audit, Remuneration, Customer and Conduct and Group Risk Committees each complete a confidential online questionnaire which is compiled into a report for the Chairman and the Chairs of each of those committees.

Communication with Members and the Annual General Meeting

The Society is committed to maintaining good communications with Members. During the year four meetings were held by the Members' Forum as well as four Member 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 vote 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.



Laurence Philip Adams
Chairman
9 February 2016

REPORT OF THE AUDIT COMMITTEE

for the year ended 31 December 2015

The Audit Committee continues to focus its work on ensuring that the Group's financial reports taken as a whole are fair, balanced and understandable and ensuring that internal audit processes are rigorous.

Membership of the Committee has changed substantially during the year and in addition to myself (as Chairman of the Committee) the other members of the Committee are Natalie Elphicke and David Rigney, both of whom are independent Non-Executive Directors. I have recent and relevant financial experience as demanded by the Corporate Governance Code. The Group Chief Executive, the Group Finance Director, the Group Secretary, the Chief Internal Auditor, the Group Risk Director and representatives of Deloitte, the external auditor, attend each meeting of the Committee. Other relevant colleagues from across the Group are also invited to attend meetings of the Committee in order to provide a deeper level of insight into key issues and developments. The Assistant Secretary acts as secretary to the Committee. The Committee acts as an Audit Committee for the Society and its subsidiary companies. I have set out below a summary of the Audit Committee's main responsibilities and activities which include:

- Monitoring the integrity of the Group's financial reporting;
- Reviewing on behalf of the Board the Group's Long Term Viability Statement, and the appropriateness of the Going Concern assumption;
- Reporting to the Board on the appropriateness of the Group's accounting policies;
- Advising the Board on whether the Committee believes the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the necessary information for the Society's Members to assess the Society's performance, business model and strategy;
- Ensuring that the work performed by the Group Internal Audit team is aligned with the principal risks to which the Society is exposed;
- Oversight of the Group's system of internal control, including the work performed by the internal audit function and financial crime prevention function; and
- Monitoring the relationship between Management and the external auditor.

During the year the Committee met on five occasions. It monitored the integrity and clarity of the financial statements and disclosures, formal announcements

relating to the Group's financial performance and reviewed the acceptability of accounting policies and significant financial judgements.

The Committee has received regular reports from the Group Finance Director outlining the basis on which it is reasonable for the Society to continue to prepare its financial statements on a going concern basis and has satisfied itself that it is appropriate to consider the Viability Assessment over a three year outlook. Prior to being submitted to the Committee the Going Concern and Viability Assessment is subject to scrutiny by the Society's Asset and Liability Committee. As part of this process the Committee monitors closely the Group's capital, liquidity and funding position, and the ongoing viability of its business model.

The Committee has conducted detailed reviews of the interim and year-end financial statements and Pillar 3 Disclosures (which are published on the Society's website) which have included consideration of the narrative reports, description of the Society's business model, strategy and risks faced by the Group, and have 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:

- **Impairment provisions on loans and advances**
The Committee has continued to monitor the performance of the Group's loan books closely during 2015. The level of impairment provisions is a key area of judgement and the Committee continues to give careful consideration to the methodologies used by management to assess the likelihood of losses against each loan book and the appropriateness of the overall level of provisions held against the Group's loan book. The Committee concluded that the assumptions used by management which support the management judgement as to the adequacy of impairment provision continue to be appropriate.
- **Provisions for regulatory and customer redress**
The Committee has considered carefully the assumptions made by management in connection with the scale of the provision recognised for this purpose in the light of the regulatory environment, and concluded that the level of provision is appropriate.
- **Financial Services Compensation Scheme levy**
The Committee continues to give careful consideration to the methodologies used by management to

identify relevant trigger events and assess the Group's exposure to the future level of levies under the Financial Services Compensation Scheme. The Committee concluded that the extent of the provision held for this purpose continues to be appropriate.

- **Revenue recognition under IAS 39 using the effective interest rate method**

The Committee has reviewed the methodology used by management designed to achieve a constant yield over the life of a loan asset. The Committee concurred with management's judgement that the methodology used for this purpose continues to be appropriate.

- **Hedge accounting and fair value measurements**

The Committee has considered the methodology adopted by management leading to the calculation of fair values for derivative instruments including compliance with requirements for hedge accounting for those instruments. The Committee is satisfied that appropriate accounting entries have been made in the Group's financial statements for this purpose.

- **Carrying value of investments in subsidiaries**

The Committee concurred with management's judgement that no change to the carrying value of investments made in the Society's subsidiary businesses is necessary and also agreed that no impairment had occurred in the value of inter-company loans.

- **Retirement benefit obligations**

The Committee considered the key assumptions used by the Scheme Actuary to determine the liability under IAS 19 in connection with the Society's Defined Benefit Retirement Scheme obligation. The Committee agreed that the assumptions used for this purpose were reasonable.

- **Discontinued operations**

The Committee considered the classification of its activities as continuing or discontinued operations in line with the requirements of IFRS 5. The committee concluded that the presentation set out within the primary statements is appropriate and that the strategic report and the notes to the accounts provide adequate disclosure.

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, where accounting assumptions and estimates have been applied and on how they satisfied themselves 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.

Assessment of Internal Controls

The Committee receives regular reports on the effectiveness of the Group's systems and controls framework. Management is responsible for establishing and maintaining adequate internal controls. The Committee is responsible for monitoring the effectiveness of those controls. This work is primarily driven through the work performed by the Internal Audit function. The Committee is responsible for approving the annual Group Internal Audit plan and receives regular reports from the Chief Internal Auditor on the progress being made by the Internal Audit team, the adequacy of the resources available to that department, the results of any unsatisfactory audits and associated action plans and on Management's implementation of Audit recommendations. In order to preserve the independence of the Chief Internal Auditor, the individual performing that role continues to have a dual reporting line to the Group Chief Executive and Chairman of the Audit Committee. In addition the Chief Internal Auditor also has direct access to the Society's Chairman. The Committee has held private meetings with the Chief Internal Auditor and the external auditor during the year. The Committee has held five private meetings in the absence of Management during the year. During the year no significant control failure or weakness was reported to the Committee.

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.

Fair, balanced and understandable

The Committee is required to assess whether the Annual report taken as a whole is fair, balanced and understandable and provides the necessary information for the Society's Members to assess the Society's performance, business model and strategy. As part of the Committee's assessment of the Annual report (prior to reporting to the Board on this topic) the Committee draws on reports prepared by and discussions with the Group Finance Director and members of his senior management team. The Committee is satisfied that senior members of the Group Finance team are fully familiar with the fair, balanced and understandable requirement. Members of that team are responsible for the overall co-ordination, verification, detailed review and challenge of the content of the Annual Report itself. The Committee receives assurance from members of the Executive team that they consider the content for which they are responsible is fair, balanced and understandable. The Committee also receives an early draft of the Annual Report to enable Members of the Committee to conduct a timely review and challenge the content of the report. The Committee is committed to improving the clarity of reporting to the Society's Members.

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. No changes have been made to this policy during the year. 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 £191k. Non-audit fees, mainly in relation to the provision of taxation services, were £172k.

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 auditor 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 then current rules of the Institute of Chartered Accountants in England and Wales.

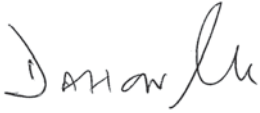
In considering the re-appointment of the audit firm, the Audit Committee has discussed the length of tenure of Deloitte LLP and the circumstances under which a re-tender for the provision of external audit services would be appropriate. Deloitte LLP took up their role as the Society's auditor in 2007 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 2015 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 as auditor to the Board and this resolution will be put to Members at the 2016 Annual General Meeting.

Other matters

Following each Audit Committee meeting, the Chairman of the Audit Committee provides an oral update to the Society's Board of Directors on matters considered by the Committee. In addition, the Board continues to receive the minutes of meetings of the Committee.

The Committee conducts an annual review of its own effectiveness which is co-ordinated by the Assistant Secretary, the result of which is reported to the Board. 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. Members of the Committee are expected to undertake relevant training as part of their ongoing development as an individual Board member. Each year as considered appropriate the Committee as a whole receives training on current topics. In 2015 this included updates on the impact of IFRS 9, regulatory themes and financial statement disclosures.

In the year ahead the Committee will continue to monitor progress with work leading to the implementation of IFRS 9 regime and will again assess whether the Audit engagement should be put out to tender.



Derek Howell
Chair of the Audit Committee
9 February 2016

REPORT OF THE REMUNERATION COMMITTEE

for the year ended 31 December 2015

Dear Member,

It is a great responsibility and a privilege for me to write my first introductory letter to the Remuneration Report, especially in a year when so much previous work to simplify and streamline our remuneration has culminated in the launch of the new Rewarding Excellence Award for 2016.

I have taken on board the feedback we received from Members last year by including the table of Directors' remuneration in the summary report sent out to all Members; more detail as always appears in this full Annual Report and on our website.

The important work of the Remuneration Committee, on behalf of Members, is to ensure all our remuneration policies align with the Board approved strategy to ensure the business is run safely and successfully. In particular we do this by ensuring that executive remuneration appropriately rewards those who bear the biggest burden of responsibility for executing this strategy, taking the right decisions on behalf of Members.

As you will read in other sections of this Annual Report, 2015 was a successful year of performance for the Society. The balance sheet remained strong, profit was robust, customer and Member feedback was very positive, and important steps have been taken to lay foundations for growing the core Building Society over the coming years. This is reflected in the Directors remuneration as shown in the table on page 56. Some of the stretch targets for customer service were not met in full, and the variable element of their remuneration reflects this.

As referenced above, the ongoing work to streamline variable pay schemes across the organisation has made great progress this year. All colleagues are now rewarded according to measures of customer service and no variable pay schemes are paid based on the achievement of sales targets. Multiple incentive schemes have now been replaced with a single, annual variable pay scheme that we have called the Rewarding Excellence Award. All colleagues except those in our Nemo business will participate in this new scheme in 2016, and in Nemo the equivalent schemes are also now greatly simplified.

The key features of the Rewarding Excellence Award are:

- It recognises and rewards all our colleagues for the results of the Society, reflecting Members' interests directly through design of the measures
- Through participation in one common scheme which pays the same percentage to all colleagues regardless of seniority it builds and rewards teamwork in an egalitarian way
- As the long-term security and health of the Society is paramount to our strategy, initial risk 'gateways' assessed by our capital and liquidity requirements must be met before any payments are triggered
- The measures chosen to reflect Members' interests and align with our strategy are Group Profit before Tax and customer service, both equally weighted
- The flat level of payment (determined by the Remuneration Committee for performance against these two measures) will be in the range of 0% to 12% of individual salary, with an award at the midpoint, 6% of salary, being payable for achieving both challenging targets set by the Board, and scope to reach the upper end of the range for exceptional results.

The Remuneration Committee, on behalf of Members, is also conscious that some of our most senior executives bear the burden of responsibility for decisions that impact the performance of the Society over multiple years, well into the future. Their salary levels reflect this responsibility of course, but we think that an element of their total remuneration should reflect the longer-term performance of the Society. Such 'Long-Term Incentive Plans' (LTIP) are understood by our Regulators and feature in the executive remuneration policies of other successful organisations.

Therefore a small number of our executives in this position will be invited to participate in a LTIP. Similar to the Rewarding Excellence Award described above, this scheme will be subject to risk 'gateways', and is being designed to reward both long-term financial performance and improved customer service with equal weighting. The details of the measures are still being finalised. Transition arrangements will be put in place to ensure these valuable executives are not disadvantaged in the meantime.

I look forward to meeting many of you at the Annual General Meeting, and to taking your comments and answering your questions about this report and the

work of the Remuneration Committee. As usual we will be holding an advisory vote on our remuneration policy and I hope that you will endorse the work of this Committee and support it.

I would just like to close by thanking Menna Richards for her valuable contribution to this Committee whilst a Director of the Society; as Chair of the Customer and Conduct Committee she played an important role in ensuring that the new simplified reward schemes reflect our conduct and customer service strategy, a role Nigel Annett will now assume on Members' behalf as he succeeds her in that capacity. I am grateful to Nigel Annett for ensuring a smooth and helpful handover of the Chair to me.



Sally Jones-Evans
Chair of the Remuneration Committee
 9 February 2016

Our Remuneration Policy

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 colleagues and 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 short-term measure at the possible expense of other longer-term 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
- 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.

How we apply this policy to the Executive Directors

The table below provides a summary of the different elements of remuneration for the Executive Directors who will be operating for 2016:

Component	Purpose	Operation	Opportunity
Base Salary	To attract and retain executives of sufficient calibre through the payment of competitive rates.	Reviewed annually (or more frequently if required).	Set at a level considered appropriate, taking into account: <ul style="list-style-type: none"> • Role and experience • Personal performance • Benchmarking comparisons • Salary increases awarded across the Society.
Benefits	Part of being a responsible employer and to assist in the performance of the job.	Executive Directors receive benefits, which include a car allowance, private medical care for themselves and their family, critical illness insurance and life insurance.	Set at a level considered appropriate by the Committee.
Pension or Pension Allowance	To provide for longer-term savings to fund retirement.	Executive Directors are invited to join the Society's pension plan or, as an alternative, be provided with an equivalent cash allowance.	Pension contribution of 15% of base salary or paid as a cash allowance.
Annual variable pay under the Rewarding Excellence Award	A plan that encourages teamwork, financial discipline and customer service.	An all-colleague annual cash plan based on Group Profit before Tax and customer service measures.	Maximum annual payment is 12% of base salary.
Long-term Incentive Plan	To align selected senior executives and senior managers to the Society's longer-term goals and objectives.	A right to a future cash payment subject to corporate performance conditions being met over up to three years.	Maximum annual payment is 28% of salary. Transitional arrangements will apply.

How we apply this policy to the Chairman and Non-Executive Directors

The Chairman and Non-Executive Directors are paid a fee for Board participation and additional fees for being members of Board committees. These fees are reviewed annually. In 2015, the base fee and committee fees were kept at the same level as 2014. Having regard to the expected greater time commitment and responsibilities arising from the Senior Persons Regime it was decided that as from 1 February 2016 the Chairman's and Non-

Executive Directors' base fee would be increased by 2% in line with the colleagues' basic pay increase.

The Chairman and Non-Executive Directors do not receive any employee benefits, pension contributions or participate in any variable pay or incentive schemes. The Chairman and Non-Executive Directors do not have service contracts and are all subject to re-election at each year's Annual General Meeting.

Annual report on remuneration

Introduction

We comply where appropriate with the Corporate Governance Code of Conduct and aim to make our remuneration policy as transparent as possible. We therefore set out in this section the following information:

- What the Executive Directors earned for 2015's performance and compared this with 2014
- What the Executive Directors can earn for 2016
- What the Chairman and the Non-Executive Directors were paid in 2015.

What the Executive Directors earned for 2015's performance

Executive Directors' single total remuneration figure

The following table shows a single total figure of remuneration for the 2015 financial year for each of the Executive Directors and compares this figure to the prior year. In respect of the annual variable pay we show the full amount of what was earned, even though half of the award will be paid a year later.

In February 2015, the Remuneration Committee decided that the base salary of Executive Directors (excluding the Group Chief Executive) should increase by 2%. This was equal to the average pay increase awarded to all other colleagues in the Group. The Group Chief Executive did not receive an award in 2015.

Individual	Year	Salary & Fees ¹	Benefits ²	Pensions ³	Annual Variable Pay	Total
Group Chief Executive Graeme Yorston	2015	335	14	50	87	486
	2014	335	14	48	132	529
Group Finance Director Stephen Hughes	2015	245	12	37	64	358
	2014	240	12	36	95	383
Group Risk Director R. Michael Jones	2015	234	12	35	n/a	281
	2014	227	15	34	n/a	276
Group Chief Operating Officer Guy Thomas (to 31/10/14)	2015	n/a	n/a	n/a	n/a	n/a
	2014	420	19	30	86	555

1. The review date for salary is 1 February 2016.

2. Benefits comprise a car allowance, life assurance, critical illness insurance and private medical insurance.

3. A cash allowance of equal value (15% of salary) may be taken in lieu of pension.

4. The 2014 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 2015 once the full set of comparator information was available. This resulted in an additional variable pay award of £60k earned by Executive Directors.

5. The 2015 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 2016 an assumption has been made that Principality's performance will be in line with the comparator group and that therefore an amount of 2.5% will be payable in respect of this measure. This figure will be adjusted upwards or downwards to

reflect actual performance once the 2015 results for the comparator group are published.

6. 50% of the variable pay award is paid in 2016 and 50% is paid in 2017. All deferred awards are subject to review annually 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. The Committee applied this discretion in 2015 and we will continue to ensure that all deferred pay is only payable when confirmed by the Group's performance in subsequent years.

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

8. The Group Risk Director does not participate in any variable pay scheme.

How the annual variable pay for 2015 was calculated

The 2015 annual variable pay awards for Executive Directors were calculated by reference to performance against a challenging sliding scale of Group Profit before Tax, Relative Return on Assets, Net Promoter Score and Customer Satisfaction targets. Performance in the year was 23.6%, demonstrated in the outcomes set out in the table below:

Variable pay scheme target	Proportion of variable pay	Actual 2015 performance	Threshold	Target	Stretch	Award %
Group Profit before Tax*	25%	£53.8m	£36.1m	£45.2m	£54.2m	9.8%
Relative Return on Assets	25%	Will not be available until May 2016	10 basis points below peer average	10 basis points above peer average	20 basis points above peer average	Will not be available until May 2016
Net Promoter Score ranking	25%	6.8	10th	6th	3rd	4.1%
Customer Satisfaction	25%	86.9%	80%	85%	87%	9.7%
Overall						23.6%

* Adjusted for one-off items

What the Executive Directors can earn for 2016

Base salary

The Committee reviews the Executive Directors' base salaries on 1 February of each financial year, taking into account factors such as individual and corporate performance, an assessment of market conditions and, most importantly, the salary increases applicable to the Group's other colleagues. The Remuneration Committee determines any salary increase based on that average percentage increase awarded to all colleagues. For 2016, they have awarded a 2% increase, the same as to all other colleagues.

Following this review, the Executive Directors' 2016 salaries are:

- Graeme Yorston £341,700
- Stephen Hughes £249,996
- R. Michael Jones £239,292

Benefits

The Executive Directors will receive the following benefits-in-kind, namely a car allowance, life assurance, critical illness insurance and private medical insurance.

Pension

The Company currently pays its Executive Directors a pension contribution of 15% of salary which may be taken as a cash allowance. From April 2016 when the pension rules change, it is likely that the Executive Directors will opt for this cash allowance.

Annual variable pay

As explained in the Chair's introductory letter, we are introducing a new all-colleague annual incentive plan called Rewarding Excellence Award from 1 January 2016. A summary is set out below:

Performance period	1 January 2016 to 31 December 2016
Participants	All employees of the Principality, except Executives such as R. Michael Jones who are responsible for reviewing risk.
Administrator	Remuneration Committee.
Initial gateway condition	Capital and liquidity conditions and the absence of any material regulatory breaches.
Performance measures	Group Profit before Tax – 50% Customer Satisfaction measures – 50%
Potential payments	Nil for threshold performance. 6% of salary for meeting challenging target performance. 12% of salary for attaining highly stretching targets.
Payment date	Subject to Audit and Remuneration Committee approval, in February 2017. There will be no partial deferral of payment.
Clawback (demanding repayment)	The Remuneration Committee can apply clawback to an award to an Executive Director and other senior executives if it is discovered that the award should not have been paid, in the event of a material misstatement of the Group's annual results or in the event of a serious regulatory breach.

Long-Term Incentive Plan

During the year the Committee decided that a LTIP was the best arrangement to ensure that the Society's most senior management is aligned to the longer-term corporate goals, prevailing market conditions, corporate governance best practice standards and the regulators' expectations.

The performance targets for the awards will be equally weighted between a financial value metric and a service excellence metric.

The level of the awards and the performance conditions are set out below:

Performance conditions	Weighting
Financial Value Metric	50%
Service Excellence Metric	50%

We are maintaining our policy that the maximum variable pay that the Chief Executive and Group Finance Director can be paid in any year is 40% of salary. In 2016 and later years, this will comprise a maximum 12% annual incentive award under the Rewarding Excellence Award (the all-colleague plan) and a maximum 28% of salary award under the LTIP.

The normal performance period of the LTIP will be three years and this will apply to awards that could be payable for the performance period 1 January 2016 to 31 December 2018, and subsequent ongoing three calendar year periods. As a transition to these longer assessments of performance we will have transitional arrangements in place whereby

the LTIP award vesting on 31 December 2016 will be assessed over 2016's performance only; and for the second LTIP award vesting on 31 December 2017, we will assess performance over the two years ending on that date.

Overall maximum variable pay opportunity for the executives is maintained at 40% of basic pay in aggregate, although via a combination of schemes. The Committee will have absolute discretion to adjust the awards under both schemes if necessary including withholding vested awards under "malus" arrangements or recovering monies paid under clawback.

No variable pay awards at the Society are pensionable.

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.

The Chairman and Non-Executive Directors' fees for 2015

The Chairman and Non-Executive Directors do not have service contracts and are subject to re-election at each year's AGM. Non-Executive Directors are paid a basic fee for participation on the Society 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 paid to the Non-Executive Directors is set at a level which allows the Society to attract and retain the required calibre of independent directors.

Fees paid to the Chairman and the Non-Executive Directors were as follows:

Non-Executive Directors	Fees	
	2015	2014
	£000	£000
Laurence Philip Adams (Chair from April 2014)	110	95
Nigel Annett	61	61
Natalie Elphicke OBE	57	53
Derek Howell (Senior Independent Director)	63	36
Sally Jones-Evans	50	-
Joanne Kenrick (to 30 September 2015)	34	46
Gordon MacLean (to 25 April 2015)	22	68
Menna Richards (to 30 September 2015)	41	53
David Rigney	50	-
Dyfrig John (to 17 April 2014)	-	31
Langley Davies (to 24 October 2014)	-	56
Total	488	499

Approval

This report was approved by the Remuneration Committee and signed on its behalf by:



Sally Jones-Evans
Chair of the Remuneration Committee

DIRECTORS' REPORT for the year ended 31 December 2015

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 2015.

Information on the Group's vision, strategy and business performance is given in the Strategic Report on pages 7 to 17.

Directors

The names of the Directors at the date of this report, together with brief biographical details, are listed on pages 41 to 43.

Three Non-Executive Directors resigned during the year. Gordon MacLean resigned from the Board following the 2015 Annual General Meeting on 24 April 2015. Joanne Kenrick and Menna Richards resigned from the Board with effect from 25 September 2015. During the year, Derek Howell succeeded Gordon MacLean as Senior Independent Director and Chairman of the Audit Committee. Sally Jones-Evans joined the Board on 24 February 2015 and David Rigney joined the Board on 9 March 2015. 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. 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 24 April 2015 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 pages 62 to 66, 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
- 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.

The Directors are also responsible for the maintenance and integrity of statutory and audited information on the Society's website, principality.co.uk. 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.

The Directors consider that the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary to assess the Group's performance, business model and strategy.

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
- 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 by the Prudential Regulatory Authority under the Financial Services Act 2012.

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.

During the year no significant control failure or weakness was reported to the Board. More detail on the internal monitoring of controls is set out in the report of the Audit Committee on page 50.

Long-term viability statement and going concern

The Directors have assessed the viability of the Group over a three year period taking into account the business strategy and the principal risks as set out in the Strategic Report and the Risk Management Report. The Directors have a reasonable expectation that the business can continue in operation and meet its liabilities as they fall due over the three year period of their assessment.

In making this statement the Directors have considered the resilience of the Group, taking account of its current position, the principal risks facing the business in severe but plausible scenarios, and the effectiveness of any mitigating actions. The assessment has considered the potential impacts of these risks on the business model, future performance, capital adequacy and liquidity over the period. The strategy and associated principal risks underpin the Group's three year plan and scenario testing, which the Directors review at least annually. The three year plan makes certain assumptions about the macroeconomic environment, the performance of the Group's lending portfolios and the availability of funding. The plan is stress tested through the Group's Internal Capital Adequacy Assessment Process ('ICAAP') and Internal Liquidity Adequacy Assessment Process ('ILAA'). These processes use both scenarios determined by the Bank of England and internal scenarios which reflect the specific nature of the Group's business. Included within these scenarios are substantial falls in residential and commercial property prices, increases in unemployment, changes to interest rates and reduced funding availability within wholesale and retail markets.

The Directors have determined that a three year period of assessment is an appropriate period over which to provide its viability statement. The three year period is considered to be most appropriate as it is the longest period over which the Board considers that it can form a reasonable view of the likely macroeconomic environment and associated key drivers of business performance.

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

Economic conditions have continued to improve during 2015. However there is a risk that the future prospects for the economy might be adversely impacted by slowing growth in China, the fall in oil prices and continuing pressures on public spending. Public and political interest in financial services will not diminish and we continue to work closely with our regulators, the Prudential Regulatory 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.

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 20 of these accounts.

The principal activities of the Group can be found in the Strategic Report and in note 20.

All group companies operate in the United Kingdom only.

b) Average number of employees

The average number of employees is disclosed in note 9.

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 2015.

No political donations were made by the Society in the year.

On behalf of the Board of Directors.



Laurence Philip Adams
Chairman

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS 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 2015 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 35. 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 regarding the appropriateness of the going concern basis of accounting and the Directors' statement on the longer-term viability of the Group contained within the Directors' report on page 61. We have nothing material to add or draw attention to in relation to:

- The Directors' confirmation on pages 27 to 40 that they have carried out a robust assessment of the principal risks facing the group, including those that would threaten its business model, future performance, solvency or liquidity;
- The disclosures on pages 27 to 40 that describe those risks and explain how they are being managed or mitigated;
- The Directors' statement on page 61 about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements;

- The Director's explanation on page 61 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We agreed with the Directors' adoption of the going concern basis of accounting and we did not identify any such material uncertainties. 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.

Independence

We are required to comply with the Financial Reporting Council's Ethical Standards for Auditors and we confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the prohibited non-audit services referred to in those standards.

Our assessment of risks of material misstatement

The assessed risks of material misstatement described overleaf 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 evaluated the design and implementation of the associated key controls identified.

Our assessment of risks of material misstatement (cont.)

Risk	How the scope of our audit responded to the risk
<p>Loan loss provisions The Group holds £49.2 million of impairment provisions at year-end (2014: £62.7 million) against total loans and advances to customers of £6,544.9 million (2014: £6,139.9 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.</p> <p>Loan loss provision balances are detailed within notes 18 and 32. Management's associated accounting policies are detailed on page 79 with detail about judgements in applying accounting policies and critical accounting estimates on page 83.</p>	<p>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 115); and using our internal real estate specialists to provide advice on commercial lending market forecasts.</p> <p>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.</p>
<p>Revenue recognition 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 £13.8 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 (2014: £15.2 million).</p> <p>Management's associated accounting policies are detailed on page 77 to 78 with detail about judgements in applying accounting policies and critical accounting estimates on page 84.</p>	<p>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.</p> <p>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.</p>

The description of risks above should be read in conjunction with the significant issues considered by the Audit Committee discussed on page 49–52.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these 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
Valuation of structured products	The valuation of complex financial instruments has been identified as a key risk for a number of years. Our controls testing did not identify any significant weaknesses in the control environment and no misstatements were required to be reported to the Audit Committee.
Financial Services Compensation Scheme levy	There were a number of changes to the timing of the recognition of the levy in the Group's 2013 financial reporting which resulted in our assessment of audit risk being significant. No significant matters were noted during our 2015 audit and no proposed changes to how levies are charged this year.
Provisions for customer remediation	The remediation was largely completed during the previous year and no material provision exists at the reporting date.
Retirement benefit obligations	There were a number of material changes to the scheme during the prior year, which resulted in our assessment of audit risk being significant. On the basis that no significant changes have been made or are planned to be made in 2015, we have classified this as a normal risk.
Financing transactions	The accounting for one of the Group's special purpose entities, Friary No.2 plc, was identified as a key risk in the 2014 audit as it represented the first year within the Group. The accounting was assessed against the requirements of IFRS 10 with no errors identified.

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 a benchmark for determining materiality. We have calculated materiality by applying 5.0% of this benchmark.

We determined planning materiality for the Group to be £2.6 million (2014: £2.2 million) which represents 0.03% of total Group assets (2014: 0.03%). This was calculated on the basis of profit before tax. The prior year materiality was adjusted for the following exceptional gains recognised during the prior 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; and
- £10.5 million gain following the sale of a Group subsidiary, Peter Alan.

No similar exceptional items were considered as part of our materiality determination in the current year.

We agreed with the Audit Committee that we would report to the committee all audit differences in excess of £51,600 (2014: £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 £1,026,800 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 61 for the financial year ended 31 December 2015 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

<p>Adequacy of explanations received and accounting records</p>	<p>Under the Building Societies Act 1986 we are required to report to you if, in our opinion:</p> <ul style="list-style-type: none"> • Proper accounting records have not been kept by the Society; or • The Society financial statements are not in agreement with the accounting records; or • We have not received all the information and explanations and access to documents we require for our audit. <p>We have nothing to report in respect of these matters.</p>
<p>Our duty to read other information in the Annual Report</p>	<p>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:</p> <ul style="list-style-type: none"> • Materially inconsistent with the information in the audited financial statements; or • Apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or • Otherwise misleading. <p>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.</p>

<p>Respective responsibilities of Directors and auditor</p>	<p>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). 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.</p> <p>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.</p>
<p>Scope of the audit of the financial statements</p>	<p>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.</p>



Matthew Perkins ACA (Senior statutory auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor, Cardiff
9 February 2016

FINANCIAL STATEMENTS

Consolidated income statement for the year ended 31 December 2015

	Notes	2015 £m	2014 £m
Continuing operations			
Interest receivable and similar income	4	243.3	258.0
Interest payable and similar charges	5	(109.2)	(124.2)
Net interest income		134.1	133.8
Fees and commission receivable	6	6.5	7.6
Fees and commission payable		(1.1)	(1.0)
Net fee and commission income		5.4	6.6
Other operating income		1.4	1.5
Other fair value gains/(losses)	7	0.9	(1.5)
Net operating income		141.8	140.4
Administrative expenses	8	(77.1)	(55.6)
Depreciation and amortisation	21 & 22	(6.6)	(9.1)
Operating expenses		(83.7)	(64.7)
Impairment provision for losses on loans and advances	18	(4.8)	(13.5)
Provision for other liabilities and charges	19	(4.3)	(8.7)
Operating profit and profit before taxation from continuing operations		49.0	53.5
Taxation expense	12	(11.3)	(11.7)
Profit for the year from continuing operations		37.7	41.8
Profit for the year from discontinued operations		-	10.5
Total profit for the year		37.7	52.3

Consolidated statement of other comprehensive income

	Notes	2015 £m	2014 £m
Profit for the year		37.7	52.3
Items that will not be reclassified subsequently to profit and loss:			
Actuarial gain/(loss) on retirement benefit obligations	11	1.1	(1.6)
Taxation	12	(0.1)	0.4
Items that may be reclassified subsequently to profit and loss:			
(Loss)/gain on available-for-sale assets		(1.3)	7.1
Taxation	12	0.3	(1.5)
Total comprehensive income for the year		37.7	56.7

The accounting policies and notes on pages 76 to 120 form part of these accounts.

Income statement of the Society for the year ended 31 December 2015

	Notes	2015 £m	2014 £m
Continuing operations			
Interest receivable and similar income	4	216.3	225.9
Interest payable and similar charges	5	(107.8)	(126.0)
Net interest income		108.5	99.9
Fees and commission receivable	6	6.1	6.9
Fees and commission payable		(0.7)	(0.6)
Net fee and commission income		5.4	6.3
Other operating income		2.7	3.1
Other fair value (losses)/gains	7	(0.4)	0.5
Net operating income		116.2	109.8
Administrative expenses	8	(65.7)	(46.2)
Depreciation and amortisation	21 & 22	(6.1)	(8.0)
Operating expenses		(71.8)	(54.2)
Impairment provision for losses on loans and advances	18	(6.2)	(11.3)
Provision for other liabilities and charges	19	(3.3)	(4.8)
Operating profit		34.9	39.5
Profit from the sale of investment in subsidiary		-	12.3
Profit before taxation from continuing operations		34.9	51.8
Taxation expense	12	(8.0)	(9.0)
Profit for the year from continuing operations		26.9	42.8
Loss for the year from discontinued operations		-	(0.4)
Total profit for the year		26.9	42.4

Statement of other comprehensive income of the Society

	Notes	2015 £m	2014 £m
Profit for the year		26.9	42.4
Items that will not be reclassified subsequently to profit and loss:			
Remeasurement of net defined benefit liability	11	1.1	(1.6)
Taxation	12	(0.1)	0.4
Items that may be reclassified subsequently to profit and loss:			
(Loss)/gain on available-for-sale assets		(1.3)	7.1
Taxation	12	0.3	(1.5)
Total comprehensive income for the year		26.9	46.8

The accounting policies and notes on pages 76 to 120 form part of these accounts.

Consolidated statement of financial position at 31 December 2015

	Notes	2015 £m	2014 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		357.6	432.6
Loans and advances to credit institutions	13	166.6	150.7
Debt securities	14	437.8	454.1
		962.0	1,037.4
Derivative financial instruments	15	21.3	30.9
Loans and advances to customers:			
Loans fully secured on residential property		6,210.1	5,720.4
Other loans		334.8	419.5
	16	6,544.9	6,139.9
Intangible fixed assets	21	1.4	1.8
Property, plant and equipment	22	46.5	43.9
Deferred tax assets	27	1.1	2.0
Other assets		3.0	3.0
Prepayments and accrued income		4.2	6.1
Total assets		7,584.4	7,265.0
Liabilities			
Shares	23	5,621.8	5,613.0
Deposits and debt securities:			
Amounts owed to credit institutions	24	543.1	227.5
Amounts owed to other customers		280.9	173.9
Debt securities in issue	25	463.5	600.3
		1,287.5	1,001.7
Derivative financial instruments	15	31.4	42.8
Current tax liabilities		5.2	7.0
Other liabilities	26	7.8	4.4
Provisions for liabilities	19	3.8	3.9
Accruals and deferred income		11.7	9.5
Deferred tax liabilities	27	-	0.3
Retirement benefit obligations	11	4.1	6.9
Subordinated liabilities	28	92.3	92.3
Subscribed capital	29	69.8	71.9
Total liabilities		7,135.4	6,853.7
General reserve		447.4	408.7
Other reserves		1.6	2.6
Total equity and liabilities		7,584.4	7,265.0

The accounting policies and notes on pages 76 to 120 form part of these accounts.

These accounts were approved by the Board on 9 February 2016. 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 2015

	Notes	2015 £m	2014 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		357.6	432.6
Loans and advances to credit institutions	13	58.6	49.7
Debt securities	14	437.8	454.1
		854.0	936.4
Derivative financial instruments	15	21.3	30.9
Loans and advances to customers:			
Loans fully secured on residential property		5,720.8	5,240.8
Other loans		306.9	370.6
	16	6,027.7	5,611.4
Investments in subsidiary undertakings	20	451.8	475.4
Intangible fixed assets	21	1.4	1.8
Property, plant and equipment	22	45.2	42.6
Deferred tax assets	27	1.1	2.0
Other assets		2.2	1.8
Prepayments and accrued income		3.8	5.7
Total assets		7,408.5	7,108.0
Liabilities			
Shares	23	5,621.8	5,613.0
Deposits and debt securities:			
Amounts owed to credit institutions	24	886.7	689.1
Amounts owed to other customers		280.9	173.9
Debt securities in issue	25	11.6	38.3
		1,179.2	901.3
Derivative financial instruments	15	30.7	40.8
Current tax liabilities		3.9	5.4
Other liabilities	26	6.8	4.3
Provisions for liabilities	19	2.7	3.4
Accruals and deferred income		9.8	8.0
Deferred tax liabilities	27	0.3	0.5
Retirement benefit obligations	11	4.1	6.9
Subordinated liabilities	28	92.3	92.3
Subscribed capital	29	69.8	71.9
Total liabilities		7,021.4	6,747.8
General reserve		385.5	357.6
Other reserves		1.6	2.6
Total equity and liabilities		7,408.5	7,108.0

The accounting policies and notes on pages 76 to 120 form part of these accounts.

These accounts were approved by the Board on 9 February 2016. Signed on behalf of the Board:

Laurence Philip Adams
Chairman



Graeme H. Yorston
Group Chief Executive



Stephen Hughes
Group Finance Director



Statement of changes in Members' interests for the year ended 31 December 2015

	2015			2014		
	General Reserve	Available for Sale Reserve	Total Equity attributable to Members	General Reserve	Available for Sale Reserve	Total Equity attributable to Members
	£m	£m	£m	£m	£m	£m
Group						
At 1 January	408.7	2.6	411.3	357.7	(3.0)	354.7
Comprehensive income for the year	38.7	(1.0)	37.7	51.0	5.6	56.6
At 31 December	447.4	1.6	449.0	408.7	2.6	411.3
Society						
At 1 January	357.6	2.6	360.2	316.4	(3.0)	313.4
Comprehensive income for the year	27.9	(1.0)	26.9	41.2	5.6	46.8
At 31 December	385.5	1.6	387.1	357.6	2.6	360.2

Consolidated statement of cash flows for the year ended 31 December 2015

	2015 £m	2014 £m
Net cash outflow from operating activities (see below)	(65.4)	(9.3)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(9.1)	(7.6)
Disposal proceeds of property, plant and equipment	0.3	-
Purchase of investment securities	(91.8)	(232.1)
Proceeds from sale and maturity of investment securities	106.8	351.2
Net proceeds from disposal of discontinued operations	-	15.2
Cash flows from financing activities	-	-
(Decrease)/increase in cash and cash equivalents	(59.2)	117.4
Cash and cash equivalents at beginning of year	583.4	466.0
Cash and cash equivalents at end of year	524.2	583.4
Represented by		
Cash and balances with the Bank of England	357.6	432.6
Loans and advances to credit institutions repayable on demand	166.6	150.8
	524.2	583.4
Net cash outflow from operating activities		
Profit after taxation	37.7	52.3
Adjusted for		
Depreciation and amortisation	6.6	9.2
Impairment losses on loans and advances to customers	4.8	13.5
Change in fair values	2.9	(20.7)
Taxation charge	11.3	11.7
Gain on disposal of discontinued operations	-	(10.5)
Other non-cash movements	1.1	(10.7)
Changes in net operating assets		
Decrease in loans and advances to credit institutions	-	10.0
(Increase) in loans and advances to customers	(419.9)	(221.1)
Decrease in other assets	-	3.2
Decrease in prepayments and accrued income	1.9	4.8
Change in derivative financial instruments	(1.8)	23.3
Increase in shares	14.5	45.2
Increase in deposits and debt securities	285.0	99.3
Increase/(decrease) in other liabilities	3.4	(3.9)
(Decrease) in provisions for liabilities	(0.1)	(8.9)
Increase in accruals and deferred income	2.2	0.8
(Decrease) in pension fund obligations	(2.8)	(1.8)
Taxation	(12.2)	(5.0)
	(65.4)	(9.3)

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2015 amounted to £10.9m (2014: £11.2m).

Statement of cash flows of the Society for the year ended 31 December 2015

	2015 £m	2014 £m
Net cash outflow from operating activities (see below)	(72.7)	(40.1)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(8.7)	(7.2)
Disposal proceeds of property, plant and equipment	0.3	-
Purchase of investment securities	(91.8)	(232.1)
Proceeds from sale and maturity of investment securities	106.8	351.2
Net proceeds from disposal of subsidiary company	-	15.2
Cash flows from financing activities	-	-
(Decrease)/increase in cash and cash equivalents	(66.1)	87.0
Cash and cash equivalents at beginning of year	482.3	395.3
Cash and cash equivalents at end of year	416.2	482.3
Represented by		
Cash and balances with the Bank of England	357.6	432.6
Loans and advances to credit institutions repayable on demand	58.6	49.7
	416.2	482.3
Net cash outflow from operating activities		
Profit after taxation	26.9	42.4
Adjusted for		
Depreciation and amortisation	6.1	8.1
Impairment losses on loans and advances to customers	6.2	11.3
Change in fair values	2.9	(20.7)
Taxation charge	8.0	9.0
Gain on disposal of subsidiary company	-	(12.3)
Other non-cash movements	1.3	(9.5)
Changes in net operating assets		
Decrease in loans and advances to credit institutions	-	10.0
(Increase) in loans and advances to customers	(432.5)	(256.9)
Decrease in loans to subsidiary companies	23.7	44.8
(Increase)/decrease in other assets	(0.5)	1.2
Decrease in prepayments and accrued income	2.0	4.2
Change in derivative financial instruments	(0.5)	21.3
Increase in shares	14.6	45.3
Increase in deposits and debt securities	276.9	68.0
Increase/(decrease) in other liabilities	2.5	(1.0)
(Decrease) in provisions for liabilities	(0.6)	(0.2)
Increase in accruals and deferred income	1.8	0.4
(Decrease) in pension fund obligations	(2.8)	(1.8)
Taxation	(8.7)	(3.7)
	(72.7)	(40.1)

Notes to the accounts for the year ended 31 December 2015

1. Accounting policies

Basis of preparation

The Group and Society's financial statements for the year ended 31 December 2015 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 61, under the heading 'Long-Term Viability Statement and 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 9 Financial Instruments	In July 2014, the International Accounting Standards Board (IASB) published the final version of IFRS 9 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
	Classification and Measurement The revised classification and measurement approach will lead to the Group's Financial Assets being reclassified as either amortised cost, fair value through other comprehensive income, or fair value through the income statement. Classification will be based on an analysis of the objectives of the Group's business model, and the contracted cash flow characteristics of its financial assets. Financial liabilities will in most cases be accounted for at present value.	
	Recognition of Impairment The impairment of financial assets under IFRS 9 will be calculated based on an expected credit loss model rather than the current incurred loss model under IAS 39. At initial recognition, a provision is required for expected credit losses within the next 12 months. Following a significant increase in Credit Risk, a lifetime expected credit loss is required to be recognised.	
	Hedge Accounting The revised hedge accounting requirements are designed to create a stronger alignment with the economic management of risk. IFRS 9 allows for the option to continue to apply the existing hedge accounting requirements of IAS 39 until the separate IASB project to consider dynamic risk management is completed.	
IFRS 11 Joint Arrangements	In May 2014, the IASB clarified details within IFRS 11 regarding accounting for Joint Arrangements. Accounting for Acquisitions of Interests in Joint Operations (Amendments to IFRS 11) amends IFRS 11 such that the acquirer of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3, is required to apply all of the principles on business combinations accounting in IFRS 3 and other IFRSs with the exception of those principles that conflict with the guidance in IFRS 11.	Accounting periods beginning on or after 1 January 2016

Notes to the accounts for the year ended 31 December 2015

1. Accounting policies (cont.)

Pronouncement	Nature of Change	Effective Date
IFRS 15 Revenue from Contracts with Customers	The changes to IFRS 15 are due to take effect from reporting periods from 1 January 2018. IFRS 15 specifies how and when an IFRS reporter will recognise revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures. IFRS 15 is due to supersede IAS 11, IAS 18, IFRIC 13, IFRIC 15 and IFRIC 18.	Accounting periods beginning on or after 1 January 2018
Annual Improvements to IFRSs 2012-2014 Cycle	As part of the Annual Improvements Cycle there have been a number of small changes made to the following accounting standards, IFRS 5 Non Current Assets Held for Sale and Discontinued Operation, IFRS 7 Financial Instruments, IAS 19 Employee Benefits and IAS 34 Interim Financial Reporting.	Accounting periods beginning on or after 1 January 2016

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 available-for-sale debt securities, 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 where 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.

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

Notes to the accounts for the year ended 31 December 2015

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 for 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 a loan.

Fees received for loan servicing and other business process outsourcing is reflected in the income statement in the period that the activity 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 (PPI) 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.

Measurement of financial assets and liabilities

Financial assets

Financial assets are classified as:

i) Loans and receivables

Loans and receivables are non-derivative 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.

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 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.

Notes to the accounts for the year ended 31 December 2015

1. Accounting policies (cont.)

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 31.

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 are 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
- 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

Notes to the accounts for the year ended 31 December 2015

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 31 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 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.

Loans and advances to credit institutions

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.

Derivative financial instruments and hedge accounting

The Group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, forward rate agreements, 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 IAS 39, 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
- iii) The underlying item matures or is sold or repaid.

Notes to the accounts for the year ended 31 December 2015

1. Accounting policies (cont.)

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.

ii) Computer software

IAS 38 '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.

Taxation

The tax expense represents the sum of the current tax charge and deferred tax movement.

The current tax charge 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 liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences. Deferred tax assets are defined as the amounts of income taxes recoverable in future periods. 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. 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 remeasurement 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 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,

Notes to the accounts for the year ended 31 December 2015

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	2% or unexpired period of the lease
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. 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

All 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.

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.

Notes to the accounts for the year ended 31 December 2015

1. Accounting policies (cont.)

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.

Advertising and promotional costs

Advertising and promotional costs are expensed as incurred. Where payment has been made in advance of the rendering of the service or the delivery of goods, a prepayment is recognised. The costs are then recognised in the income statement on a straight-line basis over the term of the contract.

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 that the HPI movements were to differ from current observations by 1%, the impact on provisions would be £0.4m. The impact of a 1% change in the forced sale discounts currently being experienced would impact provisions by £0.4m.

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.

Notes to the accounts for the year ended 31 December 2015

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 using 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. 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.

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 £0.7m. 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 11.

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 £0.9m/(£0.3m) 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 £0.6m/(£0.6m) respectively.

Customer and regulatory complaints

The Group holds provisions for customer and regulatory complaints. Provisions have been made in respect of claims in relation to PPI which in the Group's case relate to secured personal lending PPI products. 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.

The Group notes that the FCA is expected to finalise rules and guidance in relation to the handling of PPI complaints in relation to the 2014 Supreme Court decision in *Plevin vs Paragon Personal Finance Ltd* (*Plevin*), and will monitor the developments on these proposed rules and guidance.

Notes to the accounts for the year ended 31 December 2015

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.

	2015				
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Adjustment for Group transactions £m	Total £m
Net interest income	93.6	13.7	26.8	-	134.1
Other income and charges	5.8	1.9	-	-	7.7
Net operating income	99.4	15.6	26.8	-	141.8
Operating expenses	(66.7)	(4.0)	(13.0)	-	(83.7)
Impairment provision for losses on loans and advances	(1.2)	(5.0)	1.4	-	(4.8)
Provision for other liabilities and charges	(2.7)	(0.4)	(1.2)	-	(4.3)
Operating profit and profit before taxation	28.8	6.2	14.0	-	49.0
Taxation expense					(11.3)
Profit for the period from discontinued operations					-
Total profit for the year					37.7

	2014				
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Adjustment for Group transactions* £m	Total £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
Operating 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 and profit before taxation	26.9	1.2	13.9	11.5	53.5
Taxation expense					(11.7)
Profit for the period from discontinued operations					10.5
Total 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.

Notes to the accounts for the year ended 31 December 2015

	Group	
	2015 £m	2014 £m
Total assets by business segment		
Retail financial services	6,288.5	5,921.6
Secured personal lending	522.3	530.9
Commercial lending	773.6	812.5
Total assets	7,584.4	7,265.0
Total liabilities and equity by business segment		
Retail financial services and Commercial lending	7,062.1	6,734.1
Secured personal lending	522.3	530.9
Total liabilities and equity	7,584.4	7,265.0

Retail financial services and commercial lending are part of the same legal entity and liabilities are not shown for each business segment for internal reporting purposes.

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

4. Interest receivable and similar income

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
On loans fully secured on residential property	240.9	248.8	198.5	203.7
On other loans	15.1	17.6	15.1	17.6
On loans to subsidiaries	-	-	15.6	13.0
On debt securities	4.6	5.6	4.6	5.6
Profit on realisation of investments	-	0.2	-	0.2
On other liquid assets	2.0	2.4	1.8	2.4
On derivative financial instruments	(19.3)	(16.6)	(19.3)	(16.6)
	243.3	258.0	216.3	225.9

5. Interest payable and similar charges

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
On shares held by individuals	97.9	113.9	97.9	113.9
On deposits and debt securities	15.9	15.6	16.7	18.9
On subscribed capital	4.3	4.2	4.3	4.2
On subordinated liabilities	1.5	1.4	1.5	1.4
On derivative financial instruments	(10.4)	(10.9)	(12.6)	(12.4)
	109.2	124.2	107.8	126.0

Notes to the accounts for the year ended 31 December 2015

6. Fees and commission receivable

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Insurance and related financial service products	2.0	2.5	2.0	2.5
Mortgage related fees	4.0	4.3	4.0	4.3
Other fees and commission	0.5	0.8	0.1	0.1
	6.5	7.6	6.1	6.9

7. Other fair value gains and losses

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Gains/(losses) on derivatives	1.8	(23.3)	0.5	(21.3)
(Losses)/gains on hedged items attributable to the hedged risk	(0.9)	21.8	(0.9)	21.8
	0.9	(1.5)	(0.4)	0.5

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.

8. Administrative expenses

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Wages and salaries	37.1	33.7	31.6	28.9
Social security costs	3.9	3.4	3.5	3.0
Other pension costs*	1.9	(8.2)	1.7	(8.4)
	42.9	28.9	36.8	23.5
Other administrative expenses	29.7	26.7	24.4	22.7
Nemo strategic review and restructuring costs	4.5	-	4.5	-
	77.1	55.6	65.7	46.2

* Included in other pensions costs for 2014 is the pension past service credit of £10.1m. Further details can be found in note 11.

The Group has incurred exceptional costs of £4.5m in the year in respect of a strategic review of its subsidiary business, Nemo Personal Finance Limited. This related to the costs of the process to market the business and identify potential buyers, together with the restructuring cost associated with the decision to cease origination of new business.

Notes to the accounts for the year ended 31 December 2015

	Group		Society	
	2015 £000	2014 £000	2015 £000	2014 £000
Other administrative expenses include:				
Auditor's remuneration				
For audit of the Society's Annual Accounts	175	168	175	168
For audit of the Society's subsidiaries	16	13	-	-
Total	191	181	175	168
For other services				
Tax advisory	92	86	87	86
Further assurance services	80	124	29	124
All other services	-	20	-	20
Total other services	172	230	116	230
Operating lease charges				
- motor vehicles	225	243	225	243
- land and buildings	1,536	1,492	1,024	987

9. Employees

The average number employed including Executive Directors was:

	Full-time		Part-time	
	2015 Number	2014 Number	2015 Number	2014 Number
Society's Customer Support Centre and administration office	578	572	90	80
Society branch offices	200	191	123	134
Employed by the Society	778	763	213	214
Subsidiaries	109	199	19	45
Employed by the Group	887	962	232	259

10. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on pages 56 and 59 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 £1.6m (2014: £2.2m).

11. 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 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 2015 was £1.7m (2014: £1.7m). There were no contributions outstanding or prepaid at the end of the year.

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.

Notes to the accounts for the year ended 31 December 2015

11. Retirement benefit obligations (cont.)

Defined benefit scheme (cont.)

The defined benefit scheme was subject to a triennial valuation by the scheme's independent actuary on 30 September 2013.

The defined benefit scheme closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the GFRP, described on page 88.

During 2012, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the scheme with Legal & General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal & 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 was recognised in the statement of other comprehensive income.

A further £1.9m was paid into the pension scheme from the Society during 2015.

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.

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRS is £20.2m (2014: £21.3m).

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

	At 31 December				
	2015 %	2014 %	2013 %	2012 %	2011 %
Rate of increase in pensionable salaries	2.20	2.05	3.50	3.00	3.05
Rate of increase of pensions in payment and deferred pensions	2.20	2.05	3.50	3.00	3.05
Discount rate	3.75	3.55	4.50	4.60	4.70
Inflation assumption (RPI)	3.15	3.05	3.50	3.00	3.05
Inflation assumption (CPI)	2.15	2.05	2.70	2.60	2.25

The assumptions on mortality are determined by the following tables:

	2015	2014
Retired and non-retired members	SAPS CMI2015 LTR1.25%	SAPS CMI2013 LTR1.25%
The assumptions are illustrated by the following year of life expectancy at age 65:		
Retired members		
Males currently aged 65	22.1	22.4
Females currently aged 65	24.5	24.8
Non-retired members		
Males currently aged 45	23.8	24.1
Females currently aged 45	26.5	26.7

Notes to the accounts for the year ended 31 December 2015

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

	At 31 December				
	2015 £m	2014 £m	2013 £m	2012 £m	2011 £m
Target return funds	27.1	26.5	25.0	24.2	22.6
Debt securities	-	-	-	-	22.6
Annuities	23.5	25.2	23.4	22.7	-
Bonds and cash	3.5	2.9	1.3	0.5	0.9
Total fair value of plan assets	54.1	54.6	49.7	47.4	46.1
Present value of funded obligations	(57.7)	(61.0)	(66.3)	(60.1)	(57.1)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net deficit recognised in the statement of financial position	(4.1)	(6.9)	(17.1)	(13.2)	(11.5)

The actual return on plan assets was £1.8m (2014: £2.9m).

The amounts recognised in the income statement are as follows:

	Group and Society	
	2015 £m	2014 £m
Analysis of the amounts recognised in the income statement		
Interest on pension scheme assets	(1.7)	(2.2)
Interest on pension scheme liabilities	1.9	2.6
Net interest expense	0.2	0.4
Past service credit	-	(10.1)
Total amount recognised in the income statement	0.2	(9.7)
Analysis of amount recognised in statement of other comprehensive income		
(Loss)/gain on scheme assets in excess of interest	(1.8)	2.4
Experience losses on liabilities	1.2	-
Gains from changes to demographic assumptions	0.6	0.9
Gains/(losses) from changes to financial assumptions	1.1	(4.9)
Total remeasurement	1.1	(1.6)
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(6.9)	(17.1)
Movement in year:		
Net interest expense	(0.2)	(0.4)
Remeasurements	1.1	(1.6)
Contributions paid and accrued	1.9	2.1
Past service credit	-	10.1
Deficit in scheme at end of year	(4.1)	(6.9)

Notes to the accounts for the year ended 31 December 2015

11. Retirement benefit obligations (cont.)

Defined benefit scheme (cont.)

	Group and Society	
	2015 £m	2014 £m
Analysis of the movement in the fair value of pension scheme assets		
Fair value of assets at the beginning of the year	54.6	49.7
Interest on assets	1.9	2.2
Society contributions	1.9	2.1
Benefits paid	(2.6)	(1.8)
Return on plan assets less interest	(0.1)	0.6
Change in fair value of the annuity policy	(1.6)	1.8
Fair value of assets at the end of the year	54.1	54.6

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 into 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.

	Group and Society	
	Increase 0.5% £m	Decrease 0.5% £m
Discount rate	(3.9)	4.2
Inflation	3.7	(3.4)
Life expectancy (+1 year/-1 year)	1.7	(1.7)

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.

12. Taxation

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Current tax				
UK corporation tax charge for the year	11.3	10.8	8.5	7.6
Adjustments in respect of prior years	0.1	(1.0)	(0.4)	(0.5)
	11.4	9.8	8.1	7.1
Deferred tax				
Deferred tax (credit)/charge for year	(0.5)	1.4	(0.5)	1.4
Adjustments in respect of prior years	0.4	0.5	0.4	0.5
	(0.1)	1.9	(0.1)	1.9
Taxation on profit on ordinary activities	11.3	11.7	8.0	9.0

The statutory rate of corporation tax was reduced to 20.0% from 1 April 2015. The Group was subject to corporation tax at a rate of 21.0% for the period 1 January to 31 March 2015, and 20.0% for the period 1 April to 31 December 2015, resulting in an effective rate of corporation tax of 20.3% for the full year in 2015.

Notes to the accounts for the year ended 31 December 2015

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	
	2015 £m	2014 £m	2015 £m	2014 £m
Profit before taxation	49.0	64.0	34.9	51.4
Profit multiplied by the standard rate of corporation tax at 20.3% (2014: 21.5%)	9.9	13.8	7.0	11.0
Effects of				
Expenses not deductible for tax purposes	0.9	1.1	0.9	0.8
Adjustments to prior years	0.5	(0.4)	0.1	-
Other	-	(2.8)	-	(2.8)
Total taxation for the year	11.3	11.7	8.0	9.0

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	
	2015 £m	2014 £m	2015 £m	2014 £m
Current tax				
Relating to retirement benefit obligations	(0.6)	(0.6)	(0.6)	(0.6)
Revaluations of available-for-sale financial assets	(0.3)	1.5	(0.3)	1.5
	(0.9)	0.9	(0.9)	0.9
Deferred tax				
Relating to retirement benefit obligations	0.7	0.2	0.7	0.2
	0.7	0.2	0.7	0.2
Total charged to other comprehensive income	(0.2)	1.1	(0.2)	1.1

13. Loans and advances to credit institutions

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Loans and advances to credit institutions	166.6	150.7	58.6	49.7

Included in the above amount for the Group is £56.4m of collateral given under a Credit Support Annex (CSA) (2014: £32.9m).

Notes to the accounts for the year ended 31 December 2015

14. Debt securities

	Group and Society	
	2015 £m	2014 £m
Issued by UK Government	349.9	300.5
Issued by Supranational entities	51.0	79.1
Issued by other borrowers and unlisted	36.9	74.5
	437.8	454.1

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

	Group and Society	
	2015 £m	2014 £m
At 1 January	454.1	566.0
Additions	91.8	232.2
Disposals and maturities	(106.7)	(349.5)
Gains/(losses) from changes in fair value	(1.3)	7.1
(Decrease)/increase in accrued interest	(0.1)	(1.7)
At 31 December	437.8	454.1

15. Derivative financial instruments

The Group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, forward rate agreements, and similar instruments. These are commitments to exchange one set of cash flows for another. No exchange of principal takes place.

	Group			
	Contract/notional amount		Fair value	
	2015 £m	2014 £m	2015 £m	2014 £m
Derivative assets:				
Interest rate swaps	1,731.4	1,936.7	17.7	26.2
Cross currency interest rate swaps	-	15.5	-	2.0
Equity and RPI index linked interest rate swaps	32.8	36.1	3.6	2.7
Total recognised derivative assets	1,764.2	1,988.3	21.3	30.9
Derivative liabilities:				
Interest rate swaps	3,047.3	2,690.1	(31.4)	(42.8)
Total recognised derivative liabilities	3,047.3	2,690.1	(31.4)	(42.8)

Notes to the accounts for the year ended 31 December 2015

15. Derivative financial instruments (cont.)

	Society			
	Contract/notional amount		Fair value	
	2015 £m	2014 £m	2015 £m	2014 £m
Derivative assets:				
Interest rate swaps	1,731.4	1,936.7	17.7	26.2
Cross currency interest rate swaps	-	15.5	-	2.0
Equity and RPI index linked interest rate swaps	32.8	36.1	3.6	2.7
Total recognised derivative assets	1,764.2	1,988.3	21.3	30.9
Derivative liabilities:				
Interest rate swaps	2,782.7	2,374.5	(30.7)	(40.8)
Total recognised derivative liabilities	2,782.7	2,374.5	(30.7)	(40.8)

16. Loans and advances to customers

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Fully secured on residential property	6,198.1	5,708.1	5,693.6	5,213.7
Fully secured on land	330.6	393.4	330.6	393.4
Other loans	24.6	48.9	-	-
	6,553.3	6,150.4	6,024.2	5,607.1
Provision for impairment losses	(49.2)	(62.7)	(31.0)	(37.2)
Unamortised loan origination fees	13.8	15.2	7.5	4.5
Fair value adjustment for hedged risk	27.0	37.0	27.0	37.0
	6,544.9	6,139.9	6,027.7	5,611.4

17. Asset encumbrance

The wholesale funding initiatives of the Group require that from time-to-time certain assets become encumbered as collateral against such funding. Assets that have been utilised in this way cannot be used for other purposes. The Group's principal forms of encumbrance relate to secured funding transactions and third party sale and repurchase agreements, with encumbrance also arising from excess collateral balances and cash collateral posted. As at 31 December 2015 the encumbrance ratio was 21.1% (31 December 2014: 19.0%). All other assets are defined as unencumbered.

Notes to the accounts for the year ended 31 December 2015

17. Asset encumbrance (cont.)

An analysis of the Group's encumbered and unencumbered on-balance sheet assets as at 31 December 2015 is set out below. The table does not include off-balance sheet assets received by the Group as part of its participation in the FLS, which the Group is permitted to reuse.

	2015		2014	
	Encumbered £m	Unencumbered £m	Encumbered £m	Unencumbered £m
Cash in hand and balances at the Bank of England	-	357.6	-	432.6
Loans and advances to credit institutions	143.5	23.1	133.9	16.8
Debt securities	-	437.8	-	454.1
Derivative financial instruments	-	21.3	-	30.9
Loans and advances to customers	1,457.6	5,087.3	1,246.0	4,893.9
Other assets	-	56.2	-	56.8
Total	1,601.0	5,983.4	1,379.9	5,885.1

18. Provision for impairment losses

	Specific £m	Collective £m	Total £m
2015			
Group			
At 1 January 2015	36.6	26.1	62.7
Amounts written off during the year	(18.3)	-	(18.3)
Charge for loan impairment	1.0	3.8	4.8
At 31 December 2015	19.3	29.9	49.2
Society			
At 1 January 2015	22.3	14.9	37.2
Amounts written off during the year	(12.4)	-	(12.4)
Charge for loan impairment	3.0	3.2	6.2
At 31 December 2015	12.9	18.1	31.0
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

Notes to the accounts for the year ended 31 December 2015

19. Provisions for liabilities

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
At 1 January	3.9	12.7	3.4	3.6
Additions	4.3	8.7	3.3	4.8
Utilisation	(4.4)	(17.5)	(4.0)	(5.0)
At 31 December	3.8	3.9	2.7	3.4

Included in provisions is the FSCS levy of £1.7m which is the expected interest charge for scheme year April 2015 to March 2016.

Other provisions of £1.0m are held in respect of various customer and regulatory complaints (2014: £1.7m).

The contingent aspect of such provisions is described in note 30.

20. Investments in subsidiary undertakings

	Society	
	2015 £m	2014 £m
Shares in subsidiary undertakings	0.1	0.1
Loans to subsidiary undertakings	451.7	475.3
	451.8	475.4

	Subsidiary undertakings	
	Shares £m	Loans £m
Movement in investments in subsidiary undertakings:		
At 1 January 2015	0.1	475.3
Loan repayment	-	(23.6)
At 31 December 2015	0.1	451.7

Notes to the accounts for the year ended 31 December 2015

20. Investments in subsidiary undertakings (cont.)

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

The entity Principality Mortgage and Insurance Services Limited has taken the exemption from audit as set out under S479A of the Companies Act 2006.

Principality Building Society consolidates funding vehicles Friary No.1 Plc and Friary No.2 Plc into the Group accounts. These companies are not wholly owned by the Society but the Society retains substantially all of the risk and reward of the assets, and so the Society's interests in these entities are in substance no different than if they were 100% held subsidiary undertakings and consequently they are consolidated into the Group accounts.

The Society continues to participate in the Ely Bridge development, a scheme which aims to deliver over 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
 Principality Limited
 Principality Asset Management Limited
 Principality Bank Limited
 Principality Direct Limited
 Principality Estate Agency Limited
 Principality Financial Management Limited
 Principality Group 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
 Principality Surveyors Limited
 Principality Syndicated Loans Limited
 The Principality Home Information Pack Limited

Notes to the accounts for the year ended 31 December 2015

21. Intangible assets

	Computer software		Total	
	Group £m	Society £m	Group £m	Society £m
Cost:				
At 1 January 2015	7.7	7.7	7.7	7.7
Additions	0.3	0.3	0.3	0.3
Disposals	-	-	-	-
At 31 December 2015	8.0	8.0	8.0	8.0
Amortisation:				
At 1 January 2015	5.9	5.9	5.9	5.9
Charge for the year	0.7	0.7	0.7	0.7
Impairment in the year	-	-	-	-
Disposals	-	-	-	-
At 31 December 2015	6.6	6.6	6.6	6.6
Net book value:				
At 31 December 2015	1.4	1.4	1.4	1.4
At 31 December 2014	1.8	1.8	1.8	1.8

	Goodwill		Computer software		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
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
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

Notes to the accounts for the year ended 31 December 2015

22. Property, plant and equipment

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2015	63.1	61.9	36.7	29.8	99.8	91.7
Additions	2.5	2.5	6.3	5.9	8.8	8.4
Disposals	-	-	(15.4)	(15.4)	(15.4)	(15.4)
At 31 December 2015	65.6	64.4	27.6	20.3	93.2	84.7
Depreciation:						
At 1 January 2015	27.2	26.7	28.7	22.4	55.9	49.1
Charge for the year	1.9	1.9	3.7	3.3	5.6	5.2
Impairment in the year	0.3	0.3	-	-	0.3	0.3
Disposals	-	-	(15.1)	(15.1)	(15.1)	(15.1)
At 31 December 2015	29.4	28.9	17.3	10.6	46.7	39.5
Net book value:						
At 31 December 2015	36.2	35.5	10.3	9.7	46.5	45.2
At 31 December 2014	35.9	35.2	8.0	7.4	43.9	42.6

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £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 £2.3m (2014: £1.7m) on account of assets in the course of construction.

Notes to the accounts for the year ended 31 December 2015

The value of assets subject to operating leases where the Group acts as lessor is £29.4m (2014: £26.8m).

	2015		2014	
	Group £m	Society £m	Group £m	Society £m
Land and buildings:				
Freehold	33.1	32.5	32.5	31.8
Long leasehold	0.3	0.2	0.6	0.6
Short leasehold	2.8	2.8	2.8	2.8
	36.2	35.5	35.9	35.2
Occupied by the Society and subsidiary undertakings	18.3	18.3	23.5	23.5

23. Shares

	Group and Society	
	2015 £m	2014 £m
Held by individuals	5,610.2	5,596.2
Other shares	4.8	4.3
Fair value adjustment for hedged risk	6.8	12.5
	5,621.8	5,613.0

24. Amounts owed to credit institutions

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Amounts owed to credit institutions	543.1	227.5	886.7	689.1

Included in the above amount is £4.8m of collateral held under a Credit Support Annex (CSA) (2014: £5.5m).

25. Debt securities in issue

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Certificates of deposit	8.0	20.1	8.0	20.1
Fixed and floating rate notes	-	15.5	-	15.5
Other debt securities	451.9	562.0	-	-
Fair value adjustment for hedged risk	3.6	2.7	3.6	2.7
	463.5	600.3	11.6	38.3

26. Other liabilities

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Income tax	0.6	0.7	0.6	0.7
Other taxation and social security	1.0	0.8	1.0	0.8
Other creditors	6.2	2.9	5.2	2.8
	7.8	4.4	6.8	4.3

Notes to the accounts for the year ended 31 December 2015

27. Deferred tax

The movement in net deferred tax is as follows:

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
At 1 January	(1.7)	(3.8)	(1.5)	(3.6)
Income statement (credit)/charge	(0.1)	1.9	(0.1)	1.9
Statement of other comprehensive income charge	0.7	0.2	0.7	0.2
At 31 December	(1.1)	(1.7)	(0.8)	(1.5)

Deferred tax assets and liabilities are attributable to the following items:

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Deferred tax liabilities				
Accelerated tax depreciation	-	0.1	0.3	0.3
Other	-	0.2	-	0.2
	-	0.3	0.3	0.5
Deferred tax assets				
Retirement benefit obligation	(0.8)	(1.6)	(0.8)	(1.6)
Other	(0.3)	(0.4)	(0.3)	(0.4)
	(1.1)	(2.0)	(1.1)	(2.0)

The Finance No.2 Act 2015 provides that the rate of corporation tax for the 2017 Financial Year will be 19% and the rate from 1 April 2020 will be 18%. The Act also introduces from 1st January 2016 a banking surcharge of 8% on profits over £25m. The Group's future tax rate is dependent on profitability in future years. The impact of this change in rate has been assessed and will not have a material impact on the Group's deferred tax position.

The statement of other comprehensive income includes a deferred tax charge of £0.7m arising from the actuarial gain on retirement benefit obligations. The charge reflected in the income statement is not material.

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within three years. More information on the triennial valuation can be found in note 11.

28. Subordinated liabilities

	Group and Society	
	2015 £m	2014 £m
5.375% 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, but ahead of the (Permanent Interest-Bearing Shares) PIBS holders.

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 at any time prior to maturity requires the prior consent of the Prudential Regulation Authority.

Notes to the accounts for the year ended 31 December 2015

29. Subscribed capital

	Group and Society	
	2015 £m	2014 £m
7.00% Permanent Interest-Bearing Shares	60.0	60.0
Unamortised issue costs	(0.3)	(0.5)
Fair value adjustment for hedged risk	10.1	12.4
	69.8	71.9

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.

30. Financial commitments and contingent liabilities

a) Financial Services Compensation Scheme levy

The Financial Services Compensation Scheme (FSCS) provides compensation to depositors in the event that a financial institution is unable to pay amounts due. Following the failure of a number of financial institutions the FSCS raised borrowings from the UK Government to cover compensation in relation to protected deposits. These borrowings are expected to be largely repaid from the realisation of the assets of the failed institutions. The FSCS recovers the interest cost of these borrowings, together with ongoing management expenses, by way of annual management levies on Members. The FSCS also raises levies to cover anticipated capital shortfalls.

The Society holds a provision for levies due in line with IFRIC 21 Levies. It is expected that future levies will be due but these costs cannot be quantified although they are expected to be material.

b) Customer and regulatory complaints

The Group holds provisions for customer and regulatory complaints. Provisions have been made in respect of claims

in relation to Payment Protection Insurance (PPI) which in the Group's case relate to secured personal lending PPI products. At 31 December 2015, the Group holds a provision of £1.0m (2014: £0.4m), 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.

The Group notes that the FCA is expected to finalise rules and guidance in relation to the handling of PPI complaints in relation to the 2014 Supreme Court decision in *Plevin vs Paragon Personal Finance Ltd (Plevin)*, and will monitor the developments on these proposed rules and guidance.

Notes to the accounts for the year ended 31 December 2015

30. Financial commitments and contingent liabilities (cont.)

c) Commitments under non-cancellable operating leases:

	2015		2014	
	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	1.5	0.2	1.4	0.3
Due between two and five years	5.0	0.4	4.9	0.7
Due after five years	2.2	-	1.9	-
	8.7	0.6	8.2	1.0
Society commitments in respect of operating lease rentals:				
Due within one year	0.9	0.2	0.8	0.2
Due between two and five years	2.8	0.3	2.7	0.5
Due after five years	2.2	-	1.6	-
	5.9	0.5	5.1	0.7

d) Income receivable under non-cancellable operating leases:

Property rental income earned during the year was £1.1m (2014: £0.9m).

At the statement of financial position date, the Society had contracted with tenants for the following future minimum lease payments:

	Group		Society	
	2015	2014	2015	2014
Receivable within one year	1.0	1.1	1.0	1.1
Receivable between two and five years	3.5	3.6	3.5	3.6
Receivable after five years	8.0	8.4	8.0	8.4
	12.5	13.1	12.5	13.1

On 28 January 2011, a 25 year lease of floors one to four of Principality Buildings was granted to Travelodge Hotels Limited.

On 30 July 2014, a ten year lease of Culverhouse Cross was granted to Connells Group.

e) Capital commitments:

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Capital expenditure contracted for but not provided for	2.1	0.7	2.1	0.7

f) Loan commitments:

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
Loan commitments contracted but not paid	98.8	70.6	98.8	70.6

Notes to the accounts for the year ended 31 December 2015

31. Financial instruments

Categories of financial instruments

Financial assets and liabilities are measured on an ongoing 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 As at 31 December 2015	At amortised cost	Loans and receivables	Available- for-sale	Fair value through profit and loss	Total
	£m	£m	£m	£m	£m
Group assets					
Cash in hand and balances with Bank of England	357.6	-	-	-	357.6
Loans and advances to credit institutions	-	166.6	-	-	166.6
Debt securities	-	-	437.8	-	437.8
Derivative financial instruments	-	-	-	21.3	21.3
Loans and advances to customers	-	6,544.9	-	-	6,544.9
Total financial assets	357.6	6,711.5	437.8	21.3	7,528.2
Total non-financial assets					56.2
Total Group assets					7,584.4
Group liabilities					
Shares	5,621.8	-	-	-	5,621.8
Amounts owed to credit institutions	510.3	-	-	32.8	543.1
Amounts owed to other customers	280.9	-	-	-	280.9
Debt securities in issue	463.5	-	-	-	463.5
Derivative financial instruments	-	-	-	31.4	31.4
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	69.8	-	-	-	69.8
Total financial liabilities	7,038.6	-	-	64.2	7,102.8
Total non-financial liabilities					32.6
General reserve and other reserves					449.0
Total Group reserves and liabilities					7,584.4

Notes to the accounts for the year ended 31 December 2015

31. Financial instruments (cont.)

Categories of financial instruments (cont.)

Society As at 31 December 2015	At amortised cost	Loans and receivables	Available- for-sale	Fair value through profit and loss	Total
	£m	£m	£m	£m	£m
Society assets					
Cash in hand and balances with Bank of England	357.6	-	-	-	357.6
Loans and advances to credit institutions	-	58.6	-	-	58.6
Debt securities	-	-	437.8	-	437.8
Derivative financial instruments	-	-	-	21.3	21.3
Loans and advances to customers	-	6,027.7	-	-	6,027.7
Loans to and investments in subsidiaries	0.1	451.7	-	-	451.8
Total financial assets	357.7	6,538.0	437.8	21.3	7,354.8
Total non-financial assets					53.7
Total Society assets					7,408.5
Society liabilities					
Shares	5,621.8	-	-	-	5,621.8
Amounts owed to credit institutions	853.9	-	-	32.8	886.7
Amounts owed to other customers	280.9	-	-	-	280.9
Debt securities in issue	11.6	-	-	-	11.6
Derivative financial instruments	-	-	-	30.7	30.7
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	69.8	-	-	-	69.8
Total financial liabilities	6,930.3	-	-	63.5	6,993.8
Total non-financial liabilities					27.6
General reserve and other reserves					387.1
Total Society reserves and liabilities					7,408.5

Notes to the accounts for the year ended 31 December 2015

Categories of financial instruments (cont.)

Group As at 31 December 2014	At amortised cost	Loans and receivables	Available- for-sale	Fair value through profit 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 2015

31. Financial instruments

Categories of financial instruments (cont.)

Society As at 31 December 2014	At amortised cost	Loans and receivables	Available- for-sale	Fair value through profit 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 2015

Carrying 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	2015		2014	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Group assets					
Cash in hand and balances with Bank of England		357.6	357.6	432.6	432.6
Loans and advances to credit institutions	i.	166.6	166.6	150.7	150.7
Debt securities	ii.	437.8	437.8	454.1	454.1
Derivative financial instruments	iii.	21.3	21.3	30.9	30.9
Loans and advances to customers	iv.	6,544.9	6,628.1	6,139.9	6,174.7
		7,528.2	7,611.4	7,208.2	7,243.0
Group liabilities					
Shares		5,621.8	5,644.7	5,613.0	5,613.9
Amounts owed to credit institutions	vii.	543.1	543.1	227.5	227.5
Amounts owed to other customers	vii.	280.9	280.9	173.9	173.9
Debt securities in issue	vii.	463.5	462.8	600.3	602.0
Derivative financial instruments	iii.	31.4	31.4	42.8	42.8
Subordinated liabilities	viii.	92.3	88.9	92.3	87.9
Subscribed capital	viii.	69.8	61.3	71.9	60.0
		7,102.8	7,113.1	6,821.7	6,808.0

	Note	2015		2014	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Society assets					
Cash in hand and balances with Bank of England		357.6	357.6	432.6	432.6
Loans and advances to credit institutions	i.	58.6	58.6	49.7	49.7
Debt securities	ii.	437.8	437.8	454.1	454.1
Derivative financial instruments	iii.	21.3	21.3	30.9	30.9
Loans and advances to customers	iv.	6,027.7	6,079.8	5,611.4	5,646.2
Loans and advances to subsidiaries	v.	451.8	451.8	475.4	475.4
		7,354.8	7,406.9	7,054.1	7,088.9
Society liabilities					
Shares		5,621.8	5,644.7	5,613.0	5,613.9
Amounts owed to credit institutions	vii.	886.7	886.7	689.1	689.1
Amounts owed to other customers	vii.	280.9	280.9	173.9	173.9
Debt securities in issue	vii.	11.6	11.6	38.3	38.3
Derivative financial instruments	iii.	30.7	30.7	40.8	40.8
Subordinated liabilities	viii.	92.3	88.9	92.3	87.9
Subscribed capital	viii.	69.8	61.3	71.9	60.0
		6,993.8	7,004.8	6,719.3	6,703.9

The gross amount of foreign currency swaps held was nil (2014: €20.0m).

Notes to the accounts for the year ended 31 December 2015

31. Financial instruments (cont.)

Carrying and fair values (cont.)

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.
- iv) The fair value of loans and advances to customers 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 and amounts owed to other customers are assumed to approximate to the amount payable at the date of the statement of financial position.
- viii) The fair values of debt securities in issue, subordinated liabilities and subscribed capital are obtained from market prices.

	Group and Society		
	2015	Level 1	Level 2
	£m	£m	£m
Financial assets at fair value through profit or loss:			
Derivative financial instruments	21.3	-	21.3
Available-for-sale financial assets:			
Debt securities	437.8	437.8	-
Total	459.1	437.8	21.3

	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

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.

Hierarchy for fair value disclosures

Level	
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 2015 (2014: none).

Notes to the accounts for the year ended 31 December 2015

32. Credit risk

The credit risk to which the Group is exposed is described in the Risk Management Report on pages 31 to 32. 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 a) below. Credit risk in relation to treasury financial instruments is described in section b).

a) 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	
	2015 £m	2014 £m	2015 £m	2014 £m
In respect of loans and advances to customers:				
Secured by a first charge on residential property	5,693.6	5,213.7	5,693.6	5,213.7
Secured by a first charge on land	330.6	393.4	330.6	393.4
Secured by a second charge on residential property	529.1	543.3	-	-
	6,553.3	6,150.4	6,024.2	5,607.1
Provision for impairment losses	(49.2)	(62.7)	(31.0)	(37.2)
Unamortised loan origination fees	13.8	15.2	7.5	4.5
Fair value adjustments	27.0	37.0	27.0	37.0
	6,544.9	6,139.9	6,027.7	5,611.4

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	
	2015 £m	2014 £m	2015 £m	2014 £m
Retail financial services	5,244.9	4,783.9	5,244.9	4,783.9
Commercial lending	755.8	790.6	755.8	790.6
Secured personal lending	517.2	528.4	-	-
Fair value adjustments	27.0	37.0	27.0	37.0
	6,544.9	6,139.9	6,027.7	5,611.5

i) Retail financial services and secured personal lending credit risk

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.

The geographical concentration of first and second charge retail loans by account and value is shown below:

	Group by account		Group by value	
	2015 %	2014 %	2015 %	2014 %
In Wales	29.9	30.7	27.5	28.5
Outside Wales	70.1	69.3	72.5	71.5
	100.0	100.0	100.0	100.0

Notes to the accounts for the year ended 31 December 2015

32. Credit risk (cont.)

a) Loans and advances to customers (cont.)

i) Retail financial services and secured personal lending credit risk (cont.)

During 2015 buy-to-let balances increased by £159.8m. Approximately 79% of buy-to-let mortgages were on interest only products, 20% repayable by capital and interest repayments and 1% a combination of interest only and capital and interest.

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 58.2% (2014: 59.4%). Index-linked LTV banding is shown below:

	Group		Society	
	2015 %	2014 %	2015 %	2014 %
Less than 70%	70.3	68.7	71.7	70.6
More than 70% but less than 80%	14.2	15.2	13.8	14.7
More than 80% but less than 90%	9.2	9.6	8.7	9.1
More than 90% but less than 100%	4.1	3.9	3.9	3.5
More than 100%	2.2	2.6	1.9	2.1
	100.0	100.0	100.0	100.0

Performance

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than three months is 0.62% (2014: 0.75%) which compares favourably with the industry average of 1.17% (CML arrears and possession data at 30 September 2015). Residential lending fully secured by a first charge which were six months or more in arrears had arrears balances of £0.8m (31 December 2014: £0.7m) with 159 (31 December 2014: 155) cases.

The percentage of secured personal loans currently in arrears of two months or more by number is 6.87% (2014: 8.44%), which by value is 7.41% (2014: 10.14%).

The table below provides further information on the first and second charge retail loans secured on residential property by payment due status:

	Group		Group	
	2015		2014	
	£m	%	£m	%
Current	5,622.7	97.6	5,143.4	96.8
Past due up to 3 months	91.3	1.6	108.7	2.0
Past due 3 months up to 6 months	21.8	0.4	24.8	0.5
Past due 6 months up to 12 months	14.9	0.3	17.9	0.4
Past due over 12 months	10.0	0.1	15.7	0.3
Possessions	1.4	-	1.8	-
	5,762.1	100.0	5,312.3	100.0

	Society		Society	
	2015		2014	
	£m	%	£m	%
Current	5,150.2	98.2	4,674.3	97.7
Past due up to 3 months	69.2	1.3	81.5	1.7
Past due 3 months up to 6 months	12.4	0.2	14.7	0.3
Past due 6 months up to 12 months	8.9	0.2	8.9	0.2
Past due over 12 months	2.8	0.1	2.7	0.1
Possessions	1.4	-	1.8	-
	5,244.9	100.0	4,783.9	100.0

Notes to the accounts for the year ended 31 December 2015

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 £14,245.2m (2014: £12,894.0m).

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £3.3m (2014: £3.2m) 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. 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 111.

Impairment 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:

	2015 £m	2014 £m
Retail financial services	6.3	6.0
Secured personal loans	18.2	25.5
	24.5	31.5

Forbearance

The Group uses a range of forbearance options which are considered based on the borrower's financial circumstances, agreed subject to set criteria and reviewed on a case-by-case basis. Forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. Repossession of a property will only take place once all alternatives have been reviewed and there are no other solutions available. 86 properties were taken into possession during 2015 (2014: 109) with balances of £5.9m (2014: £8.0m).

The table below sets out the mortgage balances which have had some form of forbearance over the last 12 months. Where accounts have had more than one form of forbearance we have categorised the balance based on the first instance of forbearance.

2015	Revised payment schedule	Transfer to interest-only	Term extensions	Capitalisation of arrears	Other	Total
	£m	£m	£m	£m	£m	£m
Current	24.6	11.6	4.9	8.3	2.1	51.5
Past due up to 3 months	13.7	0.7	0.5	2.9	1.0	18.8
Past due 3 months up to 6 months	4.5	0.2	0.2	1.7	1.0	7.6
Past due 6 months up to 12 months	2.0	0.1	0.2	1.1	2.1	5.5
Past due over 12 months	0.9	-	0.2	0.6	5.6	7.3
	45.7	12.6	6.0	14.6	11.8	90.7

Notes to the accounts for the year ended 31 December 2015

32. Credit risk (cont.)

a) Loans and advances to customers (cont.)

i) Retail financial services and secured personal lending credit risk (cont.)

2014	Revised payment schedule	Transfer to interest-only	Term extensions	Capitalisation of arrears	Other	Total
	£m	£m	£m	£m	£m	£m
Current	23.2	8.2	7.4	8.5	1.9	49.2
Past due up to 3 months	17.1	0.1	0.9	3.6	0.7	22.4
Past due 3 months up to 6 months	4.0	0.2	0.5	1.9	1.3	7.9
Past due 6 months up to 12 months	1.9	0.3	0.2	1.5	1.8	5.7
Past due over 12 months	0.6	0.8	0.4	2.2	6.4	10.4
	46.8	9.6	9.4	17.7	12.1	95.6

The underlying performance of previous forbearance activities are reflected in the provisioning methodology and are not individually or collectively material. In addition to the specific provisions held against individual accounts, a collective provision of £0.9m (2014: £1.5m) is held in relation to accounts subject to previous forbearance.

ii) 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.

Further detail of the Group's risk management strategy in relation to commercial lending is described in the Risk Management Report on page 32.

Risk Concentrations

The Group's commercial loan portfolio, excluding impairment provisions and fair value adjustments, comprises the following:

	Group and Society			
	2015		2014	
	£m	%	£m	%
Loans to Registered Social Landlords secured on residential property	149.8	19.2	157.5	19.1
Other loans secured on residential property	308.5	39.4	279.1	33.9
Loans secured on commercial property	324.2	41.4	386.8	47.0
	782.5	100.0	823.4	100.0

Notes to the accounts for the year ended 31 December 2015

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			
	2015		2014	
	£m	%	£m	%
Office	98.2	30.3	127.5	33.0
Retail	112.0	34.5	125.6	32.5
Industrial	60.0	18.5	70.6	18.2
Leisure	21.9	6.8	32.7	8.5
Land	7.5	2.3	4.8	1.2
Other	24.6	7.6	25.6	6.6
	324.2	100.0	386.8	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:

Region	Group and Society			
	2015		2014	
	£m	%	£m	%
Wales	390.7	49.9	411.0	49.9
Greater London	187.4	24.0	168.2	20.4
South East/East of England	59.8	7.6	66.5	8.1
Midlands	35.4	4.5	46.6	5.6
South West/South of England	36.6	4.7	43.3	5.3
North West/North of England	38.1	4.9	40.2	4.9
Mixed/other	34.5	4.4	47.6	5.8
	782.5	100.0	823.4	100.0

Notes to the accounts for the year ended 31 December 2015

32. Credit risk (cont.)

a) Loans and advances to customers (cont.)

ii) Commercial lending credit risk (cont.)

The average index-linked loan to value (LTV) in respect of the Group's commercial loans is estimated to be 63.2% (2014: 70.8%). 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.

£46.6m of exposures have an LTV of greater than 100% (2014: £113.8m). Of these, £30.6m are already classified as impaired and a further £12.4m are on the watch-list, leaving £3.6m of exposures considered to be non-higher risk 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 £29.9m (2014: £30.0m) or 3.8% (2014: 3.6%) of gross balances.

Performance

The commercial lending risk procedure for loans and advances to customers is described in the risk management report on page 32.

Using the commercial credit risk grading system the commercial loan portfolio is distributed as follows (the figures exclude provision for loan impairment or unamortised loan origination fees):

	Group and Society			
	2015		2014	
	£m	%	£m	%
Exposures not classified as higher risk	708.1	90.5	698.4	84.8
Watch-list	37.8	4.8	46.1	5.6
Impaired (including past due up to 3 months)	36.6	4.7	78.9	9.6
	782.5	100.0	823.4	100.0

Watch-list 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 watch-list 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:

Region	Group and Society			
	2015		2014	
	£m	%	£m	%
Unimpaired				
Current	745.9	95.3	742.4	90.2
Past due up to 3 months	1.3	0.2	2.8	0.2
Impaired				
Past due 3 to 6 months	-	-	-	-
Past due 6 to 12 months	-	-	0.7	0.1
Past due over 12 months	-	-	-	-
Defaulted but not past due	29.9	3.8	72.9	8.9
Law of Property Act (LPA) Receivers appointed	5.4	0.7	4.6	0.6
	782.5	100.0	823.4	100.0

There are no commercial cases (2014: two) three months or more in arrears. Total arrears balances are £26k (2014: £31k).

Notes to the accounts for the year ended 31 December 2015

The total collateral held against commercial loans is estimated to be £1,442m (2014: £1,383m). Lending is classified by sector according to the property type held as collateral. 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 watch-list exposures this will typically be at least annually.

Provisions are held against impaired loans as follows:

	2015	2014
	£m	£m
Collective provisions	14.4	11.6
Specific provisions	10.3	19.5
Total provisions	24.7	31.1

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 2015, 10 (2014: 11) accounts with balances totalling £18.2m (2014: £11.7m) in value were granted forbearance concessions. The total exposure in forbearance at December 2015 stands at £60.1m and 36 accounts (2014: £147.6m, 58 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 watch-list is also considered on a regular basis.

Notes to the accounts for the year ended 31 December 2015

32. Credit risk (cont.)

b) Credit risk: Treasury financial instruments

The treasury credit risk strategy is described in the risk report on page 32.

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	
	2015 £m	2014 £m	2015 £m	2014 £m
UK Government securities	349.9	300.5	349.9	300.5
Supranational securities	51.0	79.1	51.0	79.1
UK financial institutions	224.8	256.1	116.7	155.1
	625.7	635.7	517.6	534.7

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 £4.8m (2014: £5.5m) is held over derivative financial instruments.

The following table shows the exposures broken down by Fitch ratings:

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
AAA to AA-	512.9	506.8	471.1	460.2
A+ to A-	96.6	128.9	30.3	74.5
BBB+ to BBB-	16.2	-	16.2	-
Unrated	-	-	-	-
	625.7	635.7	517.6	534.7

The geographical distribution of these exposures is as follows:

	Group		Society	
	2015 £m	2014 £m	2015 £m	2014 £m
UK	574.7	556.6	466.6	455.6
Multinational Development Banks	51.0	79.1	51.0	79.1
	625.7	635.7	517.6	534.7

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 2015

33. 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.

	2015					
	Undefined maturity	Less than 3 months	Between 3 months and 1 year	Between 1 year and 5 years	More than 5 years	Total
	£m	£m	£m	£m	£m	£m
Group						
Non-derivative liabilities						
Shares	-	3,505.0	631.0	1,420.5	-	5,556.5
Amounts owed to credit institutions	4.8	168.5	161.8	207.5	-	542.6
Other customers	-	105.9	120.4	53.5	-	279.8
Debt securities in issue	-	36.0	155.9	266.7	-	458.6
Subordinated liabilities	-	-	92.3	-	-	92.3
Subscribed capital	-	-	-	60.0	-	60.0
	4.8	3,815.4	1,161.4	2,008.2	-	6,989.8
Society						
Non-derivative liabilities						
Shares	-	3,505.0	631.0	1,420.5	-	5,556.5
Amounts owed to credit institutions	4.8	178.1	225.0	478.2	-	886.1
Other customers	-	105.9	120.4	53.5	-	279.8
Debt securities in issue	-	4.0	4.0	-	-	8.0
Subordinated liabilities	-	-	92.3	-	-	92.3
Subscribed capital	-	-	-	60.0	-	60.0
	4.8	3,793.0	1,072.7	2,012.2	-	6,882.7
Group						
Derivative liabilities						
Interest rate swaps	-	-	1.9	15.1	14.3	31.3
	-	-	1.9	15.1	14.3	31.3
Society						
Derivative liabilities						
Interest rate swaps	-	-	1.9	15.1	13.5	30.5
	-	-	1.9	15.1	13.5	30.5

Notes to the accounts for the year ended 31 December 2015

33. Liquidity risk (cont.)

	2014					
	Undefined maturity	Less than 3 months	Between 3 months and 1 year	Between 1 year and 5 years	More than 5 years	Total
	£m	£m	£m	£m	£m	£m
Group						
Non-derivative liabilities						
Shares	-	3,487.5	820.2	1,228.5	-	5,536.2
Amounts owed to credit institutions	5.5	8.0	3.0	211.0	-	227.5
Other customers	-	59.7	99.8	12.8	-	172.3
Debt securities in issue	-	51.5	106.5	438.0	-	596.0
Subordinated liabilities	-	-	-	92.3	-	92.3
Subscribed capital	-	-	-	-	71.9	71.9
	5.5	3,606.7	1,029.5	1,982.6	71.9	6,696.2
Society						
Non-derivative liabilities						
Shares	-	3,487.5	820.2	1,228.5	-	5,536.2
Amounts owed to credit institutions	5.5	31.1	78.8	573.7	-	689.1
Other customers	-	59.7	99.8	12.8	-	172.3
Debt securities in issue	-	17.0	3.0	15.5	-	35.5
Subordinated liabilities	-	-	-	92.3	-	92.3
Subscribed capital	-	-	-	-	71.9	71.9
	5.5	3,595.3	1,001.8	1,922.8	71.9	6,597.3
Group						
Derivative liabilities						
Interest rate swaps	-	-	0.6	22.5	19.6	42.7
	-	-	0.6	22.5	19.6	42.7
Society						
Derivative liabilities						
Interest rate swaps	-	-	0.6	22.5	17.6	40.7
	-	-	0.6	22.5	17.6	40.7

34. 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 repricing 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 repricing 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 £7.8m (2014: £9.8m favourable impact on reserves).

Notes to the accounts for the year ended 31 December 2015

34. Market risk (cont.)

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.

35. 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 pages 56 and 59.

Loans to and shares held by Directors

There was an aggregate of £0.3m (2014: £0.5m) 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, CF10 1UA 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 29 April 2016.

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 (2014: £0.1m).

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 paid to Society	Fees paid to Society	Rent paid to Society
	£m	£m	£m
Year ended 31 December 2015			
Nemo Personal Finance Limited	15.6	1.2	-
	15.6	1.2	-
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

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
	2015 £m	2015 £m	2014 £m	2014 £m
Nemo Personal Finance Limited	451.7	-	475.3	-
	451.7	-	475.3	-

Annual business statement for the year ended 31 December 2015

1. Statutory percentages

	At 31 December 2015	At 31 December 2014	Statutory limit
	%	%	%
The lending limit	5.6	7.1	25.0
The funding limit	18.7	15.2	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.

2. Other percentages

	2015	2014
	%	%
As a percentage of shares and borrowings:		
Gross capital	8.8	8.7
Free capital	8.6	9.0
Liquid assets	13.9	15.7
As a percentage of mean total assets:		
Profit for the year as a percentage of mean total assets	0.51	0.72
Management expenses as a percentage of mean total assets	1.13	0.90

Gross capital is the aggregate of general reserve, available for sale revenue, subscribed capital and subscribed liabilities.

Free capital is gross capital plus collective impairment provisions 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.

3. Directors

Details of Directors are contained on pages 41 to 43.

Details of Directors' service contracts are included in the Report of the Remuneration Committee on page 58.

Documents may be served on any of the Directors c/o Eversheds LLP, Reference PDV, 1 Callaghan Square, Cardiff CF10 5BT.

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

Glossary

Additional Tier 1 capital	A component of regulatory capital comprising permanent interest-bearing shares (PIBS) and other qualifying instruments after regulatory adjustments.
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 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.
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.
Business assets	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.
Capital Requirements Directive (CRD IV)	European legislation to implement Basel III, which includes the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD).
Commercial lending	Secured loans to a commercial borrower.
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	The highest quality form of capital as defined in the Capital Requirements Directive IV, comprising accumulated reserves and qualifying instruments after regulatory deductions.
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.
Covered bonds	A type of wholesale funding backed by cash flows from mortgages.
Credit risk	The risk of financial loss arising from a failure of a customer or counterparty to settle their financial and contractual obligations as they fall due.

Glossary (cont.)

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 securities in issue	Transferable certificates of indebtedness including certificates of deposits, and fixed and floating rate notes.
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 obligation to pay further contributions.
Delinquency	See Arrears.
Effective Interest Rate method (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.
Expected Loss (EL)	A regulatory capital 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 or counterparty fails to meet its obligations to the Group.
Exposure At Default (EAD)	A regulatory capital parameter used to estimate the amount outstanding at the time of default.
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 Compensation Scheme (FSCS)	A protection fund for depositors of failed institutions. This is funded by the financial services industry and each firm, including the Society, is obliged to pay an annual levy.
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.
Funding limit	The proportion of shares and borrowings not in the form of customer accounts held by individuals.
Individual Liquidity Adequacy Assessment (ILAA)	The Group's internal assessment of the levels of liquidity that need to be held by the Society to meet its regulatory liquidity requirements.

Glossary (cont.)

Impaired loans	Loans where there is evidence to suggest a measurable decrease in the present value of expected cash flows that has occurred after initial recognition of the asset, but before the statement of financial position date.
Individually/collectively assessed impairment allowances	Impairment is measured individually for assets 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 required quantity of a firm's liquidity resources and the firm's funding profile.
Internal Capital Adequacy Assessment Process (ICAAP)	The Group's internal assessment of the levels of capital that need to be held by the Society to meet its regulatory capital requirements.
International Swaps and Derivatives Association (ISDA) master agreement	A standardised contract developed by ISDA and used to enter into bilateral derivatives 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.
Internal Ratings Based (IRB)	An approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk sensitive than the standardised approach and may be Foundation or Advanced. IRB approaches may only be used with PRA permission.
Lending limit	The proportion of business assets not in the form of loans fully secured on residential property.
Leverage ratio	A Basel III ratio which measures Tier 1 capital against total on and off balance sheet assets.
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)	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 does not hold sufficient liquidity, in terms of quantity and quality, to meet its liabilities as they fall due.
Loan To Value ratio (LTV)	A ratio showing outstanding loan balance as a percentage of the value of the security.
Loss Given Default (LGD)	The difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.
Member	A person who has a share investment or a mortgage loan with the Society.

Glossary (cont.)

Net interest income	The difference between the interest received on assets and the interest paid on liabilities.
Net interest margin	This ratio calculates the net interest income as a percentage of mean total 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).
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 is used in valuing collateralised interest rate derivatives.
Over-The-Counter (OTC)	A bilateral transaction (e.g. derivatives) that is not exchange traded and is valued using valuation models.
Permanent Interest-Bearing Shares (PIBS)	Unsecured, Sterling denominated Additional Core Tier 1 capital instruments repayable at the option of the Society.
Prudential Regulation Authority (PRA)	The UK prudential regulator, which is a part of the Bank of England and alongside the FCA has responsibility for the oversight of building societies, banks and insurers. The PRA's objective is to promote the safety and soundness of regulated firms.
Probability of Default (PD)	A regulatory capital parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.
Regulatory capital	Capital allowable under regulatory rules, less certain required regulatory adjustments and deductions.
Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)	A repurchase agreement (repo) is a transaction in which 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.
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.

Glossary (cont.)

Risk-Weighted Assets (RWA)	A regulatory measure that adjusts the value of assets to reflect their level of risk when calculating capital requirements.
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	Money deposited by Members in a retail savings account with the Society and held as a liability in the statement of financial position.
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 regulatory 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 an SPE set up under 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 special purpose vehicle (SPV).
Standardised approach	The basic method used to calculate credit risk capital requirements under Basel III. 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).
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 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.



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