

Annual Report
and Accounts

2011



PRINCIPALITY
BUILDING SOCIETY

Highlights

for the year ended 31 December 2011

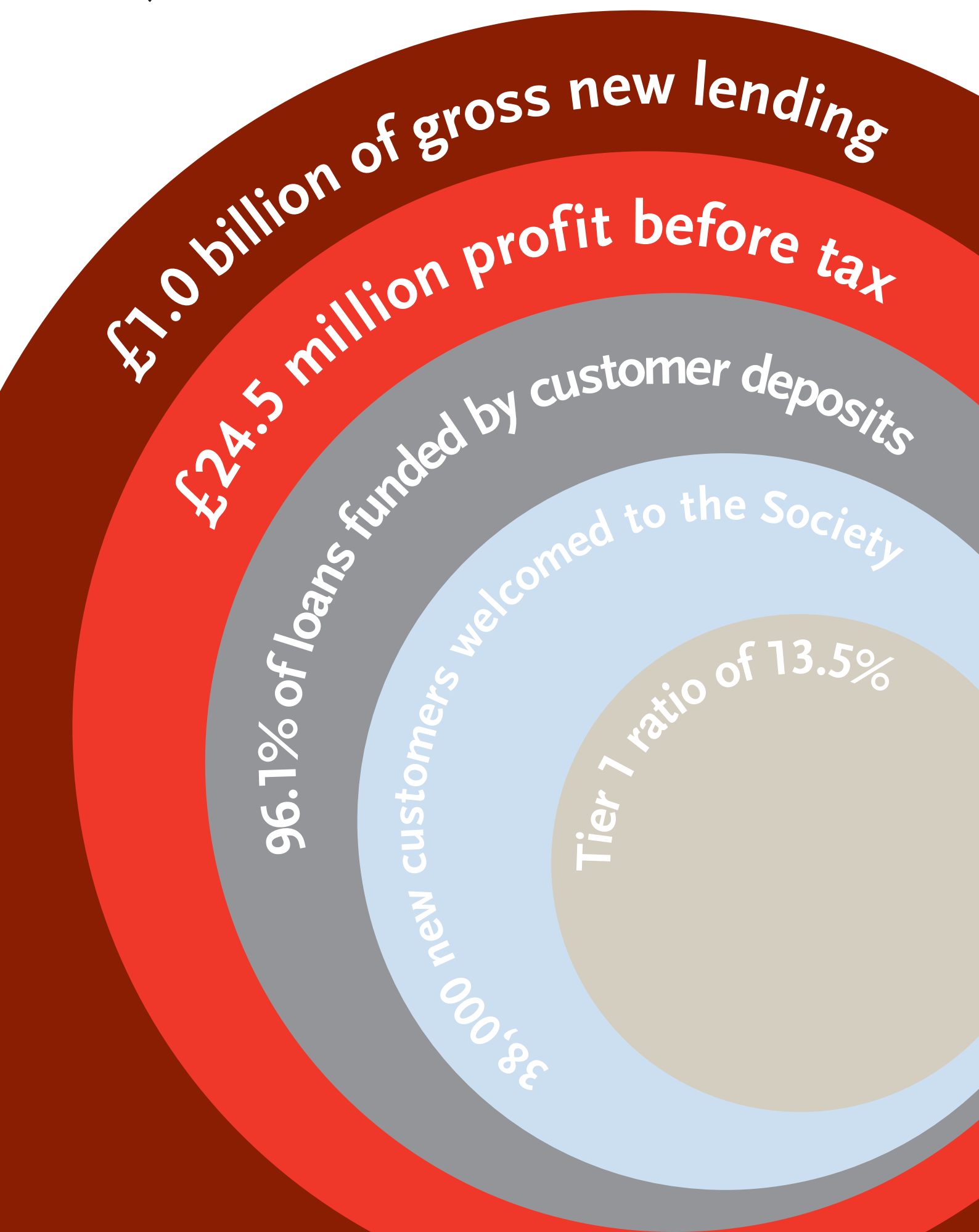


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Chairman's statement



Principality Building Society's Chairman, Dyfrig John

Another successful year at Principality. We have done this by committing further to the Welsh high street, developing more products for our Members and ensuring that, through a strong performance and a healthy capital position, our goals remain undiminished to continue to serve the needs of our Members.

We are the seventh largest building society in the UK, with assets of over £6.4bn with a key and clear goal to make a solid contribution to the Welsh economy through our network of 66 branches and agencies.

In 2011, in spite of the tough economic environment, we achieved excellent results with profit before tax of £24.5m (2010: £30.8m) which further consolidates our capital position.

Key achievements

On your high street

Our healthy financial performance has enabled us to continue to invest heavily in the future of the business, particularly in its customer facing services. In April of this year the Society opened its 52nd branch in Monmouth, hosting an exclusive party for the local community to mark the launch. Offering choice, diversity and excellent customer service on the high street, the Monmouth Principality branch also houses pa black, the new property division from Peter Alan Estate Agents, providing a complete financial and property solution. September also saw the opening of the Society's 14th agency counter in Caernarfon.

Investing in technology

To remain competitive and to meet our Members' continuing needs, we have increased our investment in

technology during the year. This has resulted in a new website which is designed to provide a one-stop money management platform for all our Members who will now be able to review all their Principality accounts. We plan to go further to allow Members to browse the latest Principality products, book appointments with branch staff, and much, much more. The success of the site has been recognised nationally, picking up two prestigious awards for 'Best Professional Business Website of the Year' at the Sitecore Awards and 'Best Financial Services Marketing Strategy' at the Marketing Industry Awards.

Business savings

Principality Commercial has expanded its product portfolio to launch Business Savings, and has tripled business savings deposits since the start of 2011, with over £150m being deposited by businesses across Wales and the UK. A further clear signal from customers, personal and business, that we offer good value and a safe base for their funds.

pa black

Peter Alan, our estate agency subsidiary, launched a new service in January 2011, pa black, which is dedicated to assisting with the purchase and sale of high-end properties in the South East of Wales. Recognising the rising demand for higher-valued properties in affluent areas across the country, pa black has combined a relationship-driven service with the latest innovations in property marketing technology, providing a differentiated service to both buyers and sellers in this niche but growing market. In 2011, Peter Alan won the prestigious The Sunday Times Estate Agent Award for 'Best Medium Estate Agency Wales 2011' and the Estate Agent Award for 'Auction Agency'. This is an outstanding accolade in a very difficult market, and our congratulations go to the team at Peter Alan.



Principality sponsored the Welsh Junior Rowing Squad kit as part of the Society's ongoing commitment to support communities across Wales

Our Members

Mutuality is based on the principles of partnership and we believe that listening to you, our Members, is the cornerstone to enhancing customer experience through process improvement, product development and innovation. Engaging with our Members is central to maintaining trusted relationships, letting you know our strategic direction and holding directors and management of the Society accountable.

In 2011, we continued our 'Member Talkback' sessions – where Members can meet with key Board members, ask questions and can discuss changes we are planning. This year we met with Members in West Wales (Haverfordwest), North Wales (Conwy) and East Wales (Brynmawr). We also have an established Members' Forum, which is a panel of 12 Members who meet with the Executive team twice a year to represent the views of customers. We would like to express our thanks to this year's forum for the valuable insight and contribution they have made to our business.

Throughout 2011, we have been working with our staff, Members and customers to discover more about what you think of Principality and what more we could do to meet and exceed your expectations. We fully recognise that without you, the Society would not exist and we are exceedingly grateful for all your feedback.

Community

The Society has had a long history of community involvement and giving something back to the region. This is achieved through its branch community commitment scheme, sponsorship portfolio and nominated Charity of the Year policy. Staff chose to support the Wales Air Ambulance emergency service as its dedicated charity

for 2011 and the Society's Annual General Meeting (AGM) in April kick-started the fundraising with the Society donating £20,000 to the charity. Breaking a world record for the 'world's longest singles darts match', swapping the day job to become zoo keepers for the day at the Welsh Mountain Zoo in Colwyn Bay and pedalling an exercise bike on the First Great Western train from Swansea to London Paddington are just some of the sponsored events that staff have been involved with. I am delighted that in total our staff raised £31,000.

Staff have also lent their time, energy and support to local community projects, helping to boost local football teams in Cardiff and Mold and propel the Welsh Junior Rowing Squad to the Home International Regatta. To mark the opening of our Monmouth branch, the Society gave Monmouth's independent charity, Bridges, a financial boost to help refresh the entrance to its community centre at Drybridge House. This resulted in a warm and welcoming reception area for its many visitors.

Principality has also expanded its wide-reaching sponsorship programme designed to promote and support social and community life, enable young people to develop life skills and support creativity and encourage the best of Wales in a safe and supportive environment. This year the sponsorship programme grew to include Glamorgan Cricket Club, Golf's Junior Wales Open and Only Boys Aloud - an initiative that has given over 200 boys from the Welsh valleys the opportunity to sing a mix of modern and traditional choral music in community venues across Wales.

Only Boys Aloud was launched to promote self-belief, confidence, aspiration and a new focus on the lives of young men in the South Wales valleys. The idea was to



The Old Vicarage, Caerphilly £425,000



Michaelstone Road, Draethen £795,000



Little Wynemig Gosh Lane, Osprey By Sea £175,000



The Old Vicarage, Caerphilly £425,000



Michaelstone Road, Draethen £795,000



Osprey By Sea £175,000



The Old Vicarage, Caerphilly £425,000



Michaelstone Road, Draethen £795,000



Osprey By Sea £175,000

Innovative digital property displays at pa black

make a difference to individuals and, through this, enrich their schools, their wider communities and, ultimately, the musical life of Wales. The wider goal was to grow the work of Only Men Aloud, an organisation with a proven record of innovation. The success of the partnership has been outstanding in harnessing the power of the arts to engage young people and was recognised at the Arts and Business Cymru Awards 2011 when Principality picked up the award for 'Arts, Business and Young People'.

Thirty years of sponsoring the National Eisteddfod of Wales was followed this year by the Society supporting Llangollen International Musical Festival, Anglesey Show and the Shrewsbury Flower Show, alongside its other longer-term support of the Royal Welsh Agricultural Show and Wales Millennium Centre.

Our Board

Principality's Board is a highly experienced group of individuals who have ensured that our Members' interests are well protected during these challenging economic times. I would like to thank all of them for the significant additional commitment, effort and time during 2011. Our Deputy Chairman, Christopher Rowlands, left the Board in September 2011 to pursue business opportunities abroad, but I would particularly like to thank Chris for the strong contribution he made to the Board during his time with the Society. In addition and on behalf of the collective Board, I would like to thank all of Principality Group's employees for their continued hard work. Without their commitment, Principality would not be the strong and thriving business it is today.

2012 outlook

The year ahead will continue to demand vigilance to existing and new challenges. We are faced with the prospect of much tougher times both domestically and in Europe – the pace of recovery has undoubtedly slowed. We recognise that household budgets are under more strain than ever, and job and spending cuts have already taken their toll. The weak outlook for growth may well adversely affect property prices across the UK and Wales, and this may serve to dent already weak levels of consumer confidence.

Such a background demands a careful and considered approach to how we will be doing business in 2012. I am confident that we have the capital strength and depth of management experience to continue to serve you, our Members, and to ensure that Principality remains at the forefront of financial services in Wales. We will therefore continue to be a strong contributor to the Welsh economy and committed to supporting our communities throughout Wales.

Dyfrig D. J. John
Dyfrig D. J. John
Chairman
31 January 2012

Chief Executive's review



Principality Building Society's Chief Executive, Peter Griffiths

These are troubled times and the global economic storm continues to rage. The capitalist model has been tested to the extreme and there is now clear evidence of a significant shift in social sentiment and a return to traditional values. Society is asking whether 'more of the same' is a good enough response to the economic crisis and its ramifications. Set against this background, many consumers are coming round to the view that the mutual way is demonstrably the better way. Your Society, founded over 150 years ago, was built on the foundations of its core values of industry, economy, thrift, perseverance, providence and temperance, and many of these values have strong provenance and huge resonance in the current market.

During these prevailing economic conditions your Society has performed strongly and it is clear that our Members appreciate the range of products, services, localness and flexibility we provide for them. We value their trust and loyalty. Whilst there are some significant short-term challenges ahead, I firmly believe the platform is there for us to flourish in the future and further build our business.

Those challenges are not new and include a much reduced savings and mortgage market, in particular the impact of *CP 11/31 Mortgage Market Review: Proposed package of reforms*, and heightened regulatory demands for capital and liquidity. Funding costs continue to increase as banks and building societies recognise, and compete for, the scarcer but more reliable high street customer. The impact of 'lower for longer' interest rates continues to cause consternation for savers but provides some relief to borrowers. We recognise all of these challenges and seek to support both our borrowing and saving Members during times of financial hardship and uncertainty.

2011 trading

I am pleased with our performance during the year. 2011 was another very good year considering the difficult circumstances we faced. Our financial results were strong and our balance sheet is stable and in good shape. We continue to look ahead with confidence and cautious optimism and we continue to invest in the future of your Society.

We also continue to try to balance the demands of all of our stakeholders and I am delighted to say that when we benchmark our customer willingness to recommend Principality, our score is amongst the best in the financial services sector in the UK. Staff satisfaction is at a record high and our brand retains very high levels of trust. All of this provides the bedrock for further development of our business in the years ahead. Gross new lending stood at £1bn with provisions for bad debts at lower levels than anticipated. Solid capital and high levels of liquidity are notable features in our balance sheet. Key features for 2011 include:

- Profit before tax of £24.5m (2010: £30.8m)
- Outstanding customer satisfaction levels
- Solid capital ratios with Tier 1 ratio of 13.49% (2010: 13.34%)
- Over 38,000 new customers welcomed to the Society
- 96.1% (2010: 101.6%) of loans funded by customer deposits
- Cost income ratio of 52.7% (2010: 48.1%)
- Successful Residential Mortgage Backed Security issue of £814.0m



Members of Only Men Aloud and Glamorgan Cricket team cut the cake at the opening of Monmouth branch with Francis Hayter, Branch Manager

Group overview

Group pre-tax profit fell from £30.8m to £24.5m, reflecting higher funding costs and a provision for an expected Financial Services Compensation Scheme charge of £1.5m (2010: £0.5m). All of our businesses recorded a profit during the year and all are well placed to deal with the recovery when it comes. We have strength and depth in our executive and senior management teams and we continue to attract the skills needed to run the business and deal with the significant challenges thrown up by current market conditions and increasing regulatory demands.

Market conditions have deteriorated since 2010. The illusion of an early recovery was shattered and we continue to tread carefully through a potential minefield of uncertainty. It is extremely difficult to plan a certain future in this uncertain world. We continue to regularly review our strategic plan and de-risk our business where we can. We will always seek to act in the interest of our Members and our commitment to a mutual future remains undiminished.

More sophisticated capital rules are forcing many firms to re-assess their current business models and the impact of the reform of financial services firms set out in The Independent Commission Review on Banking has yet to be determined.

The core Building Society business grew slightly during the year whereas many banks and building societies continue to shrink their balance sheets in an effort to meet tougher regulatory balance sheet ratios. We will continue a policy of low growth into 2012 and we will focus harder on our efforts to put 'building back into building society' as we work closely with Welsh Government to find new innovative solutions for housing needs across Wales.

Notwithstanding the dislocation in financial markets the Society successfully issued a £814.0m Residential Mortgage Backed Security in the autumn bringing in £500.0m of funding which strengthens liquidity going forward. We have clear evidence of positive wholesale investor sentiment towards our business and as a result we have no need to pursue marginal, highly priced retail savings. We have maintained our savings book broadly in line with 2010 levels and we continue to prudently fund substantially all of our lending through Member savings.

We are working hard to support borrowers who run into financial difficulties and these strategies are proving to be successful.

As the social shift gets underway, it is important that we continue to gauge Member sentiment and requirements. We have worked hard during the year to do that so that we can provide an appropriate response to Member needs in the years ahead. We have actively engaged with Members across Wales and several key themes have emerged from our research, namely:

- Members expect us to show more flexibility in these exceptional times whilst understanding the need for us to be consistent in our approach.
- We enjoy and have earned high levels of trust from our Members and we need to ensure that we protect this.
- We are valued for being 'local' and for supporting our communities and the local economy.

From this research we are taking active steps to review policies, procedures and some of our fees and charges. An immediate response has been the reduction of a number of fees as well as the removal of others.



The launch of our Charity of the Year 2011 with Bryn Terfel and staff from North Wales

We remain clear that trusted, face-to-face advice, delivered from the high street in the traditional way, is a key requirement of our Welsh Membership. We also recognise that wider UK Members wish to transact with us through the medium of technology and we seek to deliver a combination of 'bricks and clicks' to satisfy the demands of all of our Members.

Our Commercial business continues to trade profitability with a quality lending book. Commercial property values have fallen and we have recognised current market concerns on valuation in our provision numbers. Whilst loan to value ratios overall have increased slightly, our commercial business was built on a traditional relationship model. Our lending has always been based on a cash flow and ability to repay model rather than simply loan to value. Whilst not complacent, we believe that valuation concerns and potential for future default are appropriately recognised. A deliberate strategy has been implemented during the year to reduce the Group's exposure in the Commercial business and this is reflected in the decline in balances. We are starting to see small yet encouraging signs of development opportunities re-emerging as confidence returns to some parts of the commercial market. Our new Commercial savings product has been a significant success with the book tripling in size during the year to £152.4m.

Our Nemo secured loan business continued to perform well, delivering strong profits. Trading performance was almost a replica of 2010. House prices fell slightly; however default levels improved. Consumer demand for loans of this nature remains strong and the risk/reward equation is an attractive one. During the year, we reduced the book slightly with sales of loan portfolios to a major investment bank demonstrating liquidity in this asset class.

Following the outcome of the Judicial Review of the Financial Services Authority's proposed approach to the assessment and redress of complaints in respect of sales of Payment Protection Insurance, we have set aside additional provisions of £9.3m as we work through the remediation process. Notwithstanding this, the Nemo business recorded a pre-tax profit of £13.3m after provision for these potential payments.

Our estate agency, Peter Alan, continues to be challenged by market conditions driven in the main by consumer uncertainty and the lack of mortgage product particularly for the first-time buyer. As a response to these issues, we have continued to aggressively grow our lettings business as a counter cyclical play and now manage 1,200 properties, a 50% growth year on year. We have strong on-going growth plans for the lettings business which has performed extremely well during the year. In the estate agency business we have created the pa black brand during the year to broaden our footprint in this division delivering a premium service brand for higher value properties.

We have undertaken a number of property development schemes with significant success within our own estate during the year, including an initiative to turn empty space above Peter Alan and Principality branches into flats for occupation by local tenants. During 2010, floors one to four of Principality Buildings were converted into a hotel and let to Trevelodge Hotels Limited in January 2011. This has proved to be extremely popular and the plan will continue into 2012.

Our Surveyors' business has performed ahead of plan, volumes being consistent with our expectation, but ongoing low levels of mortgage demand continue to hold back the real potential of this business.



The Wales 2012 RBS 6 Nations squad pictured as never before wearing the Principality Premiership kit from the start of their careers

Outlook

Our business is not immune from ongoing issues in the global and UK economy. Confidence is fragile and the year ahead is likely to be a difficult one. I would expect sector margins and profits to be challenged in 2012 as the price paid to secure retail and wholesale funding increases. Whilst good news for savers, that cost has to be borne by borrowers and credit will remain expensive and restricted. That in turn suggests that demand for loans across all of our businesses will remain low. Housing transaction levels may take further time to recover with short-term implications for our estate agency and Surveyors' business.

It would be reasonable to expect further small falls in house prices with the possibility of some larger falls in weaker geographical areas. The key determinant will be interest rates and I would expect a 'lower for longer' environment to persist during the year ahead. Any unforeseen rapid rise in rates would further slow down an already ailing housing market and have affordability and impairment ramifications.

The diversified nature of our business provides some resilience and provides room for cautious optimism. We will continue to make investments in the business to ensure your Society is well placed for the future. We will also seek to evaluate and invest in growth opportunities that may present themselves.

The commitment of you, our Members, and the Principality team is greatly appreciated.

Peter L. Griffiths
Chief Executive
31 January 2012

Business review

for the year ended 31 December 2011

Statement of comprehensive income overview

The Group's profit before tax for the year to 31 December 2011 was £24.5m (2010: £30.8m). Underlying profit, excluding non-trading items which can vary significantly in their nature and value year-on-year were:

| | 2011 £m | 2010 £m |
|------------------------------------------------|-------------|-------------|
| Profit before tax | 24.5 | 30.8 |
| Gain on repurchase of subordinated liabilities | (1.0) | (3.1) |
| Gain on the sale of gilts | (0.8) | (6.3) |
| Provisions for other liabilities and charges | 11.2 | 17.1 |
| Underlying profit | 33.9 | 38.5 |

Profit

Net interest margin

Net interest income is the sum of the amount earned on assets (a combination of retail mortgages, commercial mortgages and liquid assets) less liabilities (savings products and borrowings) divided by total average assets. At 1.65% (2010: 1.79%) the Group's net interest margin continues to benefit from the higher margins earned in the secured personal lending business.

The continued unavailability of senior unsecured wholesale funding has been addressed by the issue of a Residential Mortgage Backed Security (RMBS) during the year. Retail cost of funding is increasing and the impact of holding more lower yielding sovereign securities has resulted in some margin compression during the year. This increased cost of funding has been offset to some extent by higher margins earned on new mortgages and loans. The high cost of funding will continue to drive margin compression, which remains a key but manageable risk for the Group.

Net interest margin has been enhanced by gains of £0.8m (2010: £6.3m), equivalent to 1bps (2010: 6bps), arising from the profit on the sale of gilts.

Other income

The Group's non-interest income at £20.6m (2010: £17.1m) includes insurance income, estate agency income, property services income and income generated from a number of other complementary activities. These together generated 16.44% (2010: 13.25%) of total income. The performance of sales and renewals in life, investment and general insurance products has increased by 1.73% on last year and accounts for 26.04% (2010: 31.42%) of other income. Property rental income has increased by 52.61% to £0.8m as a result of granting a lease of floors one to four of Principality Buildings to Travelodge Hotels Limited at the beginning of the year. A further increase in fee income has

been derived from the commercial lending portfolio where a number of loans have been restructured on maturity.

During the year, the secured personal lending subsidiary sold loan portfolios totalling £48.1m with a profit of £1.4m received during the year. The Group has retained the servicing rights to these assets, ensuring future income streams. Substantially all the risks and rewards of the assets were transferred on sale. The assets have been derecognised from the Group statement of financial position.

Property services and lettings income is 17.55% ahead of last year with both the estate agency and lettings performing well. During the year the pa black brand was launched targeting a premium estate agency service for higher value properties. Early indications are positive, with the brand helping to drive future income as these properties typically earn higher margins.

Administrative expenses

Strategic investments to enhance the Society's e-commerce capabilities, including a new website, along with other key investments in Principality Property Solutions and the pa black brand, have resulted in an increase in the ratio of operating expense as a percentage of total mean assets to 1.04% (2010: 1.00%). The cost to income ratio was 52.7% (2010: 48.1%). We consciously continue to invest strategically to increase diversity in our income streams and provide long-term value.

The impact of the VAT increase from 17.5% to 20.0%, which is largely irrecoverable, has increased costs by over £0.4m on the same period last year.

Impairment provisions for losses on loans and advances

The charge for impairment provisions of £24.6m (2010: £22.2m) for the Group was £2.4m higher than last year.

| | 2011 £m | 2010 £m |
|---------------------------|-------------|-------------|
| Retail financial services | 4.3 | 2.8 |
| Commercial lending | 7.0 | 9.6 |
| Secured personal lending | 13.3 | 9.8 |
| Total | 24.6 | 22.2 |

Whilst the total charge for residential impairments in the retail financial services and secured personal lending divisions are £5.0m higher than last year, arrears rates are stable and amounts written off broadly similar.

The increase in the charge is driven by more pessimistic impairment assumptions relating to forced sale discounts and lower house prices reflecting the current economic environment. Accounts subject to forbearance activity have been separately reviewed for inclusion in impairment calculations for the first time recognising an additional provision of £0.5m. The average loan-to-value (LTV) ratio of 62.6% (2010: 61.6%) for first and second charge residential lending is 1.0% higher than last year as a result of a modest fall in house prices.

Market conditions for the Commercial Lending Division remain difficult. There have been a small number of defaults in the year triggered mostly by tenant failures and the consequent inability of borrowers to meet their loan payments. Due to the erosion of commercial and residential property values in recent years, there is also a cohort of loans in negative equity; however, in the majority of cases the cash flows generated by the properties held as security or borrowers' other resources are enabling contractual repayments to be maintained.

Accumulated impairment on mortgages secured on commercial property was 2.11% (2010: 1.52%) of balances. In assessing the appropriate level of Commercial Lending provisions, account is taken of all situations where there is actual or apparent financial distress. Management keeps a very close focus on all such loans, 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.

Provisions for other liabilities and charges

A provision of £1.5m has been charged in the year in respect of the Financial Services Compensation Scheme levy payable in September 2013. There is some uncertainty in respect of the future operation of the scheme and the extent of levies payable beyond March 2012.

Other provisions of £9.7m (2010: £17.1m) have been made in respect of various customer claims, including claims in relation to previous sales of Payment Protection Insurance. It is expected that any liability will predominantly crystallise over the next 12 months.

Further information on the level of provisions and the uncertainties therein can be found in notes 2 and 39.

Derivatives and hedge accounting

All derivatives are recorded on the statement of financial position at fair value with any valuation movements being taken to the income statement. Derivatives are only used to the extent to which the Group will be affected by changes in interest rates or other market indices, and are therefore used solely to hedge risk exposures and not for speculative purposes.

The £0.1m gain (2010: £0.2m gain) relating to fair value adjustments on derivatives and hedge accounting represents the net fair value adjustments on derivative instruments that are matching risk exposures on an economic basis. Some income statement volatility arises on these items due to accounting ineffectiveness of designated hedges or because hedge accounting has not been adopted or is not achievable. The gain is primarily due to timing differences in cash flows and interest rate reset dates between the derivative instrument and the hedged assets and liabilities. The impact will trend to zero over time.

Taxation

The statutory rate of corporation tax was reduced to 26.0% from 1 April 2011. The Group was subject to corporation tax at a rate of 28.0% for the period 1 January to 31 March 2011, and 26.0% for the period 1 April to 31 December 2011, resulting in an effective statutory rate of corporation tax of 26.5% for the full year in 2011.

The actual effective tax rate for the Group was 28.9% (2010: 24.7%) compared with the statutory rate of tax of 26.5% (2010: 28.0%). The rate differential is mainly due to disallowable expenditure. The prior year comparative includes the repurchase of £10.0m of subordinated liabilities, the profit on which was treated as non-taxable.

The reduction of the UK corporation tax rate to 25.0% from 1 April 2012 has resulted in a deferred tax adjustment arising from the reduction in the statement of financial position carrying value of the net deferred tax liability to reflect the anticipated rate of tax at which the liability is expected to reverse.

Statement of financial position

Loans and advances to customers including forbearance

The Group continues to focus on the quality of business written, concentrating on affordability and LTV ratios in underwriting loans and mortgages. Whilst lending criteria remain tight, residential first charge mortgage completions have increased by 7.00% from the prior year to £809.6m. Excluding fair value adjustments, loans and advances to customers were:

| | 2011 | | 2010 | |
|---------------------------|----------------|--------------|----------------|--------------|
| | £m | % | £m | % |
| Retail financial services | 3,630.2 | 70.3 | 3,293.2 | 67.1 |
| Commercial lending | 913.0 | 17.7 | 937.9 | 19.1 |
| Secured personal lending | 621.7 | 12.0 | 677.7 | 13.8 |
| Total | 5,164.9 | 100.0 | 4,908.8 | 100.0 |

Buy-to-Let mortgages make up 20.36% of mortgages in the retail financial services division. This has increased by 43.11% during the year following a deliberate growth strategy. The average LTV for first and second charge residential lending is 62.6% (2010: 61.6%) with 75.1% under 80% LTV and 7.6% in negative equity.

The Board's primary focus remains the sustainability of the business so that it can deliver value to Members whilst balancing the risks contained within the portfolios.

A deliberate strategy has been implemented during the year to reduce the Group's exposure in the second charge and commercial lending portfolios and this is reflected in the decline in balances.

We continue to support our Members and customers who are experiencing financial difficulties and agree the most appropriate course of action. Short-term temporary actions could include revised payment schedules, payment holidays or a switch to 'interest only'. Where revised payment schedules are insufficient to meet normal contractual monthly instalments or where a customer fails to meet the revised payment terms, the case will continue to accrue arrears and impairment provisions will be made where appropriate.

If a Member or customer demonstrates they are able to meet a payment schedule at a normal commercial rate for a period of six months, and only if they request it, the arrears may be 'capitalised' on their account. This will result in an enlarged outstanding balance but no arrears. Consequently these cases will no longer be reported as in arrears but still considered for impairment provisioning.

Our approach to dealing with Members and customers in financial difficulties means that we will only take possession of a property as a last resort. The number of properties taken into possession during the year was 91 (2010: 74) with 40 remaining unsold at the end of the year (2010: 44).

Treasury and liquid assets

Liquidity, together with funding and capital, are the key aspects of financial risk management. The Financial Services Authority (FSA) increased its focus and attention on liquidity resulting in the publication of a policy statement, PS 09/16, in 2009. The FSA also set out a separate risk management framework for building societies, PS 10/5. Compliance with these new policy

statements has been a key objective of the Group over the last 18 months. During the year the Group continued to perform internal stress tests on its liquidity which consistently demonstrates a strong position after allowing for a range of extreme stress scenarios and mitigating actions. The results of these scenarios are brought together into the Group's Individual Liquidity Adequacy Assessment (ILAA) document which is reviewed at least annually by the Board.

In December 2010, the Basel Committee on Banking Supervision issued proposals for liquidity risk management, standards and monitoring. These included a short-term liquidity stress metric, the Liquidity Coverage Ratio (LCR), and a long-term liquidity metric, the Net Stable Funding Ratio (NSFR). Whilst these proposals are subject to ongoing refinement and have not yet been enacted into UK or European law, the Group's interpretations of these ratios are reviewed on a monthly basis by the Asset and Liability Committee.

Liquid assets typically comprise cash deposits held with central banks and unencumbered securities that may be sold or refinanced through a repurchase agreement (repo) either directly with the central banks to which the Group has access or with other market counterparties. Whilst liquid assets have declined slightly during the year, the proportion assigned to the 'Liquid Assets Buffer' as defined by the FSA in BIPRU 12 has increased from 59.22% to 88.13%. Of the other liquid assets not assigned to the 'Liquid Assets Buffer', which typically comprise investments with other financial institutions, 2.40% (2010: 0.84%) are less than A rated under Fitch credit ratings.

The Group holds £514.0m of self-issued Residential Mortgage Backed Securities (RMBS), £386.0m of which are capable of repo financing either directly with the market or with central banks to which the Group has direct access, and therefore represent contingent liquidity available to the Group if necessary. These assets are not recognised in the statement of financial position.

The Group has a £10.0m (2010: £10.0m) exposure to Anglo Irish Bank Corporation Limited due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. This scheme is approved by the European Commission under EC Treaty state aid rules. The agreement between the Irish Government, the European Union and International

Monetary Fund (IMF) for a restructuring plan in November 2010 contained guarantees for the full repayment of its senior unsecured bonds. All interest repayments to date have been met. In light of these facts, the directors do not consider this exposure impaired. The Group has no direct exposures to Greece, Italy, Portugal or Spain and only £15.0m of exposures outside the UK, including the Anglo Irish exposure. Based on available information, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, the Board has concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

A weekly review is undertaken by the Treasury Committee on current and expected credit risk, liquidity risk and interest rate risk of all Treasury assets with a view to highlighting the likelihood of any future performance difficulties and losses based on emerging published data and intelligence.

Funding

The Society has a strong funding base, predominantly represented by retail savings, with limited reliance placed on senior unsecured wholesale markets. The statement of financial position has been actively managed in response to retail and wholesale markets and during the year the Society entered into a Residential Mortgage Backed Security (RMBS) issue, the Society's first-ever external securitisation. The RMBS issue involved the formation of a Special Purpose Entity (SPE) which provides security to an £814.0m amortising bond issued in August by the Group. The AAA rated bond issued internally by the Society as part of the Covered Bond Programme was delisted and £832.1m of mortgages previously transferred to Principality Covered Bond LLP were transferred back to the Society.

As at 31 December 2011, £764.2m of loans issued by the Society had been transferred to the SPE which remain on the statement of financial position of the Society as it retains the risks and rewards. The amortised value of the bond was £814.0m, with £514.0m retained by the Group.

Despite fierce competition in the retail savings market the Society has maintained savings balances at £5bn which represent 96.1% (2010: 101.6%) of all mortgage balances. Fixed rate retail products represent 51.78% (2010: 54.81%) of all savings balances.

Borrowings from wholesale markets have increased during the year. At 13.96% (2010: 11.03%) of all shares, deposits and loans, the Group's borrowings represent a continued low dependence on wholesale markets. The Group has not been directly affected by the challenges in the wholesale market as a result of the ongoing Eurozone crisis.

During the year, Moody's reviewed the ratings of 12 UK financial institutions, including Principality, to reflect their expectation of lower levels of exceptional Government support in the future. The first stage of the Moody's review, measuring an institution's standalone strength before consideration of potential Government support,

was announced in early August 2011 and this resulted in an upgrade of our Bank Financial Strength Rating from D- to D+. However, in October 2011 Moody's concluded its review of systemic support assumptions from the UK Government, and the impact of this was a reduction in the Group's long-term rating from Baa2 to Ba1. The downgrade does not reflect deterioration in financial strength of Principality and a number of other financial institutions also received long-term downgrades at the same time.

Fitch announced in November 2011, as part of its broad review of the larger and relatively highly-rated European banks, that Principality's rating be maintained citing resilient profitability, sound majority prime owner-occupied mortgage book, good levels of capitalisation and the holding of significant good quality liquid assets.

| | 2011 | |
|---------|------------|-----------|
| | Short-term | Long-term |
| Moody's | NP | Ba1 |
| Fitch | F2 | BBB+ |

| | 2010 | |
|---------|------------|-----------|
| | Short-term | Long-term |
| Moody's | P2 | Baa2 |
| Fitch | F2 | BBB+ |

Given the low reliance placed on wholesale markets, the impact of the downgrading by Moody's is not considered significant.

Defined benefit pension scheme

The defined benefit scheme closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the Group Flexible Retirement Plan (GFRP). The Group injected £1.0m into the defined benefit scheme on closure and has injected a further £2.0m during this year.

The defined benefit scheme was subject to a triennial valuation by the Scheme's independent actuary on 30 September 2010, at which date there was a deficit of £8.2m. This valuation was approved by the Trustees on 2 December 2011. To eliminate the deficit, the Trustees and the Society have agreed that additional contributions will be paid into the scheme as a rate of £1.0m per annum.

Capital

Capital comprises the Group's general reserve, permanent interest-bearing shares (subscribed capital) and subordinated debt. This capital is held to support the development of the business, to protect Members' deposits and provide 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. Total capital has increased from £492.5m at the beginning of the year to £509.1m.

The Group continues to manage its capital in accordance with the EU Capital Requirements Directive (Basel II), as required by the FSA. At 31 December 2011, regulatory capital stood at £477.8m (2010: £477.6m). A reconciliation of total capital to regulatory capital is presented below:

| | 2011 | 2010 |
|-----------------------------------------------------------------|--------------|--------------|
| | £m | £m |
| Total capital | 509.1 | 492.5 |
| Adjusted for: | | |
| Other reserves not eligible for inclusion in regulatory capital | (2.0) | (0.4) |
| Intangibles | (2.5) | (2.1) |
| Fair value adjustments to subscribed capital | (16.1) | (10.0) |
| Fair value adjustments to subordinated liabilities | - | (2.4) |
| Amortisation adjustments to subordinated liabilities | (10.7) | - |
| Regulatory capital | 477.8 | 477.6 |

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 final maturity on 8 July 2016 subject to regulatory approval. From 8 July 2011, the rate of interest became LIBOR plus 1.005% reset quarterly. The subordinated liabilities, as a lower Tier 2 instrument, will amortise out of regulatory capital over five years from July 2011 under GENPRU 2.2.196. This will reduce the solvency ratio, over the five year period, to the same percentage as the Tier 1 ratio.

At the end of the year, risk-weighted assets were £2,640.2m (2010: £2,584.3m) with key capital ratios standing at:

| | 2011 % | 2010 % |
|----------------|-----------|-----------|
| Core Tier 1 | 11.48 | 11.27 |
| Tier 1 | 13.49 | 13.34 |
| Solvency ratio | 16.89 | 17.33 |

In July 2011, the European Commission released its proposal for implementing Basel III in Europe along with a plan for a single European rulebook for regulation (the package is commonly referred to as CRD IV).

The objective of Basel III is to improve the banking sector's ability to absorb shocks arising from financial and/or economic stress and reduce the impact of any 'spill-over' affecting the global economy. Basel III raises the requirement with respect to the quality and quantity of the regulatory capital base and enhances the risk coverage of the capital framework.

Basel III also introduces a number of macro-prudential elements into the capital framework to help contain systemic risks. Basel III has yet to be incorporated into the European and UK regulatory framework and therefore remains subject to change.

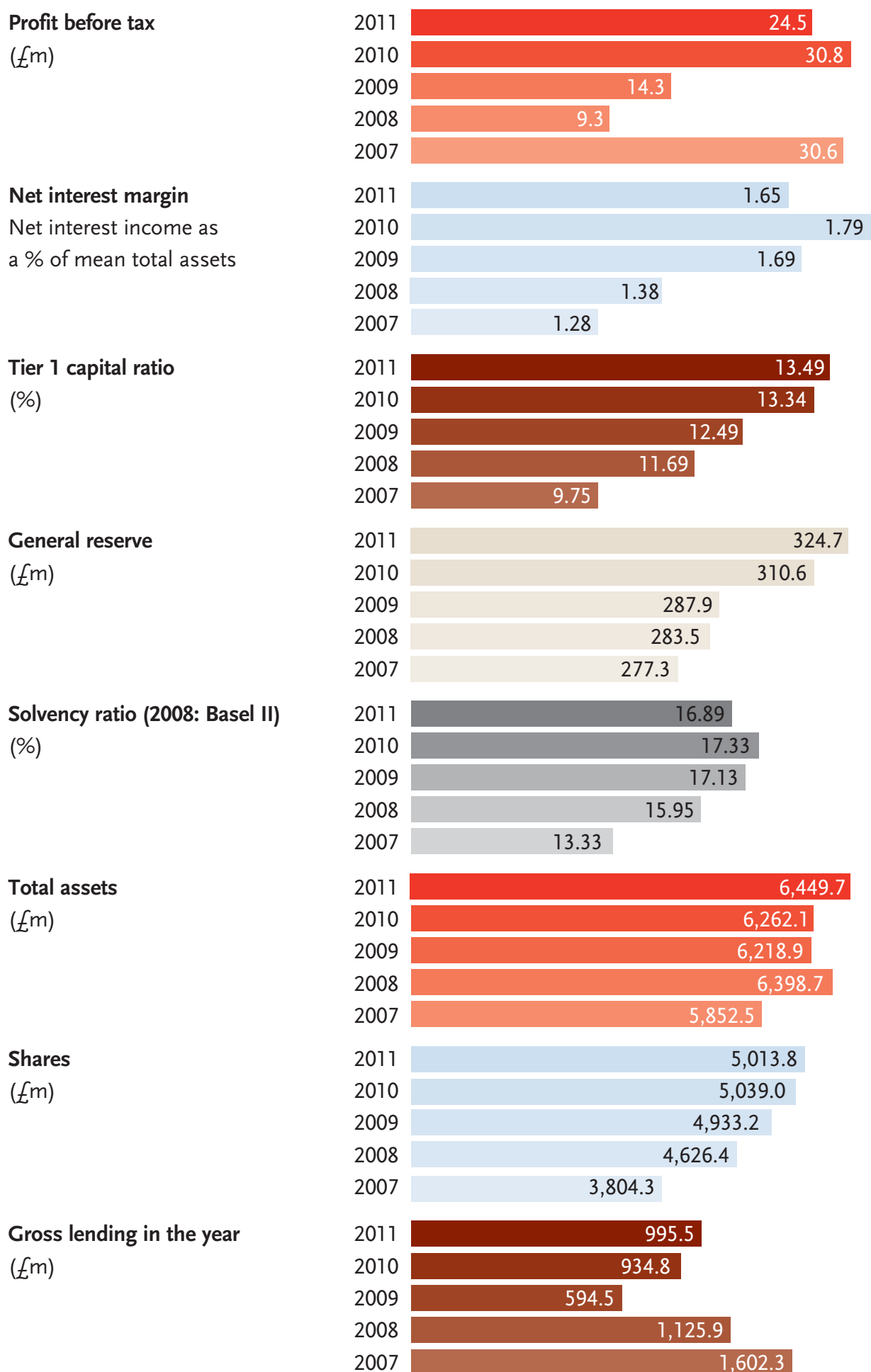
Core Tier 1 and Tier 1 ratios are well in excess of the minimum established by the FSA and Basel III requirements as currently drafted.

During the year the Group has continued to perform internal stress tests regularly on its capital base, and these tests have consistently demonstrated a capital surplus after applying a range of severe stress scenarios. The results of these scenarios are brought together into the Group's Internal Capital Adequacy Assessment Process (ICAAP) document which is reviewed at least annually by the Board.

The Group currently adopts the Standardised approach and is in the process of applying to the FSA for permission to use an Internal Ratings Based (IRB) approach to retail credit risk and capital management. This will allow the Group to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.

Key performance indicators

The following indicators illustrate Principality Group's performance during 2011 compared to the preceding four years:



Key performance indicators

The following indicators illustrate Principality Group's performance during 2011 compared to the preceding four years:

| Year ended 31 December | 2011 | 2010 | 2009 | 2008 | 2007 |
|------------------------------------------------|-----------|-----------|-----------|-----------|-----------|
| Capital and Profit | | | | | |
| Gross capital ratio | 8.75% | 8.71% | 8.52% | 8.00% | 8.53% |
| Free capital ratio | 9.04% | 8.93% | 8.71% | 7.94% | 8.07% |
| Profit after tax as a % of mean total assets | 0.27% | 0.37% | 0.17% | 0.09% | 0.38% |
| Other income as a % of net operating income | 16.44% | 13.25% | 15.12% | 20.18% | 34.45% |
| Operating expenses as a % of mean total assets | 1.04% | 1.00% | 0.95% | 1.04% | 1.27% |
| Assets | | | | | |
| Growth | 2.99% | 0.69% | (2.81%) | 9.33% | 21.17% |
| Loans and advances to customers | £5,220.1m | £4,960.4m | £4,736.9m | £4,884.3m | £4,584.0m |
| Liquid assets | £1,114.7m | £1,194.8m | £1,380.3m | £1,382.0m | £1,196.7m |
| Liquid assets as a % of shares and borrowings | 19.14% | 21.12% | 24.49% | 23.98% | 22.39% |
| Core liquidity ratio | 16.88% | 12.53% | 10.44% | 4.36% | 0.09% |
| Funding | | | | | |
| Borrowings | £808.6m | £618.6m | £713.6m | £1,186.0m | £1,540.0m |
| Funding limit | 13.96% | 11.03% | 12.78% | 20.60% | 29.03% |
| Employees | | | | | |
| Average number of people employed | 1,173 | 1,126 | 1,049 | 997 | 1,206 |
| Other measures | | | | | |
| Number of branches | 52 | 51 | 51 | 50 | 50 |
| Number of agency branches | 14 | 13 | 5 | 5 | 5 |
| Number of estate agency branches | 23 | 23 | 23 | 23 | 26 |



W. Guy Thomas
Group Finance Director
 31 January 2012

Risk management report

Risk overview

The management of the business and the execution of the Group's strategy involve the potential exposure to a number of risks. The Group aims to manage appropriately all the risks that arise from its activities and believes that its risk management philosophy should reflect an awareness of actual and potential risk exposures, the quantification of the probable impact of such exposures and the development and implementation of measures that manage such exposures within agreed limits.

Governance structure

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

Risk governance is provided by a structure consisting of four key risk management committees. Each committee includes appropriate representation from the Executive Committee, divisional management and risk specialists:

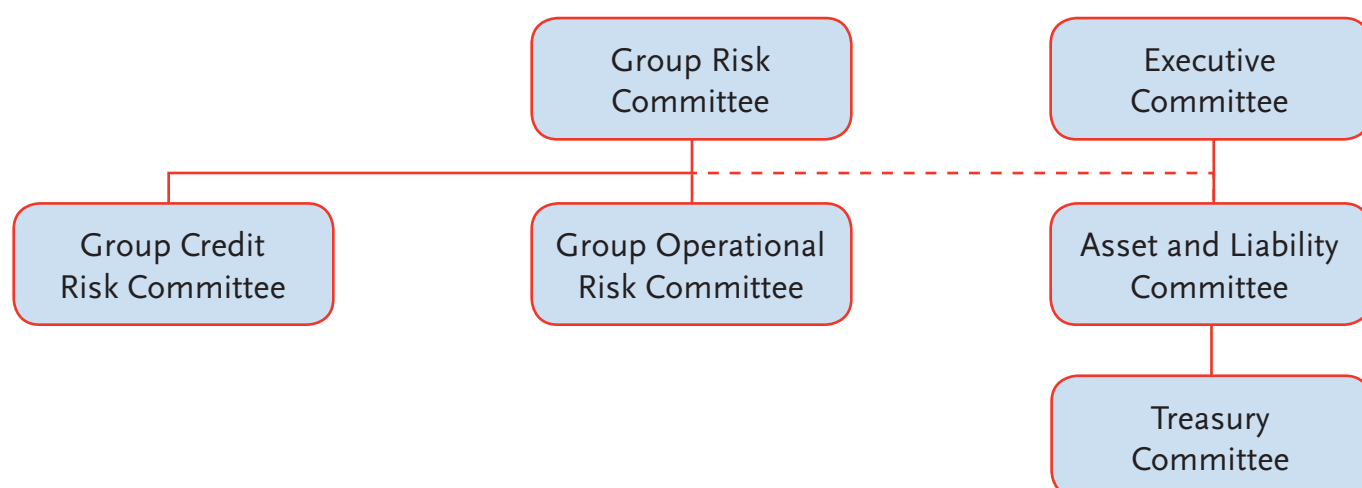
Group Risk Committee (GRC) is chaired by a non-executive director, and has responsibility for ensuring a Group-wide co-ordinated approach towards the oversight and management of key strategic and corporate risks.

Group Credit Risk Committee (GCRC) is chaired by the Director of Group Risk 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, market, liquidity and interest rate risk. ALCO reports to the Group's Executive Committee and to the GRC. Weekly monitoring is conducted by the Society's Treasury Committee, which is a subsidiary of ALCO.

Group Operational Risk Committee (GORC) is chaired by the Director of Group Risk, and is responsible for monitoring and reviewing exposure to operational risks arising from the Group's day-to-day activities.

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 and Group Finance. The role of these functional specialists is to maintain and review policies, establish limits which are consistent with the Group's risk appetite, monitor and report on compliance with those limits and generally to provide an oversight role in relation to the management of risk.



Principal risks

The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, operational risk and pension obligation risk. As a mutual, the Group maintains a relatively low risk appetite.

Group Internal Audit provides independent assurance regarding the activities of the 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 has continued its programme of regular reviews of major strategic risks. This includes an assessment of the potential impact of changes in the macro-economic environment, new regulation, competitor strategy, customer preferences, and emerging technology.

The key risks to the Group are linked to the overall performance of the economy and the resultant effect on unemployment, house price indices, commercial property market values and performance, and overall liquidity as the markets seek to refinance borrowings against a background of continuing volatility and the risk of sovereign default. The impact of other regulatory changes and any potential replacement funding scheme for the FSCS are also direct risks for the Group. Specific risks to the Group are reviewed as part of the Individual Capital Adequacy Assessment Process (ICAAP) and are detailed below.

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 liquid and investment assets held by Group Treasury for liquidity requirements and for general business purposes.

Market background

The outlook remains uncertain, with economic pressures and political uncertainty placing additional strain on the sector. For that reason the Group's forecasts and plans have taken account of scenarios that include the risk of further decreases in house prices, impacts on commercial property market values and performance, a sustained deterioration in the macro-economic environment, and consequential increases in unemployment. These forecasts have been prepared by management and stressed accordingly in line with FSA guidance.

Risk mitigation

The controlled management of credit risk is critical to the success of the Group's lending strategy. The quality of individual lending decisions, subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the business, has a direct impact on the achievement of the financial objectives of the Group.

Each business area, residential first and second charge lending, commercial lending and treasury, has its own individual Credit Risk Policy Statement setting out its risk appetite including policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring. In addition, each business area maintains a detailed procedures manual setting out operating rules and standards.

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 Board. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

Retail credit risk

The Group continues to focus on the underlying quality of business written, and lending criteria remain conservative. Applicant quality is monitored closely, defined in terms of credit, LTV 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'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. Experience in these areas allows for feedback into the underwriting process. In common with other building societies, the Society participates in the Government's Mortgage Rescue Scheme but has chosen not to take part in the Homeowner Mortgage Support Scheme. When accounts are in default, careful consideration is given to the most appropriate realisation strategy likely to result in the best outcome for the Group and the customer.

Commercial credit risk

Commercial risk appetite is regularly reviewed in the light of changing economic and market conditions and is also subject to annual review. The Group remains cautious with regard to commercial lending which is undertaken on a prudent basis reflected in a decrease in the statement of financial position year-on-year, but where management has adopted a strategy geared towards reducing overall exposure to development finance and larger, single counterparty loans. Commercial lending is operated 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 activity. When accounts are in default, careful consideration is given to the most appropriate realisation strategy likely to result in the best outcome for the Group and the customer.

Responsibility for the overall quality of the lending book and the adequacy of credit procedures and controls rests with Commercial Liability and Asset Management Committee with oversight provided by Group Risk 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 risk management policy.

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 and the Executive Committee (EXCO).

Liquidity risk

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

Market background

Wholesale funding markets remain fragile, with underlying confidence in the interbank market also weak, reflecting broader concerns regarding the possibility of contagion risk arising from sovereign default. The relative cost of funds remains substantially higher than at the onset of recession in 2007, and the withdrawal of Government backed funding in January 2012 is expected to further impact the availability and price of both wholesale and retail funding in the forthcoming year.

The introduction of a new liquidity regime has led to increased demand for longer-term funding and better quality Government issued debt for use as liquid assets. This trend is expected to continue with the phased implementation of regulations in forthcoming years. Conditions in the wholesale market have led to greater competition and increased cost of retail savings, significantly impacted by institutions pursuing a retail funding strategy aimed at replacing potentially unavailable or expensive wholesale funding.

Risk mitigation

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

ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing. The Group conducts an Individual Liquidity Adequacy Assessment (ILAA) at least annually. This is used to assess the Group's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Group. The most recent ILAA was approved by the Board in December 2011. The Group's ILAA includes stress tests that consider a range of severe scenarios and their impact on the Group, particularly with respect to retail saving outflows. The ILAA concludes that the Group's liquidity reserves are adequate to sustain the Group over an extended severe stress during which contingent actions aimed at stabilising the situation would be deployed.

As at 31 December 2011, 86.04% of the Group's funding was raised from retail sources. The Group has continued to be successful in securing and retaining retail deposits over the last year partly reflecting a perceived 'flight to quality' as savers continue to look for a safe haven in the face of an uncertain and volatile economic environment. The Society expects to face increasing levels of competition for retail savings over the next twelve months and will continue to review and enhance its product range to maintain its competitive position. Medium-term funding was boosted in August 2011 when the Society entered the external securitisation market for the first time, successfully launching a £814.0m RMBS.

As at 31 December 2011, the Group's core liquidity ratio (as defined in the glossary in pages 95 to 98) was 16.88% (2010: 12.53%). The year-on-year increase in 'Liquid Asset Buffer' eligible balances reflect a prudent view on the global economic outlook and in particular its impact on liquidity instruments issued by European Banks.

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.

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 ALCO, EXCO and GRC which approves the market risk policy and receives regular reports on all aspects of market risk, including interest rate risk and foreign currency risk. Reporting lines and terms of reference are set out clearly by the Board which also receives monthly reports from the Group Finance Director covering significant issues dealt with by ALCO.

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

Interest rate risk

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

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

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

Market background

Over the last two years, customer preference has continued to move towards variable rate mortgages and fixed rate savings bonds. Along with other mortgage providers, the lower interest rate environment and the availability of credit have exposed us to changes in customer behaviour, driven by associated changes in the financial dynamics of transactions, particularly with respect to early repayment of fixed rate mortgages. The effect of this, however, has not been material.

Risk mitigation

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

ALCO regularly considers, in particular, the Society's options and strategies in the current low interest rate environment 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 prepared and stressed accordingly, in line with FSA guidance.

Use of derivatives

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

The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and interest rate caps.

The table below describes the principal activities undertaken by the Group, the related interest rate risks associated with those activities and the types of derivatives which are typically used to manage such risks.

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.

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

Operational risk

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

Market background

With an increasingly diverse business model and a more competitive operating environment, it is recognised that the Group is exposed to increased levels of operational risk, for example in terms of systems capability and staff competencies. The financial services sector also faces growing levels of financial crime, particularly in relation to e-distribution channels, which require increasingly sophisticated anti-fraud controls.

Risk mitigation

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

The Group's operational risk management framework sets out the strategy for identifying, assessing and managing 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 crystallisation of operational risks is captured through the recording of operational losses (and near misses). The analysis of loss events is used to identify any potential systemic weaknesses in operational processes.

Pension obligation risk

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

To mitigate these risks, management, together with the Trustees of the Scheme, regularly review reports prepared by the Scheme's independent actuaries and takes appropriate actions which may, for example, include adjusting the investment strategy and/or contribution levels.

Capital management

The Group conducts an Internal Capital Adequacy Assessment Process (ICAAP) at least annually. This is used to assess the Group's capital adequacy and determine the levels of capital required to support the current and future risks in the business. The ICAAP covers all material risks to determine the capital requirement over a five-year horizon and includes stress scenarios which are intended to meet regulatory requirements. The capital requirements are presented to the Board for approval with the most recent review being completed in December 2011. The ICAAP is used by the FSA to determine and set the Group's Individual Capital Guidance (ICG).

The amounts and composition of the Group's capital requirements are determined by assessing the Basel II Pillar 1 minimum capital requirement, the Group's economic capital requirement, the impact of stress and scenario tests under Pillar 2 and the ICG. The Group manages its capital above the minimum ICG threshold, including a capital planning buffer, at all times. Capital levels for the Group are reported to, and monitored by the Board on a monthly basis.

To meet Basel II Pillar 3 requirements, the Group publishes further information about its exposures and its risk management procedures and policies. It is anticipated that the 2011 version of the Pillar 3 report will be published on the Society's website (www.principality.co.uk) in April 2012.

The Group is in the process of applying to the FSA for permission to use an Internal Ratings Based approach for retail credit risk and capital management. This will allow the Group to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.



R. Michael Jones
Director of Group Risk
31 January 2012

The Valleys
Heart and Soul of Wales
thevalleys.co.uk



Tim Rhys-Evans with valleys singing sensations Only Boys Aloud, headlining a concert for the first time at the Parc & Dare in Treorchy

Board of directors



① Dyfrig D. J. John
CBE FCIB (Age 61)
Chairman

Appointed a non-executive director on 1 July 2009, he became Chairman in April 2010. He is Chairman of the Nominations Committee and a member of the Remuneration Committee.

Other Directorships and Appointments

Board member of the Wales Millennium Centre, member of the Silk Commission on Devolution in Wales and President of the HSBC Bank UK Pension Association.

② Peter L. Griffiths
OBE ACIB (Age 53)
Chief Executive

Joined Principality in December 2001 and became Chief Executive in March 2002. He was appointed a director on 2 January 2002. He is Chairman of: Peter Alan Limited, Nemo Personal Finance Limited and Loan Link Limited. He is a director of all the Society's subsidiary undertakings which have not carried on business throughout the year. These can be seen listed in Note 22 on page 65. He is Chairman of the Executive Committee, Commercial Liability and Asset Management Committee and Building Society Management Committee. He is a member of the Asset and Liability and Group Risk Committees.

Other Directorships and Appointments

Chairman of the Building Societies Association and a member of the advisory Board for Bangor Business School.

③ W. Guy Thomas
BSc (Hons) ACA FCT C.Dir (Age 56)
Group Finance Director

Joined the Society as Finance Director on 1 November 2003. He is a director of Peter Alan Limited, Nemo Personal Finance Limited, Loan Link Limited and Principality Covered Bond LLP. He is also Chairman of the Asset and Liability Committee and a member of the Executive, Commercial Liability and Asset Management and Group Risk Committees.

④ Gordon MacLean
BA FCA (Age 57)
Non-Executive Director

Appointed a non-executive director on 1 April 2006. He is Chairman of the Audit Committee and a member of the Nominations Committee.

Other Directorships and Appointments

Director of 9 Highcliffe Road Management Company Limited.

⑤ Christopher Jones
BA (Age 48)
Non-Executive Director

Appointed a non-executive director on 1 April 2006. He is Chairman of the Remuneration Committee and a member of the Nominations Committee.

Other Directorships and Appointments

Director of Dŵr Cymru Cyf, Glas Cymru Cyf, Glas Cymru (Securities) Cyf, Dŵr Cymru (Financing) Limited, Welsh Water Utilities Finance plc and Dŵr Cymru (Holdings) Limited. He is also Deputy Chairman of the Council of The Prince's Trust Cymru.

⑥ Langley Davies
BSc (Hons) ACA (Age 52)
Non-Executive Director

Appointed a non-executive director on 1 May 2007. He is a director of Nemo Personal Finance Limited and Loan Link Limited, Chairman of the Group Risk Committee and a member of the Audit and Nominations and Commercial Liability and Asset Management Committees.

Other Directorships and Appointments

Partner in Ruperra Properties LLP and Hensol Properties LLP. Director of Vansdirect Limited and Cardiff Hub Limited.

⑦ Keith Brooks
(Age 63)
Non-Executive Director

Appointed a non-executive director on 1 May 2007. He is a director of Peter Alan Limited and a member of the Building Society Management, Group Risk, Remuneration and Nominations Committees. During the year he was appointed to the role of Senior Independent Director.

Other Directorships and Appointments

Chairman of Vista Retail Support Group Limited and a partner in Airport Investments and Enterprises.

⑧ Graeme H. Yorston
FCIB MBA (Age 54)
Executive Director Building Society & Propco

Joined the Society as Chief Operating Officer on 3 July 2006 and was appointed a director on 19 October 2007. He is a director of Nemo Personal Finance Limited and Loan Link Limited. He is a member of the Executive Committee, Building Society Management, Asset and Liability and Group Risk Committees.

⑨ Joanne Kenrick
LLB (Age 45)
Non-Executive Director

Appointed a non-executive director on 1 January 2009. She is a member of the Audit and Nominations Committees.

Other Directorships and Appointments

Marketing Director of Homebase Limited, a director of the 53 Rosslyn Hill Residents Association Limited and a director of MLC Contracting Limited.

Directors' report

for the year ended 31 December 2011

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 2011.

Directors

The names of the directors at the date of this report, together with brief biographical details, are listed on pages 21 and 22.

Christopher Rowlands resigned from the Board effective from 1 October 2011, and there have been no new appointments during the year. In order to comply with UK Corporate Governance Code, and as permitted by Rule 26(1), all of the directors will retire and stand for re-election at the Annual General Meeting in April 2012. 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.

Business objectives and activities of the Society and its subsidiaries

The Society's business objective is to provide Members with the benefits of a mutual organisation through the design, manufacture and delivery of attractive mortgage and savings products. The Society's principal activity is the provision of housing finance funded mainly from Members' savings. It also offers commercial loans and a range of insurance and financial services.

The Society's trading subsidiaries engage in complementary activities including:

- Estate agency, lettings and property services; and
- The provision of secured personal loans.

The directors consider that no activities carried out during 2011 were outside the powers of the Society.

The Society has not acquired or established, or allowed a subsidiary undertaking to acquire or establish, a non-core business to which Section 92A of the Building Societies Act 1986 applies.

New activities

During the year, the Group has:

- Opened a new branch in Monmouth and a new agency in Caernarfon, as well as launching a new website;
- Launched pa black, designed to assist in the sale and purchase of high end properties;

- Entered into a lease with Travelodge Hotels Limited for floors 1 - 4 of Principality Buildings; and
- Issued a RMBS in August 2011.

Profits and capital

Profit before tax was £24.5m (2010: £30.8m). The profit after tax transferred to the general reserve was £17.4m (2010: £23.2m).

Total Group general reserves at 31 December 2011 were £324.7m (2010: £310.6m).

Gross capital at 31 December 2011 was £509.1m (2010: £492.5m), including £107.0m of subordinated debt and £75.4m of permanent interest-bearing shares (PIBS).

The ratio of gross capital as a percentage of shares and borrowings at 31 December 2011 was 8.75% (2010: 8.71%) and the free capital ratio was 9.04% (2010: 8.93%). The Annual Business Statement on page 93 contains an explanation of these ratios.

Mortgage arrears

At 31 December 2011 there were 824 (2010: 782) mortgage accounts across the Group on which payments were 12 or more months in arrears. Within these accounts the total amount of principal outstanding was £37.5m (2010: £39.0m) and the total amount of arrears was £8.0m (2010: £8.0m), for which provision has been made where appropriate.

Material differences between market and book value of land and buildings

The Board considers that the market value of the Group's freehold and leasehold properties is in excess of the book value.

Corporate social responsibility

Charitable donations

During the year the Group made charitable donations of £20k (2010: £45k). No contributions were made for political purposes.

Environmental policy

Environmental considerations continue to be high on the Group's agenda. Having investigated the suitability of Solar PV Panels, a large 47Kw scheme was initiated for the roof at our Culverhouse Cross Headquarters building for Peter Alan and the Property Services businesses. This is a large scheme installed and registered in time to benefit from the Governments feed in tariff prior to changes made in December 2011. This scheme will not only reduce costs but will also save around 39,000 kilograms of CO2 emissions per annum. During 2012 we will investigate the suitability

of this technology for other locations across the Group's portfolio.

During 2011, over 39,000 kilograms of paper have been recycled, 157,000kwh of electricity saved and landfill reduced by 88m³. Over 98 large (1,100 litre) recycling bins of waste were taken out of Principality House during 2011 that prior to 2009 would have gone to landfill. Lighting has been changed to more efficient units as well as installing further sensors to ensure lighting is turned off when not in use.

A robust planned maintenance regime for all of the Group's air conditioning units has been developed, ensuring maximum efficiency at all times.

Employees

The Society recognises the importance of effective communication with staff. Communication includes an intranet site, in-house publications, conferences and regular team cascade meetings. Employee feedback is welcomed and encouraged through a variety of methods such as a joint staff and management forum and participation in staff surveys. In addition, there is regular consultation with union representatives.

Great importance is placed on the recruitment, training and retention of high-calibre employees. Competitive remuneration packages and individual performance plans, clearly linked to corporate objectives through balanced business scorecards, are key elements in the reward strategy.

It is the Society's policy to ensure that all employees and applicants for employment are afforded equal opportunity regardless of gender, sexual orientation, ethnic origin, age or disability. Wherever practical, arrangements will be made for continuing the employment of, and arranging appropriate training for, employees who become disabled during their employment with the Society.

Supplier payment policy

It is the Society's policy to discharge suppliers' invoices for the complete provision of goods and services in full conformity with the conditions of the purchase and within the agreed payment terms. It is intended that this policy be continued in 2012.

At 31 December 2011 the total amount owed to suppliers was equivalent to 27 days credit (2010: 27 days).

Auditor

At the Annual General Meeting on 21 April 2011 the Members passed a resolution that Deloitte LLP be re-appointed as auditors for the ensuing year.

Responsibilities of the directors

The following statement, which should be read in conjunction with the statement of the auditor's responsibilities on page 35, 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, subject to any material departures disclosed and explained in the Annual Accounts; and
- Prepare the Annual Accounts on the going concern basis, unless it is inappropriate to presume that the Society will continue in business.

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

Directors' responsibilities for accounting records and internal controls

The directors are responsible for ensuring that the Group:

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

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

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

Going concern

The Chairman's statement and Chief Executive's review on pages 1 to 7, together with the Business Review on pages 8 to 14, set out a review of the business for the year and the Society's future plans. In addition, Note 40 to the financial statements on pages 77 to 91 gives detail of the Group's financial instruments and hedging activities; and its exposures to credit, liquidity and market risk. The principal risks and uncertainties faced by the Society and the Group, financial risk management objectives and policies, and the way in which the Group uses financial derivatives, are summarised in the Risk Management report on pages 15 to 19 and in Note 40 on pages 77 to 91.

As presented in the consolidated statement of financial position, the Group meets its funding requirements, which include the need to maintain a sufficient liquidity buffer, mainly from retail sources supplemented by a RMBS issue during the year. The current economic conditions create some uncertainty over the availability of wholesale funding in the foreseeable future.

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

The assets held for liquidity purposes are assessed and regularly reviewed for counterparty risks, and the directors consider that the Group is not exposed to losses on those assets that would affect the decision to adopt the basis of going concern. The directors consider that the overall level of capital, including Tier 1 capital of £381.5m (13.49% as a percent of risk-weighted assets) and a solvency ratio of 16.89% is adequate.

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

The future

We fully expect the strained economic conditions to continue for some time, with increased pressures due to reductions in public spending, higher levels of unemployment and increased global pressures. There is no doubt that against that backdrop, and as the impact of the Vickers Review is felt, there will be increased demand for retail savings and further consolidation within the sector. Public and political interest in financial services will not diminish and we are closely monitoring the move from the Financial Services Authority to the Prudential Regulation Authority and the Financial Conduct Authority.

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

On behalf of the Board of Directors



Dyfrig D. J. John
Chairman
31 January 2012

Corporate governance report

The Society has continued to comply with the UK Corporate Governance Code in so far as its provisions are relevant to building societies.

The Board

The Board focuses on strategic issues, control of the business, review of operational and management performance, oversight of subsidiary companies and maintaining a system of effective corporate governance. The Board Controls and Procedures Manual sets out matters reserved to the Board and those which are delegated to management. This is reviewed annually by the Board.

During the year Christopher Rowlands, Deputy Chairman, resigned from the Board to take up another role. The role of Deputy Chairman presently remains open and the process to fill the Board vacancy created by this resignation has commenced. Keith Brooks has been appointed to undertake the role of the Senior Independent Director.

The Board operates through its regular monthly meetings and four committees: Audit, Remuneration, Nominations and Group Risk. The current Board committee structure was ratified in 2010 with some minor alterations to terms of reference and membership of those committees taking place during 2011.

Board and Committee membership and attendance record

| | Board | Audit | Remuneration | Nominations | Group Risk |
|-----------------------|-------|-------|--------------|-------------|------------|
| Dyfrig John | 14/14 | - | 7/7 | 1/1 | - |
| Keith Brooks | 14/14 | - | 7/7 | 1/1 | 4/5 |
| Langley Davies | 14/14 | 6/6 | - | 1/1 | 2/2 |
| Peter Griffiths | 14/14 | - | - | 1/1 | 3/5 |
| Christopher Jones | 14/14 | - | 7/7 | 1/1 | - |
| Joanne Kenrick | 13/14 | 6/6 | - | 1/1 | - |
| Gordon MacLean | 13/14 | 6/6 | - | 1/1 | - |
| Christopher Rowlands* | 7/9 | - | - | - | 3/3 |
| Guy Thomas | 14/14 | - | - | - | 4/5 |
| Graeme Yorston | 14/14 | - | - | - | 4/5 |

* Resigned from the Board with effect from 1 October 2011.

The Nominations Committee meets as and when required to consider and recommend new appointments to the Board. The Nominations Committee met in October and agreed to begin the recruitment process for a new non-executive director.

Audit Committee

The Committee is chaired by Gordon MacLean with Langley Davies and Joanne Kenrick as its other members, all of whom are independent non-executive directors. Gordon MacLean and Langley Davies have recent and relevant financial experience. The Chief Executive, the Group Finance Director, the Group Secretary, the Head of Group Audit, the Head of Group Compliance and representatives of Deloitte, the external auditor, attend each meeting. The Assistant Secretary acts as secretary to the Committee. The Committee acts as an Audit Committee for the Society and its subsidiary companies.

The work of the Committee principally falls under three main areas: reviewing accounting policies and the contents of financial reports to ensure the integrity of those statements and particularly the key financial judgements; monitoring the internal control environment; and oversight of internal and external audit including oversight of the relationship with the external auditor.

During the year the Committee met on six occasions. It monitored the integrity of the financial statements and formal announcements relating to the Group's financial performance and reviewed relevant accounting policies and any significant financial judgements contained in them. The Committee has reviewed the adequacy of the Group's impairment charges and is satisfied that these charges are appropriate. The Committee receives regular reports from the Head of Group Internal Audit on the adequacy of the control environment and has reviewed the effectiveness of the Group's financial controls and the internal control and risk management systems, compliance with financial services legislation and regulations, and has monitored progress to ensure that any required remedial action has been or is being taken on any identified weaknesses.

During 2011 the UK Bribery Act came into effect and the Committee monitored the progress of work to conform with this Act.

The Committee reviewed Deloitte's overall work plan and approved their remuneration and terms of engagement and considered in detail the results of the audit, Deloitte's performance and independence and the effectiveness of the overall audit process. To evaluate the performance and effectiveness of the external auditor, feedback is sought from key stakeholders via a questionnaire. Responses are analysed and presented to the Committee for review and discussion. The Committee remains satisfied with the performance of Deloitte and has recommended Deloitte's re-appointment as auditor to the Board and this resolution will be put to Members at the 2012 Annual General Meeting.

The Committee has implemented the Group's policy which restricts the engagement of the external audit firm, presently Deloitte, in relation to non-audit services. The policy is designed to ensure that the provision of such services does not have an impact on the external auditor's independence and objectivity. It identifies engagements that can only be undertaken with appropriate authority from the Committee Chairman or the Committee where non-audit fees will exceed pre-set thresholds.

The Committee receives an annual report on the non-audit services being provided and the cumulative total of non-audit fees. These were conducted in accordance with the framework established to govern such assignments and are considered to be consistent with the professional and ethical standards expected of the external auditor. The non-audit fees of £466k paid in the year relate to tax advice, specialist corporate finance consultancy and additional assurance in relation to the RMBS. The Group audit fee paid in the year was £130k. The Committee requires management robustly to justify all proposals to use the Group's external auditor for non-audit services. A breakdown of audit and non-audit fees can be found in Note 9.

The Committee has approved the Group Internal Audit plan and regularly reviewed the Internal Audit department's resources, work progress, results and management's implementation of its recommendations. The Committee also reviews and, if appropriate, approves any adjustments to be made to the audit plan. The Head of Group Internal Audit has direct access to the Committee Chairman and the Society's Chairman. The internal audit function generally conforms to the standards set by the Institute of Internal Auditors. The Committee remains keen to ensure that the internal audit team and other teams within the Oversight function are properly resourced to enable them to fulfil their remit. During the year the Committee has held private meetings with the Head of Group Internal Audit, the Head of Group Compliance and Deloitte during the year.

The Committee receives regular reports on the Group's arrangements whereby employees can raise specific concerns and details of any action being taken to follow up specific reports.

The Group maintains a financial crime policy and the Audit Committee receives an update at each meeting in relation to any material fraud and any associated action taken.

The Committee has written terms of reference which are reviewed annually. The Committee reports on its activities to the Board.

Auditor independence

The appointment of the external auditor is co-ordinated through the Audit Committee which recommends any appointment or re-appointment to the Board. This is normally undertaken through a process of competitive tendering. There are no contractual obligations in place which restrict the Society's choice of external auditor and no auditor liability agreement has been entered into by the Society. 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 2011 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 the current year.

In addition the external auditor is required to rotate the audit partner responsible for the Society every five years and a new audit partner has been appointed who will take up his position in early 2012.

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.

Remuneration Committee

This Committee of non-executive directors is chaired by Christopher Jones. The other members during the year were Keith Brooks and Dyfrig John. The Committee has written terms of reference which are reviewed annually. It considers remuneration policy and the Board delegates to this Committee decisions on executives' remuneration and compensation packages. The Committee monitors changing trends in directors' remuneration in the market place including consideration of the FSA Code on Remuneration Practice. The Committee is responsible for maintaining the Group's Remuneration Policy. In performing its duties the Committee draws on the advice of independent consultants – Hewitt New Bridge Street – who have no other connection with the Society. No individual is present at a meeting when his or her own pay is decided. Fees payable to the Chairman and other non-executive directors are determined by the Board on recommendations from the executive directors. Details of directors' remuneration are set out on page 33. The Committee reports on its activities to the Board.

Nominations Committee

The Nominations Committee is chaired by Dyfrig John and usually consists of a minimum of two further non-executive directors together with the Chief Executive. It has written terms of reference which are reviewed annually. The Committee is responsible for succession planning and acts as a nomination committee for all new Board appointments. The terms upon which directors are appointed are available from the Group Secretary on request. The Committee reports on its activities to the Board.

Group Risk Committee

The Group Risk Committee is chaired by Langley Davies. The other members of the Committee include Keith Brooks, Senior Independent Director, the Chief Executive, the Group Finance Director, the Executive Director (Building Society and PropCo), the Director of Group Risk, the Group Secretary and a number of other senior managers across the Group. The Committee has written terms of reference which are reviewed annually. The Committee is responsible for considering and recommending the Group's risk appetite, capital and liquidity adequacy to the Board. It is responsible for maintaining an appropriate governance structure to ensure that risks across the Group are identified and managed effectively and for monitoring and reviewing internal and external risks. The Committee reports on its activities to the Board.

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

Board balance and independence

At the end of 2011 the Board comprised a non-executive Chairman and five other non-executive directors and three executive directors. Each of the non-executive directors, including the Chairman, is considered by the Board to be independent in judgement and free of any relationships likely to affect his or her judgement.

The Chairman and Chief Executive

The Chairman leads the Board and 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 Chief Executive's responsibilities are set out in a role profile approved by the Board.

Board appointments

Non-executive candidates are sought in various ways, including through press advertisements and with the assistance of external search consultants. Candidates must meet the Financial Services Authority's fitness and propriety standards. 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. The Board has resolved that from and including 2012 all directors will stand for re-election annually. A copy of the letter of appointment for a non-executive director can be obtained on request from the Group Secretary.

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 Society has a programme for meeting directors' training requirements. Newly appointed non-executive directors are provided with appropriate training on their roles and responsibilities. Subsequent training is provided on an ongoing basis to meet particular needs.

Performance evaluation

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

In January 2012 the Board undertook an evaluation of the performance of the Chairman and an evaluation of its own performance. The Audit, Remuneration and Group Risk Committees each undertook a review of their own effectiveness during the year.

Communication with Members and the Annual General Meeting

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

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

Risk management and internal control

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

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

There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Group.

The process currently consists of:

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

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



Dyfrig D. J. John
Chairman
31 January 2012



Principality funded a £12 million loan towards the Welsh Housing Partnership to create a more credible institutional rental model for Wales. Pictured are Head of Principality Commercial, Peter Hughes, Minister Jane Hutt, Welsh Housing Partnership Chair Ian Williams, first tenant Charlotte Awcock, Community Housing Cymru Chief Executive Nick Bennett and Minister Huw Lewis.

Report of the Remuneration Committee

The report has been divided into separate sections for audited and unaudited information.

Unaudited information

Remuneration principles

Principality is proud to be a mutually owned business, operated to provide benefits to its Members. Through our remuneration policy, we seek to promote the best interests of our Members and, in particular, to ensure that the business is run safely and successfully so as to keep our Members' savings safe and their other financial relationships with us secure and reliable. It follows that the two most important principles underlying our approach to remuneration, in particular of the executive directors, are:

- To set the overall remuneration at a level which is competitive but not excessive, so that we are able to attract and retain high quality people who can ensure that Principality continues to trade successfully in a highly competitive and uncertain marketplace; and
- To structure that remuneration, particularly the variable elements, in such a way that our people are incentivised and rewarded for good performance that furthers the interests of Members but does not encourage risk-taking that is excessive or in any other way inappropriate for a mutual institution.

Principality seeks to maintain high standards of corporate governance at all times. In this report, we set out information which meets the key disclosure requirements of the Combined Code on Corporate Governance.

Recent Regulatory Developments: Financial Services Authority Remuneration Code

The Group is covered by the provisions and requirements of the Financial Services Authority's (FSA) 'Remuneration Code', being classified as a 'Tier 2' firm which primarily impacts on the Group's overall pay and incentive structures. As a Tier 2 firm, the Code, initially published in December 2010, became fully effective from 1 January 2011 with a transitional period to implement the Code's requirements which ran until 30 June 2011.

The work put in place over the past two years has meant that we already comply with much of the Code. During 2011, we have continued to respond to the FSA's requirements and have submitted the Group's agreed approach to the Code to the FSA, which included our approach to the identification of staff covered by the Code, the ratios of fixed to variable remuneration and the deferral arrangements for Code Staff bonus schemes. More specifically we have considered the guidance issued by the FSA on the disclosure of remuneration covering the requirements of the Capital Requirements Directive,

and guidance from the Committee of European Banking Supervisors. During 2012, the Committee will continue to maintain its compliance with the Code and all future regulatory developments.

The work of the Remuneration Committee

The Remuneration Committee comprises Christopher Jones (Chairman), Keith Brooks and Dyfrig John, all of whom are independent non-executive directors. The Committee met on seven occasions during the year (2010: six times). The Committee is responsible for determining, on behalf of the Board, the overall remuneration practices and policies for all staff and, in particular, the level of remuneration of the three executive directors and eight other senior Code Staff, who have been identified by the Committee as having a potential material impact on the Society's risk profile.

During the year the Committee reviewed the following:

- The annual pay review for staff across the Group;
- The design of bonus schemes against targets for executives and Code Staff including consideration of the FSA Remuneration Code;
- The scheme rules for both the executive Annual Bonus Scheme and the Group Performance Bonus Scheme;
- The pensions strategy in relation to future plans for the, closed to future accrual, defined benefit pension scheme (closed to future accrual in July 2010);
- Compliance with all elements of the FSA Remuneration Code; and
- The Group Reward, and other policies and the Terms of Reference for the Committee. Full Terms of Reference for the Committee can be found on the Society's website.

The Committee draws on the advice of independent external advisors if it considers this beneficial when performing its duties. This year Hewitt New Bridge Street provided benchmarking of executive, Chairman and non-executive directors remuneration packages. This consultancy has no other connection with the Society. KPMG and Eversheds provided advice on forthcoming legislative changes relating to pensions, on taxation and pensions strategy.

Elaine Morris, Group Secretary, acts as secretary to the Committee. The Group HR Director attends each Committee meeting as well as the Head of Group HR. The Chief Executive, the Group Finance Director and the Director of Group Risk are invited to attend the Committee's meetings as needed and the Committee considers their views when reviewing the remuneration of senior executives, managers and staff. They are not involved in discussions concerning their own pay.

Components of executive remuneration

There are five elements of pay for executive directors - base salary, annual bonus, Group Performance Bonus, pension benefits and benefits in kind (details of which are set out on page 33 and 34). Awards under both bonus schemes are non-pensionable.

Base salary

Base salary determined by the Committee reflects the individual's skills, experience and performance as well as the responsibilities of the role. The Committee considers salary levels for similar roles within a comparator group of the largest building societies. When determining executive salaries the Committee has regard to economic factors, remuneration trends and the general level of salary increases awarded through the Group. In 2011, a 2.5% increase was made to executive directors' salaries, the same as the average increase for all Society staff.

Annual bonus

The Annual Bonus Scheme provides an opportunity to reward executive directors for achieving stretching targets for the financial year. It is based on the achievement of a basket of performance targets related to financial, customer service, people and process measures, together with personal objectives. To ensure affordability and to protect the interests of Members, the financial measure is a stretching profit target. The maximum bonus achievable under the Annual Bonus Scheme is 40% of salary. The scheme also specifies regulatory capital and liquidity hurdles which the Society must meet before any award can be made.

Three executive directors, Peter Griffiths, Guy Thomas and Graeme Yorston, are eligible for annual bonus awards of 20% in respect of performance during 2011. In accordance with the Remuneration Code, 60% of this award will be paid in February 2012, with the balance being paid in three equal instalments in February 2013, 2014 and 2015. Under the scheme rules, the remainder of the deferred award is subject to annual review and may be reduced or withdrawn at the discretion of the Committee in line with the requirements set out in the FSA's Remuneration Code.

Group Performance Bonus

The Group Performance Bonus (GPB) is designed to incentivise executive directors to achieve sustained returns, in particular through the growth of profitable new business within the Group. The GPB is based on a comparison of the Group's annual performance (in terms of the post-tax return on mean assets) with that of a comparator group consisting of the largest building societies. The maximum bonus achievable under the GPB scheme is 60% of salary. Thresholds for regulatory capital and liquidity must also be met before any comparison of the Group's performance with the comparator group is calculated and any award made. Payment is not made if the performance falls below 90% of the average of the comparator group.

In accordance with the Remuneration Code, 60% of this scheme's award for 2011 will be calculated and paid in June 2012, when the results are known for the comparator group of companies, some of which have a year-end date

of March 2012. An accrual is made in these accounts of an amount equal to the payment for performance at the average of the comparator group. Under the scheme rules, the remainder of the deferred award (40%) will be paid in equal instalments over the following three years, subject to annual review and may be reduced or withdrawn at the discretion of the Committee in line with the requirements set out in the FSA's Remuneration Code.

Non-executive directors' remuneration

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 for the Chairman and non-executive directors are set by the Board on recommendations from the executive directors.

In 2011, benchmarking data was sourced from Hewitt New Bridge Street as the Society recognised that the time demands and responsibilities for its non-executive directors have increased substantially over the past number of years due to the increase in regulatory demands. The benchmarking data showed that the Society's non-executive director fees were below the market median for our comparator group of the largest building societies. Therefore, the Chairman and non-executive director basic fees were increased by 2.5%, equal to the average increase for all staff and executive directors, and the fees for services on the Board Committees were also increased.

Details of non-executive directors' remuneration are set out on the following page. The Chairman and non-executive directors do not participate in any bonus schemes or any pension arrangements.

Audited information

Directors' remuneration in respect of the year to 31 December 2011

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

| | Salary & fees | Benefits | Annual bonus | Group performance bonus | Sub-total | Increase accrued pension | Pension | Total |
|----------------------------|---------------|-----------|--------------|-------------------------|--------------|--------------------------|------------|--------------|
| | £000 | £000 | £000 | £000 | £000 | £000 | £000 | £000 |
| Executive 2011 | | | | | | | | |
| Peter Griffiths | 302 | 13 | 60 | 106 | 481 | - | 45 | 526 |
| Guy Thomas | 211 | 13 | 42 | 74 | 340 | - | 32 | 372 |
| Graeme Yorston | 200 | 11 | 40 | 70 | 321 | - | 30 | 351 |
| Total | 713 | 37 | 142 | 250 | 1,142 | - | 107 | 1,249 |
| Executive 2010 | | | | | | | | |
| Peter Griffiths | 296 | 13 | 74 | 177 | 560 | 5 | 19 | 584 |
| Haydn Warman (to 09/03/10) | 34 | 3 | - | 12 | 49 | 3 | - | 52 |
| Guy Thomas | 207 | 13 | 52 | 124 | 396 | 3 | 13 | 412 |
| Graeme Yorston | 196 | 11 | 49 | 118 | 374 | - | 27 | 401 |
| Total | 733 | 40 | 175 | 431 | 1,379 | 11 | 59 | 1,449 |

| | Salary and fees | |
|--------------------------------------|-----------------|--------------|
| | £000 | £000 |
| Non-executive directors | | |
| David Williams (to 23/04/10) | - | 22 |
| Dyfrig John | 68 | 55 |
| Eurfyl ap Gwilym (to 23/04/10) | - | 20 |
| Christopher Rowlands (to 01/10/11) | 34 | 38 |
| Christopher Jones | 35 | 35 |
| Gordon MacLean | 45 | 44 |
| Langley Davies | 63 | 46 |
| Keith Brooks | 54 | 45 |
| Joanne Kenrick | 34 | 32 |
| Sub-total | 333 | 337 |
| Executive remuneration total | 1,249 | 1,449 |
| Total directors' remuneration | 1,582 | 1,786 |

1. The 2010 Group Performance Bonus (GPB) was calculated in July 2011 once the full set of results for the comparator group was available. This resulted in an additional bonus entitlement of £174k earned by executive directors in relation to the final outcome of the Scheme. This sum is payable over three years.
2. The 2011 GPB is based on an assumption of average performance relative to the comparator group and will be adjusted upwards or downwards to reflect actual performance once the other 2011 results are known.
3. The figures under Benefits include cars, fuel, and personal medical insurance.

Executive directors' service contracts

The following directors have service contracts in relation to their executive duties which provide for a 12-month notice period or termination payment:

| | Date of contract |
|-----------------|------------------|
| Peter Griffiths | 14/11/06 |
| Guy Thomas | 14/11/06 |
| Graeme Yorston | 31/12/07 |

Executive directors' pension arrangements

The defined benefit pension scheme was closed during 2010. At the end of 2010 the transfer value of accrued pension was £334k for Peter Griffiths and £363k for Guy Thomas.

From 1 August 2010 all three executives received pension contributions of 15% of basic salary payable into a defined contribution scheme or elected to be paid as a cash allowance. These pension contributions are recorded in the directors' remuneration table opposite. Life assurance of four-times basic salary in the event of death in service is maintained.

Conclusion

The Group has performed well in 2011 reflecting sound management and the benefits of strategies put in place in previous years. This result has been achieved in a year of extremely challenging and uncertain market conditions. Our good trading performance has protected the interests of our Members and has enabled us to continue to provide strong Member value. The Committee believes that having appropriate remuneration arrangements and policies in place, as set out in this report, has contributed to this positive result.

The Committee recommends this report to Members for approval at our Annual General Meeting.



Christopher Jones
Chairman
31 January 2012

Independent Auditor's report to the Members of Principality Building Society

We have audited the Group and Society financial statements of Principality Building Society for the year ended 31 December 2011 which comprise the Consolidated and Society Statements of Comprehensive Income, the Consolidated and Society Total Statements of Recognised Income and Expense, the Consolidated and Society Statements of Financial Position, the Consolidated and Society Statements of Cash Flows and the related Notes 1 to 41. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

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.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements which give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Society's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- Give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31 December 2011 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.

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; and
- 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.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Building Societies Act 1986 requires us to report to you if, in our opinion:

- 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.



Mark McQueen
Senior Statutory Auditor
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Cardiff, United Kingdom
31 January 2012



Staff at our AGM are always on hand to help

Consolidated statement of comprehensive income

for the year ended 31 December 2011

| | Notes | 2011 £m | 2010 £m |
|-------------------------------------------------------|---------|-------------|-------------|
| Interest receivable and similar income | 4 | 235.4 | 222.4 |
| Interest payable and similar charges | 5 | (130.4) | (110.6) |
| Net interest income | | 105.0 | 111.8 |
| Fees and commission receivable | 6 | 20.6 | 17.9 |
| Fees and commission payable | 7 | (1.4) | (1.6) |
| Net fee and commission income | | 19.2 | 16.3 |
| Other operating income | | 1.4 | 0.8 |
| Other fair value (losses)/gains | 8 | (0.1) | 0.2 |
| Net operating income | | 125.5 | 129.1 |
| Administrative expenses | 9 | (60.0) | (56.4) |
| Depreciation and amortisation | 24 & 25 | (6.2) | (5.7) |
| Operating expenses | | (66.2) | (62.1) |
| Impairment provision for losses on loans and advances | 21a | (24.6) | (22.2) |
| Provision for other liabilities and charges | 21b | (11.2) | (17.1) |
| Operating profit | | 23.5 | 27.7 |
| Other gains | 35 | 1.0 | 3.1 |
| Profit before taxation | | 24.5 | 30.8 |
| Taxation expense | 13 | (7.1) | (7.6) |
| Profit for the year | | 17.4 | 23.2 |

Consolidated statement of total recognised income and expense

| | Notes | 2011 £m | 2010 £m |
|---------------------------------------------------------------------|-----------|-------------|-------------|
| Profit for the year | | 17.4 | 23.2 |
| Actuarial loss on retirement benefit obligations | 12 | (4.2) | (0.5) |
| Movement in deferred tax relating to retirement benefit obligations | 34 | 0.9 | - |
| Total recognised income for the year | 37 | 14.1 | 22.7 |

All items dealt with in arriving at the profit before tax and the profit for the financial year, and the preceding financial year, as above, relate to continuing operations.

The accounting policies and notes on pages 43 to 92 form part of these accounts.

Statement of comprehensive income of the Society

for the year ended 31 December 2011

| | Notes | 2011 £m | 2010 £m |
|-------------------------------------------------------|---------|------------|-------------|
| Interest receivable and similar income | 4 | 192.5 | 177.3 |
| Interest payable and similar charges | 5 | (130.1) | (110.6) |
| Net interest income | | 62.4 | 66.7 |
| Fees and commission receivable | 6 | 9.9 | 10.1 |
| Fees and commission payable | 7 | (0.5) | (0.5) |
| Net fee and commission income | | 9.4 | 9.6 |
| Other operating income | | 1.5 | 1.2 |
| Other fair value (losses)/gains | 8 | (0.1) | 0.2 |
| Net operating income | | 73.2 | 77.7 |
| Administrative expenses | 9 | (45.0) | (42.4) |
| Depreciation and amortisation | 24 & 25 | (5.0) | (4.6) |
| Operating expenses | | (50.0) | (47.0) |
| Impairment provision for losses on loans and advances | 21a | (11.3) | (12.4) |
| Provision for other liabilities and charges | 21b | (1.9) | (1.0) |
| Operating profit | | 10.0 | 17.3 |
| Other gains | | 1.0 | 3.1 |
| Profit before taxation | | 11.0 | 20.4 |
| Taxation expense | 13 | (2.7) | (4.6) |
| Profit for the year | | 8.3 | 15.8 |

Statement of recognised income and expense of the Society

| | Notes | 2011 £m | 2010 £m |
|---------------------------------------------------------------------|-----------|------------|-------------|
| Profit for the year | | 8.3 | 15.8 |
| Actuarial loss on retirement benefit obligations | 12 | (4.2) | (0.5) |
| Movement in deferred tax relating to retirement benefit obligations | 34 | 0.9 | - |
| Total recognised income for the year | 37 | 5.0 | 15.3 |

All items dealt with in arriving at the profit before tax and the profit for the financial year, and the preceding financial year, as above, relate to continuing operations.

The accounting policies and notes on pages 43 to 92 form part of these accounts.

Consolidated statement of financial position

at 31 December 2011

| | Notes | 2011 £m | 2010 £m |
|----------------------------------------------------|-------|----------------|----------------|
| Assets | | | |
| Liquid assets: | | | |
| Cash in hand and balances with the Bank of England | | 532.9 | 320.7 |
| Loans and advances to credit institutions | 14 | 172.1 | 73.3 |
| Debt securities | 15 | 409.7 | 800.8 |
| | | 1,114.7 | 1,194.8 |
| Derivative financial instruments | 16 | 45.5 | 38.7 |
| Loans and advances to customers: | | | |
| Loans fully secured on residential property | 18 | 4,644.9 | 4,338.1 |
| Other loans fully secured on land | 19 | 530.0 | 571.5 |
| Other loans | 18 | 45.2 | 50.8 |
| | 20 | 5,220.1 | 4,960.4 |
| Investment in joint venture | 23 | - | - |
| Intangible fixed assets | 24 | 2.5 | 2.1 |
| Property, plant and equipment | 25 | 43.7 | 40.9 |
| Deferred tax assets | 34 | 3.3 | 3.3 |
| Other assets | 26 | 4.9 | 3.8 |
| Prepayments and accrued income | 27 | 15.0 | 18.1 |
| Total assets | | 6,449.7 | 6,262.1 |

| | | | |
|-------------------------------------|-----|----------------|----------------|
| Liabilities | | | |
| Shares | 28 | 5,013.8 | 5,039.0 |
| Deposits and debt securities: | | | |
| Amounts owed to credit institutions | 29 | 115.4 | 245.4 |
| Amounts owed to other customers | 30 | 306.9 | 286.9 |
| Debt securities in issue | 31 | 386.3 | 86.3 |
| | | 808.6 | 618.6 |
| Derivative financial instruments | 16 | 57.4 | 55.7 |
| Current tax liabilities | | 3.1 | 1.3 |
| Other liabilities | 32 | 8.6 | 6.7 |
| Provisions for liabilities | 21b | 26.7 | 24.8 |
| Accruals and deferred income | 33 | 9.9 | 12.7 |
| Deferred tax liabilities | 34 | 1.0 | 1.5 |
| Retirement benefit obligations | 12 | 11.5 | 9.3 |
| Subordinated liabilities | 35 | 107.0 | 112.3 |
| Subscribed capital | 36 | 75.4 | 69.2 |
| Total liabilities | | 6,123.0 | 5,951.1 |
| General reserve | 37 | 324.7 | 310.6 |
| Other reserves | 38 | 2.0 | 0.4 |
| Total equity and liabilities | | 6,449.7 | 6,262.1 |

The accounting policies and notes on pages 43 to 92 form part of these accounts.

These accounts were approved by the Board on 31 January 2012.

Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Peter L. Griffiths Chief Executive

W. Guy Thomas Group Finance Director





Statement of financial position of the Society

at 31 December 2011

| | Notes | 2011 £m | 2010 £m |
|----------------------------------------------------|-------|----------------|----------------|
| Assets | | | |
| Liquid assets: | | | |
| Cash in hand and balances with the Bank of England | | 532.9 | 320.7 |
| Loans and advances to credit institutions | 14 | 72.3 | 71.8 |
| Debt securities | 15 | 409.7 | 800.8 |
| | | 1,014.9 | 1,193.3 |
| Derivative financial instruments | 16 | 45.5 | 38.7 |
| Loans and advances to customers: | | | |
| Loans fully secured on residential property | 18 | 4,068.5 | 3,711.2 |
| Other loans fully secured on land | 19 | 530.0 | 571.5 |
| | 20 | 4,598.5 | 4,282.7 |
| Investments in subsidiary undertakings | 22 | 587.5 | 653.7 |
| Investment in joint venture | 23 | - | - |
| Intangible fixed assets | 24 | 1.8 | 1.4 |
| Property, plant and equipment | 25 | 39.3 | 36.7 |
| Deferred tax assets | 34 | 3.3 | 3.1 |
| Other assets | 26 | 2.9 | 3.7 |
| Prepayments and accrued income | 27 | 14.0 | 17.3 |
| Total assets | | 6,307.7 | 6,230.6 |

| | | | |
|-------------------------------------|-----|----------------|----------------|
| Liabilities | | | |
| Shares | 28 | 5,013.8 | 5,039.0 |
| Deposits and debt securities: | | | |
| Amounts owed to credit institutions | 29 | 317.5 | 242.6 |
| Amounts owed to other customers | 30 | 306.9 | 286.9 |
| Debt securities in issue | 31 | 83.8 | 86.3 |
| | | 708.2 | 615.8 |
| Derivative financial instruments | 16 | 57.4 | 55.7 |
| Current tax liabilities | | 0.6 | 0.9 |
| Other liabilities | 32 | 6.4 | 4.8 |
| Provisions for liabilities | 21b | 5.1 | 4.9 |
| Accruals and deferred income | 33 | 8.9 | 11.4 |
| Deferred tax liabilities | 34 | 1.1 | 1.6 |
| Retirement benefit obligations | 12 | 11.5 | 9.3 |
| Subordinated liabilities | 35 | 107.0 | 112.3 |
| Subscribed capital | 36 | 75.4 | 69.2 |
| Total liabilities | | 5,995.4 | 5,924.9 |
| General reserve | 37 | 310.3 | 305.3 |
| Other reserves | 38 | 2.0 | 0.4 |
| Total equity and liabilities | | 6,307.7 | 6,230.6 |

The accounting policies and notes on pages 43 to 92 form part of these accounts.

These accounts were approved by the Board on 31 January 2012.

Signed on behalf of the Board:

Dyfrig D. J. John Chairman



Peter L. Griffiths Chief Executive



W. Guy Thomas Group Finance Director



Consolidated statement of cash flows

for the year ended 31 December 2011

| | 2011 £m | 2010 £m |
|------------------------------------------------------------------|----------------|----------------|
| Net cash outflow from operating activities (see below) | (120.5) | (118.8) |
| Cash flows from investing activities | | |
| Purchase of intangible assets and property, plant and equipment | (9.9) | (9.9) |
| Purchase of investment securities | (1,342.9) | (2,228.2) |
| Proceeds from sale and maturity of investment securities | 1,736.1 | 2,510.1 |
| Disposal of shares in joint venture | - | 1.9 |
| Cash flows from financing activities | | |
| Subordinated debt repurchase | (2.0) | (6.9) |
| Increase in cash and cash equivalents | 260.8 | 148.2 |
| Cash and cash equivalents at beginning of year | 390.9 | 242.7 |
| Cash and cash equivalents at end of year | 651.7 | 390.9 |
| Represented by: | | |
| Cash and balances with the Bank of England | 532.9 | 320.7 |
| Loans and advances to credit institutions repayable on demand | 118.8 | 70.2 |
| | 651.7 | 390.9 |
| Net cash inflow from operating activities | | |
| Profit before taxation | 24.5 | 30.8 |
| Adjusted for: | | |
| Depreciation and amortisation | 6.2 | 5.7 |
| Loss on sale of property, plant and equipment | 0.4 | 0.3 |
| Increase in impairment losses on loans and advances to customers | 24.6 | 22.2 |
| Change in fair values | 9.4 | (1.2) |
| Other non-cash movements | (0.9) | (2.9) |
| Changes in net operating assets | | |
| (Increase)/decrease in loans and advances to credit institutions | (50.1) | 50.0 |
| (Increase) in loans and advances to customers | (280.8) | (242.5) |
| (Increase) in other assets | (1.1) | (2.6) |
| Decrease in prepayments and accrued income | 3.1 | 0.9 |
| (Decrease)/increase in derivative financial instruments | (5.1) | 2.8 |
| (Decrease)/increase in shares | (34.2) | 103.8 |
| Increase/(decrease) in deposits and debt securities | 189.9 | (94.6) |
| Increase in other liabilities | 1.9 | 1.0 |
| (Decrease)/increase in accruals and deferred income | (0.9) | 15.9 |
| (Decrease) in pension fund obligations | (2.0) | (1.1) |
| Taxation | (5.4) | (7.3) |
| | (120.5) | (118.8) |

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2011 amounted to £5.5m (2010: £4.8m).

Statement of cash flows of the Society

for the year ended 31 December 2011

| | 2011 £m | 2010 £m |
|------------------------------------------------------------------|----------------|----------------|
| Net cash outflow from operating activities (see below) | (170.2) | (120.5) |
| Cash flows from investing activities | | |
| Purchase of intangible assets and property, plant and equipment | (8.5) | (8.5) |
| Purchase of investment securities | (1,342.9) | (2,228.2) |
| Proceeds from sale and maturity of investment securities | 1,736.1 | 2,510.1 |
| Disposal of shares in joint venture | - | 1.9 |
| Cash flows from financing activities | | |
| Subordinated debt repurchase | (2.0) | (6.9) |
| Increase in cash and cash equivalents | 212.5 | 147.9 |
| Cash and cash equivalents at beginning of year | 389.4 | 241.5 |
| Cash and cash equivalents at end of year | 601.9 | 389.4 |
| Represented by: | | |
| Cash and balances with the Bank of England | 532.9 | 320.7 |
| Loans and advances to credit institutions repayable on demand | 69.0 | 68.7 |
| | 601.9 | 389.4 |
| Net cash inflow from operating activities | | |
| Profit before taxation | 11.0 | 20.4 |
| Adjusted for: | | |
| Depreciation and amortisation | 5.0 | 4.6 |
| Loss on sale of property, plant and equipment | 0.4 | 0.1 |
| Increase in impairment losses on loans and advances to customers | 11.3 | 12.4 |
| Change in fair values | 9.4 | (1.2) |
| Other non-cash movements | (1.1) | (2.8) |
| Changes in net operating assets | | |
| (Increase)/decrease in loans and advances to credit institutions | (0.1) | 49.9 |
| (Increase) in loans and advances to customers | (323.5) | (222.0) |
| Decrease in loans to subsidiary companies | 66.2 | 15.2 |
| Decrease/(increase) in other assets | 0.8 | (2.7) |
| Decrease in prepayments and accrued income | 3.3 | 1.0 |
| (Decrease)/increase in derivative financial instruments | (5.1) | 2.8 |
| (Decrease)/increase in shares | (34.2) | 103.7 |
| Increase/(decrease) in deposits and debt securities | 92.3 | (95.8) |
| Increase in other liabilities | 1.5 | 0.4 |
| (Decrease) in accruals and deferred income | (2.3) | (0.3) |
| (Decrease) in pension fund obligations | (2.0) | (1.1) |
| Taxation | (3.1) | (5.1) |
| | (170.2) | (120.5) |

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies

Basis of preparation

The Group and Society's financial statements for the year ended 31 December 2011 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 25, under the heading 'Going concern'. At the date of authorisation of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue but not yet effective:

| Pronouncement | Nature of Change | Effective Date |
|-----------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------|
| IFRS 7 Disclosures – Transfers of Financial Assets | The amendment requires additional and/or enhanced disclosures to help evaluate risk exposures relating to the transfer of financial assets and the effect of those risks on an entity's financial position, particularly those that involve securitisation of financial assets. The amendment is not expected to have a significant impact for the Group. | Accounting periods beginning on or after 1 July 2011 |
| Amendment to IAS 12 Deferred Tax: Recovery of Underlying Assets | The amendment provides a practical approach for measuring deferred tax liabilities and deferred tax assets when investment property is measured using the fair value model in <i>IAS 40 Investment Property</i> . The amendment is not expected to have a significant impact for the Group. | Accounting periods beginning on or after 1 January 2012 |
| IFRS 7 Disclosures – Transfers of Financial Assets | The amendment requires additional disclosures about offsetting financial assets and financial liabilities. The amendment is not expected to have a significant impact for the Group. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 10 Consolidated Financial Statements | The new standard replaces <i>IAS 27 Consolidated and Separate Financial Statements</i> and <i>SIC-12 Consolidation – Special Purpose Entities</i> by introducing a single consolidation model for all entities based on control. The new standard is currently being reviewed by the Group but is not expected to have a significant impact. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 11 Joint Arrangements | The new standard introduces new accounting requirements for joint arrangements, replacing <i>IAS 31 Interests in Joint Ventures</i> . The Group currently has no joint arrangements in place. The new standard, therefore, is not expected to impact the Group. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 12 Disclosure of Involvement with Other Entities | The new standard requires enhanced disclosures regarding both consolidated and unconsolidated entities in which an entity has involvement. The new standard is currently being reviewed by the Group but is not expected to have a significant impact. | Accounting periods beginning on or after 1 January 2013 |
| IFRS 13 Fair Value Measurement | The new standard replaces guidance on fair value measurement in existing IFRS accounting literature with a single standard. The standard does not change the requirements regarding which items should be measured or disclosed at fair value but does require enhanced disclosures. The new standard is currently being reviewed by the Group and, with the exception of enhanced disclosures, is not expected to have a significant impact. | Accounting periods beginning on or after 1 January 2013 |

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

Basis of preparation (continued)

| Pronouncement | Nature of Change | Effective Date |
|---------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------|
| IAS 19 Employee Benefits | IAS 19 has been amended resulting from the Post-Employment Benefits and Termination Benefit projects. The standard makes improvements by eliminating an option to defer the recognition of gains and losses, known as the 'corridor method', streamlining the presentation of changes in assets and liabilities arising from defined benefit plans, changes to the rate of return on assets, and enhancing the disclosure requirements for defined benefit plans, providing better information about the characteristics of defined benefit plans and the risks that entities are exposed to through participation in those plans. The new standard is currently being reviewed by the Group and, with the exception of enhanced disclosures, is not expected to have a significant impact. | Accounting periods beginning on or after 1 January 2013 |
| IAS 27 Separate Financial Statements | IAS 27 has been amended to remove the consolidation requirements previously forming part of the standard. Consolidation requirements now contained in IFRS 10. The amendment is currently being reviewed by the Group but is not expected to have a significant impact. | Accounting periods beginning on or after 1 January 2013 |
| IAS 28 Investment in Associates and Joint Ventures | IAS 28 has been amended to conform to the changes arising from the issuance of IFRS 10, IFRS 11 and IFRS 12. The amendment is currently being reviewed by the Group but is not expected to have a significant impact. | Accounting periods beginning on or after 1 January 2013 |
| IAS 32 Financial Instruments: Presentation | IAS 32 has been amended to conform to the changes arising from the issuance of IFRS 7. The amendment is not expected to have a significant impact for the Group. | Accounting periods beginning on or after 1 January 2014 |
| IFRS 9 Financial Instruments – Classification and Measurement | The new standard addresses phase 1 of the IASB's project to replace <i>IAS 39 Financial Instruments</i> and requires financial assets to be classified at amortised cost or fair value. The available-for-sale (AFS) category currently used by the Group will not be available. Early adoption is permitted once endorsed by the EU. The impact of IFRS 9 on the Group is currently being considered. | Accounting periods beginning on or after 1 January 2015 |
| IFRS 7 Disclosures – Transfers of Financial Assets | IFRS 7 has been amended to require disclosures about the first-time adoption of IFRS 9. The amendment is not expected to have a significant impact for the Group. | Accounting periods beginning on or after 1 January 2015 |

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 any impact cannot be quantified as this standard has not been finalised nor formally adopted by the EU.

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

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

Accounting convention

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

Basis of consolidation

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

Subsidiaries

A subsidiary is an entity whose operating and financing policies 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 a special purpose entity (SPE) controlled by the Group. The securitisation enables a subsequent issuance of debt by the SPE to investors who gain the security of the underlying assets as collateral. The SPE is fully consolidated into the Group's accounts under Standing Interpretations Committee 12 *Consolidation – Special Purpose Entities*. The transfer of the mortgage loans to the SPE is not treated as sales 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 SPE. In the accounts of the Society, the proceeds received from the transfer are accounted for as a deemed loan repayable to the SPE. To manage interest rate risk, the Society enters into derivative transactions with the SPE, 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 receivable and payable

Interest receivable and payable for loans and advances to customers and customer accounts are recognised in the statement of comprehensive income 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 carrying amount of the financial asset or financial liability. Where calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the product (for example prepayment options) but does not consider future credit losses. The calculation includes all amounts received or paid by the Group that are an integral part of the overall return and the direct incremental transaction costs related to the acquisition or issue of a product.

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

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

Fees and commissions

Loan origination fees are reflected in the calculation of the effective interest rate on the loan.

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

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

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

Measurement of financial assets and liabilities

Financial assets

Financial assets are classified as:

i) Loans and receivables

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

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

being recognised in the statement of comprehensive income.

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 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 statement of comprehensive income. 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 statement of comprehensive income.

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 statement of comprehensive income.

iv) Financial assets at fair value accounted through the statement of comprehensive income

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 statement of comprehensive income. Subsequent measurement is at fair value with changes in value reflected in the statement of comprehensive income.

v) Financial assets held-for-trading

The Group does not hold any financial assets classified as held for trading.

Financial liabilities

Financial liabilities are measured at:

i) Amortised cost

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

Borrowings are subsequently measured at amortised cost using the effective interest method. Amortised cost is adjusted for the amortisation of any transaction costs and premiums and discounts. The amortisation is recognised in interest expense and similar charges using the effective interest method.

Permanent interest-bearing shares (subscribed capital) which are redeemable at specific dates at the option of the Society are classified as liabilities.

ii) Fair Value Through Profit and Loss (FVTPL)

Financial liabilities are classified as at FVTPL when the financial liability is designated as at FVTPL.

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

- such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise; or
- 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
- 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 40.

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 or the debt being restructured to reduce the burden on the borrower.

The Group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant or individual, 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 Buy-to-Let mortgages and accounts subject to forbearance, and collectively assessed for impairment.

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

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

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

- i) total aggregate exposure to the customer including cross collateralisation;
- ii) the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
- iii) the amount and timing of expected receipts and recoveries;
- iv) the likely funds available on liquidation or bankruptcy including any guarantees;
- v) the extent of other creditors' commitments ranking ahead of the Society, and the likelihood of other creditors continuing to support the company;
- vi) the realisable value of security at the expected date of sale and likelihood of successful repossession; and
- vii) the likely deduction of any 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 statement of comprehensive income.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the statement of comprehensive income.

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 40 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.

Derivative financial instruments and hedge accounting

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

i) Derivative financial instruments

Derivatives are initially measured at fair value and are subsequently re-measured to fair value at each reporting date with movements recorded in the statement of comprehensive income. 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, then the derivative is classified as a net asset or liability, as appropriate.

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

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 statement of comprehensive income.

iii) Hedge accounting

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

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

The Group discontinues hedge accounting when:

- i) it is evident from testing that a derivative is not, or has ceased to be, highly effective as a hedge;
- ii) the derivative expires, or is sold, terminated or exercised;
- or
- iii) the underlying item matures or is sold or repaid.

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

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 statement of comprehensive income immediately.

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

ii) Computer software

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 tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the statement of comprehensive income because it excludes

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

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

Deferred tax related to fair value re-measurement of available-for-sale investments, which is charged or credited directly to the available-for-sale reserve, is also credited or charged directly to the available-for-sale reserve and is subsequently recognised in the statement of comprehensive income 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, 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 statement of comprehensive income 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:

| | |
|-----------------------------------------|-----------|
| Free erations to buildings | 10% |
| Plant, equipment, fixtures and fittings | 10% - 15% |
| Computer equipment | 20% - 33% |
| Motor vehicles | 25% |

*Or unexpired period of the lease

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, if deemed appropriate.

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 statement of comprehensive income.

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 further obligation to pay further contributions. Payments into the defined contribution scheme are charged to the statement of comprehensive income 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. Pension scheme assets are measured using closing market values. Pension 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 statement of comprehensive income. 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 recognised income and expense.

Notes to the accounts

for the year ended 31 December 2011

1. Accounting policies (continued)

Leases

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

i) As lessee

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

ii) As lessor

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

Debt securities in issue, subordinated liabilities and permanent interest-bearing shares

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

Segmental reporting

A business segment is defined as a group of assets and operations providing products and services that are subject to different risks and returns from those 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 financial statements.

Government grants

Government grants are recognised at their fair value where there is a reasonable assurance that the grant will be received and the Group will comply with all the attached conditions.

Government grants are recognised as income in the statement of comprehensive income over the periods necessary to match them with the related costs to which they are intended to compensate, on a systematic basis.

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.

Notes to the accounts

for the year ended 31 December 2011

2. Judgements in applying accounting policies and critical accounting estimates

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

Impairment provision on loans and advances

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

Key assumptions included in the measurement of the incurred loss include data regarding the probability of any account going into default, the probability of defaulted accounts progressing to possession and the eventual loss incurred in the event of forced sale or write-off. The House Price Index (HPI) and the discount applied on forced sale are key assumptions on the residential mortgage books. To the extent the HPI movements were to differ from current observations by 1%, the impact on provisions would be £1.2m. The impact of a 1% change in the forced sale discounts currently being experienced would impact provisions by £1.2m.

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

Collateral values are updated at the date of each statement of financial position based on the best information publically 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.

Impairment provision on investment securities

The Group has a £10.0m (2010: £10.0m) exposure to Anglo Irish Bank Corporation Limited due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. This scheme is approved by the European Commission under EC Treaty state aid rules. The agreement between the Irish Government, the European Union and International Monetary Fund (IMF) for a restructuring plan in November 2010 contained guarantees for the full repayment of its

senior unsecured bonds. All interest repayments to date have been met. In light of these facts, the directors do not consider this exposure impaired. The Group has no direct exposures to Greece, Italy, Portugal and Spain as at 31 December 2011.

Based on the best information available, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, the Board has concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

Fair value of derivatives and available-for-sale assets

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

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

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 £1.0m. The impact of a 0.1% increase in the discount rate would be to reduce the value of pension obligations by approximately £1.0m. Further details on the assumptions used in valuing retirement benefit obligations can be found in Note 12.

Other provisions for liabilities and charges

i) Payment Protection Insurance (PPI)

Provisions have been made in respect of claims in relation to previous sales of PPI which, in the Group's case, relate to secured personal lending PPI products. In August 2010, the FSA released their Policy Statement PS10/12 on *The Assessment and Redress of Payment Protection Complaints*.

Notes to the accounts

for the year ended 31 December 2011

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

The ultimate cost is inherently uncertain and, in determining the level of provisions required, it is necessary for management to exercise significant judgement. The principal assumptions underlying the provision relate to the number of cases requiring redress, the estimated average cost of redress per case and the number of customers applying for redress where there would appear to be a supportable claim.

At 31 December 2011, the Group holds a provision of £21.6m (2010: £19.8m), 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. A 1% increase in the expected level of complaints would increase the value of the required provision by £0.3m.

Provisions are only made where the Group has responsibility for the original sale of the product. No provision has been made for sales by third parties as external legal advice has concluded that it is unlikely that the Group would be liable for redress in respect of such sales.

ii) Financial Services Compensation Scheme (FSCS) levy

Along with other deposit taking institutions, the Group has a provision for liabilities under the FSCS. As at 31 December 2011, the Group holds a provision of £3.7m in respect of levies payable in September 2012 and 2013.

The principal assumption underlying the provision relates to the interest charged on the loans funding the scheme by HM Treasury. A 1% increase in the expected level of interest would increase the value of the required provision by £0.7m.

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

- Future interest rates;
- Capital shortfalls from insufficient recoveries to fully repay loans from HM Treasury;
- The Group's share of industry protected deposits as at 31 December 2011; and
- The future structure of the replacement scheme.

Further detail of the FSCS and the provision held are included in Note 39.

Taxation

Significant estimates are required in determining the provision for corporation tax. There are a number of transactions for which the final tax determination is uncertain at the date of the statement of financial position.

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 £0.1m/(£0.1m) 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 £0.3m/(£0.3m) respectively.

Notes to the accounts

for the year ended 31 December 2011

3. Business segments

The Group operates four main business segments: retail financial services, secured personal lending, property services including estate agency 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.

| | 2011 | | | | | |
|-------------------------------------------------------|---------------------------|--------------------|--------------------------|-------------------|-----------------------------------|-------------|
| | Retail financial services | Commercial lending | Secured personal lending | Property services | Adjustment for Group transactions | Total |
| | £m | £m | £m | £m | £m | £m |
| Net interest income | 53.1 | 9.3 | 42.6 | - | - | 105.0 |
| Other income and charges | 8.3 | 1.1 | 2.6 | 11.0 | (2.5) | 20.5 |
| Net operating income | 61.4 | 10.4 | 45.2 | 11.0 | (2.5) | 125.5 |
| Administrative expenses | (43.2) | (2.0) | (9.3) | (9.7) | (2.0) | (66.2) |
| Impairment provision for losses on loans and advances | (4.3) | (7.0) | (13.3) | - | - | (24.6) |
| Provision for other liabilities and charges | (1.5) | - | (9.3) | (0.4) | - | (11.2) |
| Operating profit/(loss) | 12.4 | 1.4 | 13.3 | 0.9 | (4.5) | 23.5 |
| Other gains | 1.0 | - | - | - | - | 1.0 |
| Profit before taxation | 13.4 | 1.4 | 13.3 | 0.9 | (4.5) | 24.5 |

| | 2010 | | | | | |
|-------------------------------------------------------|---------------------------|--------------------|--------------------------|-------------------|-----------------------------------|-------------|
| | Retail financial services | Commercial lending | Secured personal lending | Property services | Adjustment for Group transactions | Total |
| | £m | £m | £m | £m | £m | £m |
| Net interest income | 55.9 | 10.8 | 45.1 | - | - | 111.8 |
| Other income and charges | 8.9 | 0.9 | (0.1) | 9.5 | (1.9) | 17.3 |
| Net operating income | 64.8 | 11.7 | 45.0 | 9.5 | (1.9) | 129.1 |
| Administrative expenses | (39.6) | (2.0) | (9.3) | (9.0) | (2.2) | (62.1) |
| Impairment provision for losses on loans and advances | (2.8) | (9.6) | (9.8) | - | - | (22.2) |
| Provision for other liabilities and charges | (0.5) | - | (16.2) | (0.4) | - | (17.1) |
| Operating profit/(loss) | 21.9 | 0.1 | 9.7 | 0.1 | (4.1) | 27.7 |
| Other gains | 3.1 | - | - | - | - | 3.1 |
| Profit before taxation | 25.0 | 0.1 | 9.7 | 0.1 | (4.1) | 30.8 |

Comparatives include a £3.6m transfer from the main business segments to 'Adjustment for Group transactions' to reflect changes in internal reporting during the year.

Notes to the accounts

for the year ended 31 December 2011

3. Business segments (continued)

| | Group | |
|----------------------------------------------|----------------|----------------|
| | 2011 | 2010 |
| | £m | £m |
| Total assets by business segment | | |
| Retail financial services | 4,904.9 | 4,640.0 |
| Secured personal lending | 627.0 | 680.2 |
| Commercial lending | 913.0 | 937.9 |
| Property services | 4.8 | 4.0 |
| Total assets | 6,449.7 | 6,262.1 |
| Total liabilities by business segment | | |
| Retail financial services | 5,819.3 | 5,577.9 |
| Secured personal lending | 625.6 | 680.2 |
| Commercial lending | - | - |
| Property services | 4.8 | 4.0 |
| Total liabilities | 6,449.7 | 6,262.1 |

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

4. Interest receivable and similar income

| | Group | | Society | |
|------------------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| On loans fully secured on residential property | 237.6 | 232.1 | 179.0 | 172.9 |
| On other loans fully secured on land | 21.7 | 22.2 | 21.7 | 22.2 |
| On other loans to subsidiaries | - | - | 15.9 | 14.1 |
| On debt securities | 7.7 | 11.7 | 7.5 | 11.7 |
| Profit on realisation of investments | 0.8 | 6.3 | 0.8 | 6.3 |
| On other liquid assets | 2.9 | 1.7 | 2.9 | 1.7 |
| On derivative financial instruments | (35.3) | (51.6) | (35.3) | (51.6) |
| | 235.4 | 222.4 | 192.5 | 177.3 |

Notes to the accounts

for the year ended 31 December 2011

5. Interest payable and similar charges

| | Group | | Society | |
|-------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| On shares held by individuals | 132.8 | 124.5 | 132.8 | 124.5 |
| On deposits and debt securities | 12.4 | 7.9 | 12.1 | 7.9 |
| On subscribed capital | 4.2 | 4.2 | 4.2 | 4.2 |
| On subordinated liabilities | 4.1 | 5.9 | 4.1 | 5.9 |
| On derivative financial instruments | (23.1) | (31.9) | (23.1) | (31.9) |
| | 130.4 | 110.6 | 130.1 | 110.6 |

6. Fees and commission receivable

| | Group | | Society | |
|--------------------------------------------------|-------------|-------------|------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Insurance and related financial service products | 7.2 | 6.3 | 5.5 | 5.4 |
| Estate agency | 4.8 | 4.9 | - | - |
| Mortgage related fees | 3.3 | 3.4 | 3.3 | 3.4 |
| Other fees and commission | 5.3 | 3.3 | 1.1 | 1.3 |
| | 20.6 | 17.9 | 9.9 | 10.1 |

7. Fees and commission payable

| | Group | | Society | |
|-----------------------|------------|------------|------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Mortgage related fees | 1.0 | 1.2 | 0.1 | 0.1 |
| Bank charges | 0.4 | 0.4 | 0.4 | 0.4 |
| | 1.4 | 1.6 | 0.5 | 0.5 |

8. Other fair value gains and losses

| | Group and Society | |
|----------------------------------------------------------------|-------------------|------------|
| | 2011 | 2010 |
| | £m | £m |
| Gains/(losses) on derivatives | 5.2 | (2.8) |
| (Losses)/gains on hedged items attributable to the hedged risk | (5.3) | 3.0 |
| | (0.1) | 0.2 |

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

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for the year ended 31 December 2011

9. Administrative expenses

| | Group | | Society | |
|-----------------------------------------------|-------------|-------------|-------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Wages and salaries | 31.0 | 31.2 | 22.7 | 23.5 |
| Social security costs | 3.2 | 2.9 | 2.4 | 2.2 |
| Other pension costs | 1.1 | 1.1 | 1.0 | 1.0 |
| | 35.3 | 35.2 | 26.1 | 26.7 |
| Other administrative expenses | 24.7 | 21.2 | 18.9 | 15.7 |
| | 60.0 | 56.4 | 45.0 | 42.4 |
| Other administrative expenses include: | £000 | £000 | £000 | £000 |
| Auditor's remuneration: | | | | |
| For audit of the Society's Annual Accounts | 104 | 103 | 104 | 103 |
| For audit of the Society's subsidiaries | 26 | 26 | - | - |
| Total | 130 | 129 | 104 | 103 |
| For other services: | | | | |
| Tax advisory | 57 | 107 | 57 | 107 |
| Specialist consultancy | 307 | - | 307 | - |
| Further assurance services | 90 | 38 | 90 | 38 |
| All other services | 12 | 10 | 12 | 10 |
| Operating lease charges | | | | |
| - motor vehicles | 252 | 257 | 228 | 228 |
| - land and buildings | 1,727 | 1,627 | 1,019 | 859 |

10. Employees

The average number employed including executive directors was:

| | Full-time | | Part-time | |
|-----------------------------------|------------|------------|------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | Number | Number | Number | Number |
| Society's Customer Support Centre | 467 | 443 | 67 | 71 |
| Society branch offices | 192 | 190 | 131 | 124 |
| Employed by the Society | 659 | 633 | 198 | 195 |
| Subsidiaries | 258 | 245 | 58 | 53 |
| Employed by the Group | 917 | 878 | 256 | 248 |

11. Emoluments of the Society's directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on page 33 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 (2010: £1.8m).

In addition, ex-gratia pensions amounting to £24k (2010: £23k) were paid to former directors.

Notes to the accounts

for the year ended 31 December 2011

12. Retirement benefit obligations

The Group operates two pension schemes, a defined benefit and a defined contribution 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. Membership of the Scheme is, however, available at the discretion of the Society and a small number of new members have been admitted to the Scheme on this basis subsequent to 1 January 2001.

The defined benefit scheme closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the Group Flexible Retirement Plan (GFRP). The Group injected £1.0m into the defined benefit scheme on its closure and has injected a further £2.0m during 2011 to help reduce the current deficit.

The defined benefit scheme was subject to a triennial valuation by the Scheme's independent actuary on 30 September 2010, at which date there was a deficit of £8.2m. This valuation was approved by the Trustees on 2 December 2011. To eliminate the deficit, the Trustees and the Society have agreed that additional contributions will be paid into the scheme at a rate of £1.0m until the deficit is eliminated.

A defined contribution scheme is one into which the Group and the employee pay fixed contributions, without any further obligation to pay further contributions. Staff employed after 1 January 2001 and those staff who were formerly a member 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 2011 was £892k (2010: £486k). There were no contributions outstanding or prepaid at the end of the year.

Scheme management consists of a Board of Trustees, comprising five individuals, two of which 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, BlackRock Investment Management (UK) Limited and Standard Life Investments. Assets were also held with UBS Global Assets Management during the year. In addition the Trustees may hold cash from time to time. The assets managed by Standard Life Investments, UBS Global Assets Management and BlackRock Investment Management (UK) Limited during the year were invested to target a long-term rate of return well in excess of inflation.

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

Updated calculations prepared by the scheme actuary on the IAS 19 basis at 31 December 2011, including the unfunded liability referred to above, reflected a deficit amounting to £11.5m (2010: £9.3m). Under the recovery plan agreed as part of the triennial valuation, the assumed rate of pension revaluation in deferment and guaranteed minimum pensions reverted to the Retail Prices Index (RPI) from the Consumer Price Index (CPI) used in 2010. The use of the RPI and CPI will be reviewed in 2014. The impact of this change was to increase the deficit by £1.3m.

The major assumptions used by the actuary were:

| | At 31 December | | | | |
|----------------------------------------------------------------------------|----------------|------|------|------|------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| | % | % | % | % | % |
| Rate of increase in pensionable salaries | 3.05 | 3.55 | 3.60 | 2.70 | 3.20 |
| Rate of increase of pensions in payment and deferred pensions | 3.05 | 3.55 | 3.60 | 2.70 | 3.20 |
| Discount rate | 4.70 | 5.40 | 5.65 | 6.25 | 5.70 |
| Inflation assumption (RPI) | 3.05 | 3.55 | 3.60 | 2.70 | 3.20 |
| Inflation assumption (CPI) | 2.25 | 3.05 | n/a | n/a | n/a |
| The long-term rates of return expected on investments in the schemes were: | 5.60 | 6.30 | 6.50 | 6.50 | 6.50 |

Notes to the accounts

for the year ended 31 December 2011

12. Retirement benefit obligations (continued)

The assumptions on mortality are determined by the following tables:

| | 2011 | 2010 |
|--------------------------------------------------------------------------------------------|---------------|---------------|
| Retired and non-retired members | SAPS LC1%B | SAPS LC1%B |
| The assumptions are illustrated by the following year of life expectancy at age 65: | | |
| Retired members | | |
| Males currently aged 65 | 22.9 | 22.8 |
| Females currently aged 65 | 25.7 | 25.6 |
| Non-retired members | | |
| Males currently aged 45 | 24.9 | 24.8 |
| Females currently aged 45 | 27.7 | 27.6 |

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

| | At 31 December | | | | |
|----------------------------------------------------------------------|----------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| | £m | £m | £m | £m | £m |
| Target return funds | 22.6 | 22.4 | 18.6 | 17.8 | 21.5 |
| Debt securities | 22.6 | 20.4 | 21.4 | 17.7 | 17.6 |
| Equities | - | - | - | - | - |
| Bonds and cash | 0.9 | 0.4 | 0.4 | - | - |
| Total fair value of plan assets | 46.1 | 43.2 | 40.4 | 35.5 | 39.1 |
| Present value of funded obligations | (57.1) | (52.0) | (49.8) | (36.3) | (40.5) |
| Present value of unfunded obligations | (0.5) | (0.5) | (0.5) | (0.5) | (0.5) |
| Net deficit recognised in the statement of financial position | (11.5) | (9.3) | (9.9) | (1.3) | (1.9) |

The amounts recognised in the statement of comprehensive income are as follows:

| | Group and Society | |
|------------------------------------------------------------------------------------|-------------------|--------------|
| | 2011 | 2010 |
| | £m | £m |
| Analysis of pension costs (included in administrative expenses) | | |
| Current service cost | - | (0.5) |
| | - | (0.5) |
| Analysis of finance credit (included in other operating income) | | |
| Expected return on pension scheme assets | (2.8) | (2.7) |
| Interest on pension scheme liabilities | 2.8 | 2.8 |
| Net credit to other financial income | - | 0.1 |
| Analysis of amount recognised in statement of recognised income and expense | | |
| Actuarial loss | (4.2) | (0.5) |
| Analysis of the movement in the statement of financial position deficit | | |
| Deficit in scheme at beginning of year | (9.3) | (9.9) |
| Movement in year: | | |
| Current service cost | - | (0.5) |
| Other finance credit | - | 0.1 |
| Actuarial loss | (4.2) | (0.5) |
| Contributions paid | 2.0 | 1.5 |
| Deficit in scheme at end of year | (11.5) | (9.3) |

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for the year ended 31 December 2011

12. Retirement benefit obligations (continued)

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

| | Group and Society | |
|----------------------------------|-------------------|-------------|
| | 2011 | 2010 |
| | £m | £m |
| At 1 January | 43.2 | 40.4 |
| Expected return on scheme assets | 2.7 | 2.6 |
| Society contributions | 2.1 | 1.6 |
| Scheme member contributions | - | 0.2 |
| Benefits paid | (1.3) | (1.4) |
| Actuarial losses | (0.6) | (0.2) |
| At 31 December | 46.1 | 43.2 |

Details of experience gains and losses

| | Group and Society | | | | |
|-------------------------------------------------------------------------------------|-------------------|---------|----------|---------|---------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| Difference between the expected and actual return on scheme assets: | | | | | |
| (Loss)/gain amount | (£0.6m) | (£0.2m) | £2.8m | (£6.2m) | (£0.7m) |
| Percentage of scheme assets | 1.3% | 0.4% | 6.9% | 17.5% | 1.8% |
| Experience gains and losses on scheme liabilities: | | | | | |
| (Loss)/gain amount | (£3.6m) | (£0.3m) | (£11.6m) | £6.9m | (£0.8m) |
| Percentage of the present value of scheme liabilities | 6.2% | 0.6% | 23.0% | 18.8% | 1.9% |
| Total amount recognised in statement of total recognised income and expense: | | | | | |
| (Loss)/gain amount | - | (£0.5m) | (£8.8m) | £0.7m | (£1.5m) |
| Percentage of the present value of scheme liabilities | 0.0% | 1.0% | 17.5% | 1.8% | 3.7% |

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRSs is £7.8m (2010: £3.6m).

The actual return on plan assets was £2.7m (2010: £2.6m).

13. Taxation

| | Group | | Society | |
|--------------------------------------------------|------------|------------|------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Current tax | | | | |
| UK corporation tax charge for the year | 6.7 | 8.3 | 2.8 | 5.1 |
| Adjustments in respect of prior years | - | (1.0) | (0.4) | (0.4) |
| | 6.7 | 7.3 | 2.4 | 4.7 |
| Deferred tax | | | | |
| Deferred tax charge for year | 0.2 | (0.3) | 0.2 | (0.2) |
| Adjustments in respect of prior years | 0.2 | 0.6 | 0.1 | 0.1 |
| | 0.4 | 0.3 | 0.3 | (0.1) |
| Taxation on profit on ordinary activities | 7.1 | 7.6 | 2.7 | 4.6 |

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for the year ended 31 December 2011

13. Taxation (continued)

The statutory rate of corporation tax was reduced to 26.0% from 1 April 2011. The Group was subject to corporation tax at a rate of 28.0% for the period 1 January to 31 March 2011, and 26.0% for the period 1 April to 31 December 2011, resulting in an effective rate of corporation tax of 26.5% for the full year in 2011.

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 | |
|----------------------------------------------------------------------------------|------------|------------|------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Profit before taxation | 24.5 | 30.8 | 11.0 | 20.4 |
| Profit multiplied by the standard rate of corporation tax at 26.5% (2010: 28.0%) | 6.5 | 8.6 | 2.9 | 5.7 |
| Effects of: | | | | |
| Expenses not deductible for tax purposes | 0.3 | 0.3 | 0.3 | 0.3 |
| Adjustments to prior years | 0.2 | (0.4) | (0.2) | (0.3) |
| Other | 0.1 | (0.9) | (0.3) | (1.1) |
| Total taxation for the year | 7.1 | 7.6 | 2.7 | 4.6 |

Included in the Group profit for 2010 was a gain of £3.1m on the repurchase of £10.0m of subordinated liabilities which is non-taxable.

14. Loans and advances to credit institutions

Repayable from the date of the statement of financial position in the ordinary course of business:

| | Group | | Society | |
|-----------------------------------|--------------|-------------|-------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Accrued interest | 0.2 | 0.1 | 0.2 | 0.1 |
| On demand | 67.9 | 45.7 | 18.1 | 44.2 |
| Less than three months | 53.0 | 3.0 | 3.0 | 3.0 |
| Credit Support Annex (CSA) assets | 51.0 | 24.5 | 51.0 | 24.5 |
| | 172.1 | 73.3 | 72.3 | 71.8 |

The International Swaps and Derivatives Association (ISDA) Master Agreement is Principality's preferred agreement for documenting derivative activity. For certain counterparties a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions. £51.0m has been pledged at the statement of financial position date (2010: £24.5m).

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for the year ended 31 December 2011

15. Debt securities

| | Group and Society | |
|----------------------------------------|-------------------|--------------|
| | 2011 | 2010 |
| | £m | £m |
| Issued by UK Government | 242.8 | 352.9 |
| Issued by Supranational entities | 25.9 | 26.6 |
| Issued by other borrowers and unlisted | 141.0 | 421.3 |
| | 409.7 | 800.8 |

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

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

| | Group and Society | |
|-----------------------------------|-------------------|--------------|
| | 2011 | 2010 |
| | £m | £m |
| Accrued interest | 2.3 | 3.0 |
| Less than three months | 132.9 | 330.1 |
| Between three months and one year | 166.4 | 271.2 |
| Between one year and five years | 56.7 | 196.5 |
| Greater than five years | 51.4 | - |
| | 409.7 | 800.8 |

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

| | Group and Society | |
|-------------------------------------------|-------------------|--------------|
| | 2011 | 2010 |
| | £m | £m |
| At 1 January 2011 | 800.8 | 1,084.5 |
| Additions | 1,342.9 | 2,228.2 |
| Disposals and maturities | (1,735.3) | (2,508.2) |
| Gains/(losses) from changes in fair value | 2.1 | (1.8) |
| Decrease in accrued interest | (0.8) | (1.9) |
| At 31 December 2011 | 409.7 | 800.8 |

Notes to the accounts

for the year ended 31 December 2011

16. Derivative financial instruments

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

| | Group and Society | | | |
|-------------------------------------------------------------------------------------------|--------------------------|----------------|---------------|---------------|
| | Contract/notional amount | | Fair value | |
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Derivative assets held for hedging purposes and designated fair value hedges: | | | | |
| Interest rate swaps | 1,686.8 | 2,048.2 | 38.6 | 28.3 |
| Cross currency interest rate swaps | 33.4 | 51.4 | 6.3 | 10.4 |
| Equity and RPI index-linked interest rate swaps | - | - | 0.6 | - |
| Total recognised derivative assets | 1,720.2 | 2,099.6 | 45.5 | 38.7 |
| Derivative liabilities held for hedging purposes and designated fair value hedges: | | | | |
| Interest rate swaps | 1,678.1 | 1,594.0 | (57.4) | (55.7) |
| Total recognised derivative assets/(liabilities) | 1,678.1 | 1,594.0 | (57.4) | (55.7) |

17. Assets measured at fair value

| | Group and Society | | |
|---------------------------------------------------------------|-------------------|--------------|-------------|
| | 2011 | Level 1 | Level 2 |
| | £m | £m | £m |
| Financial assets at fair value through profit or loss: | | | |
| Derivative financial instruments | 45.5 | - | 45.5 |
| Available-for-sale financial assets: | | | |
| Debt securities | 409.7 | 409.7 | - |
| Total | 455.2 | 409.7 | 45.5 |

| | Group and Society | | |
|---------------------------------------------------------------|-------------------|--------------|-------------|
| | 2010 | Level 1 | Level 2 |
| | £m | £m | £m |
| Financial assets at fair value through profit or loss: | | | |
| Derivative financial instruments | 38.7 | - | 38.7 |
| Available-for-sale financial assets: | | | |
| Debt securities | 800.8 | 800.8 | - |
| Total | 839.5 | 800.8 | 38.7 |

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

| Level | Hierarchy for fair value disclosures |
|-------|------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1 | Quoted prices (unadjusted) in active markets for identical assets or liabilities. |
| 2 | Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices). |
| 3 | Inputs for the asset or liability that are not based on observable market data. There are no instruments classified as level 3 in 2011 (2010: none). |

Notes to the accounts

for the year ended 31 December 2011

18. Loans fully secured on residential property

| | Group | | Society | |
|---------------------------------------|----------------|----------------|----------------|----------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Gross balances | 4,669.9 | 4,357.7 | 4,042.5 | 3,682.1 |
| Provision for impairment losses | (63.2) | (55.5) | (27.4) | (20.0) |
| Unamortised loan origination fees | 28.2 | 35.1 | (1.8) | (2.5) |
| Fair value adjustment for hedged risk | 55.2 | 51.6 | 55.2 | 51.6 |
| | 4,690.1 | 4,388.9 | 4,068.5 | 3,711.2 |

Within the Group totals above there was £45.2m partially secured against residential property (2010: £50.8m).

19. Other loans fully secured on land

| | Group and Society | |
|-------------|-------------------|-------|
| | 2011 | 2010 |
| | £m | £m |
| Other loans | 530.0 | 571.5 |

20. Loans and advances to customers

Maturity analysis of loans and advances to customers from the date of the statement of financial position:

| | Group | | Society | |
|---------------------------------------|----------------|----------------|----------------|----------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Less than three months | 143.4 | 163.4 | 130.4 | 150.2 |
| Between three months and one year | 299.4 | 267.4 | 271.7 | 239.5 |
| Between one year and five years | 958.0 | 1,081.0 | 795.6 | 916.1 |
| More than five years | 3,799.1 | 3,417.4 | 3,374.8 | 2,947.8 |
| | 5,199.9 | 4,929.2 | 4,572.5 | 4,253.6 |
| Provision for impairment losses | (63.2) | (55.5) | (27.4) | (20.0) |
| Unamortised loan origination fees | 28.2 | 35.1 | (1.8) | (2.5) |
| Fair value adjustment for hedged risk | 55.2 | 51.6 | 55.2 | 51.6 |
| | 5,220.1 | 4,960.4 | 4,598.5 | 4,282.7 |

On 11 August 2011 the Group entered into a Residential Mortgage Backed Security (RMBS) issue, the Group's first ever external securitisation. The RMBS issue involved the formation of Friary No.1 plc which is consolidated into the accounts of the Group. The plc provides security to an £814.0m amortising bond issue made by the Society as part of this issue.

As at 31 December 2011, £764.2m of loans issued by the Society had been transferred to Friary No.1 plc which remain on the statement of financial position of the Society as it retains the risks and rewards. These assets are treated as encumbered. The amortised value of the bond was £814.0m, with £514.0m retained by the Group. These self-issued securities are capable of repo financing either directly with the market or with central banks to which the Group has access.

On 12 August 2011 a £700m AAA rated bond issued internally by the Society as part of the Covered Bond Programme was delisted and £832.1m of mortgages previously transferred to Principality Covered Bond LLP were transferred back to the Society.

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for the year ended 31 December 2011

21a. Provision for impairment losses

| | Fully secured on residential property | | Fully secured on land | |
|-------------------------------------|---------------------------------------|-------------|-----------------------|------------|
| | Specific | Collective | Specific | Collective |
| | £m | £m | £m | £m |
| 2011 | | | | |
| Group | | | | |
| At 1 January 2011 | 43.6 | 11.9 | - | - |
| Amounts written off during the year | (16.9) | - | - | - |
| Provision for loan impairment | 17.4 | 3.2 | 4.0 | - |
| At 31 December 2011 | 44.1 | 15.1 | 4.0 | - |
| Society | | | | |
| At 1 January 2011 | 8.1 | 11.9 | - | - |
| Amounts written off during the year | (3.9) | - | - | - |
| Provision for loan impairment | 4.1 | 3.2 | 4.0 | - |
| At 31 December 2011 | 8.3 | 15.1 | 4.0 | - |
| 2010 | | | | |
| Group | | | | |
| At 1 January 2010 | 42.6 | 6.7 | - | - |
| Amounts written off during the year | (16.0) | - | - | - |
| Provision for loan impairment | 17.0 | 5.2 | - | - |
| At 31 December 2010 | 43.6 | 11.9 | - | - |
| Society | | | | |
| At 1 January 2010 | 5.8 | 6.7 | - | - |
| Amounts written off during the year | (4.9) | - | - | - |
| Provision for loan impairment | 7.2 | 5.2 | - | - |
| At 31 December 2010 | 8.1 | 11.9 | - | - |

21b. Provisions for liabilities

| | Group | | Society | |
|-----------------------|-------------|-------------|------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| At 1 January | 24.8 | 9.4 | 4.9 | 5.6 |
| Additions | 11.2 | 17.1 | 1.9 | 1.0 |
| Utilisation | (9.3) | (1.7) | (1.7) | (1.7) |
| At 31 December | 26.7 | 24.8 | 5.1 | 4.9 |

Included in provisions is the Financial Services Compensation Scheme levy of £3.7m which is based on the Group's share of protected deposits. The contingent aspect of the levy is described in Note 39.

Other provisions of £21.6m have been made in respect of various customer claims, including claims in relation to previous sales of Payment Protection Insurance. It is expected that the liability will predominantly crystallise over the next 12 months. The contingent aspect of this provision is described in Note 39.

Notes to the accounts

for the year ended 31 December 2011

22. Investments in subsidiary undertakings

| | Society | |
|-------------------------------------------|--------------|--------------|
| | 2011 | 2010 |
| | £m | £m |
| Shares in subsidiary undertakings: | | |
| At cost | 1.1 | 1.1 |
| Loans to subsidiary undertakings | 586.4 | 652.6 |
| | 587.5 | 653.7 |

| | Subsidiary undertakings | |
|------------------------------------------------------------|-------------------------|--------------|
| | Shares | Loans |
| | £m | £m |
| Movement in investments in subsidiary undertakings: | | |
| At 1 January 2011 | 1.1 | 652.6 |
| Loan repayment | - | (66.2) |
| At 31 December 2011 | 1.1 | 586.4 |

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 |
|------------------------------------------------------|-----------------------|-----------------------------------------------------|-------------------------|---------------------|--------------------|
| Peter Alan Limited | England and Wales | Estate agency and financial services | Ordinary and preference | 100% | Direct |
| 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 |
| Friary Two Limited | England and Wales | Special purpose entity | Ordinary | 100% | Direct |

The Society also holds 100% of the ordinary share capital of the following subsidiary undertakings which have not carried on business during the year:

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

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23. Investment in joint venture

On 18 August 2010, the Group disposed of its 50% interest in Friary One Limited at par. There were no other joint ventures which operated during the year.

24. Intangible assets

| | Goodwill | | Computer software | | Total | |
|-----------------------------|------------|----------|-------------------|------------|------------|------------|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| 2011 | | | | | | |
| Cost: | | | | | | |
| At 1 January 2011 | 0.7 | - | 4.8 | 4.8 | 5.5 | 4.8 |
| Additions | - | - | 1.1 | 1.1 | 1.1 | 1.1 |
| Disposals | - | - | - | - | - | - |
| At 31 December 2011 | 0.7 | - | 5.9 | 5.9 | 6.6 | 5.9 |
| Amortisation: | | | | | | |
| At 1 January 2011 | - | - | 3.4 | 3.4 | 3.4 | 3.4 |
| Charge for the year | - | - | 0.7 | 0.7 | 0.7 | 0.7 |
| Disposals | - | - | - | - | - | - |
| At 31 December 2011 | - | - | 4.1 | 4.1 | 4.1 | 4.1 |
| Net carrying amount: | | | | | | |
| At 31 December 2011 | 0.7 | - | 1.8 | 1.8 | 2.5 | 1.8 |
| At 31 December 2010 | 0.7 | - | 1.4 | 1.4 | 2.1 | 1.4 |

| | Goodwill | | Computer software | | Total | |
|-----------------------------|------------|----------|-------------------|------------|------------|------------|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| 2010 | | | | | | |
| Cost: | | | | | | |
| At 1 January 2010 | 0.7 | - | 4.4 | 4.4 | 5.1 | 4.4 |
| Additions | - | - | 0.4 | 0.4 | 0.4 | 0.4 |
| Disposals | - | - | - | - | - | - |
| At 31 December 2010 | 0.7 | - | 4.8 | 4.8 | 5.5 | 4.8 |
| Amortisation: | | | | | | |
| At 1 January 2010 | - | - | 2.6 | 2.6 | 2.6 | 2.6 |
| Charge for the year | - | - | 0.8 | 0.8 | 0.8 | 0.8 |
| Disposals | - | - | - | - | - | - |
| At 31 December 2010 | - | - | 3.4 | 3.4 | 3.4 | 3.4 |
| Net carrying amount: | | | | | | |
| At 31 December 2010 | 0.7 | - | 1.4 | 1.4 | 2.1 | 1.4 |
| At 31 December 2009 | 0.7 | - | 1.8 | 1.8 | 2.5 | 1.8 |

The goodwill arose following the acquisition of 100% of the ordinary share capital of Loan Link Limited on 1 December 2004.

In accordance with the requirements of IAS 36, the Group completed an impairment review of the carrying value for goodwill as at 31 December 2011 to ensure that the carrying value is stated at no more than its recoverable amount. No impairment provision is required as a result of this review.

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25. Property, plant and equipment

| | Land and buildings | | Equipment, fixtures, fittings & vehicles | | Total | |
|----------------------------|--------------------|-------------|------------------------------------------|-------------|-------------|-------------|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| Cost: | | | | | | |
| At 1 January 2011 | 51.6 | 47.8 | 29.3 | 20.1 | 80.9 | 67.9 |
| Additions | 2.7 | 2.6 | 6.1 | 4.8 | 8.8 | 7.4 |
| Disposals | (0.2) | (0.2) | (3.5) | (3.2) | (3.7) | (3.4) |
| At 31 December 2011 | 54.1 | 50.2 | 31.9 | 21.7 | 86.0 | 71.9 |
| Depreciation: | | | | | | |
| At 1 January 2011 | 19.5 | 17.7 | 20.5 | 13.5 | 40.0 | 31.2 |
| Charge for the year | 1.6 | 1.5 | 3.9 | 2.8 | 5.5 | 4.3 |
| Disposals | - | - | (3.2) | (2.9) | (3.2) | (2.9) |
| At 31 December 2011 | 21.1 | 19.2 | 21.2 | 13.4 | 42.3 | 32.6 |
| Net book amount: | | | | | | |
| At 31 December 2011 | 33.0 | 31.0 | 10.7 | 8.3 | 43.7 | 39.3 |
| At 31 December 2010 | 32.1 | 30.1 | 8.8 | 6.6 | 40.9 | 36.7 |

Included within land and buildings additions is £0.9m (2010: £4.6m) on account of assets in the course of construction. The value of assets subject to operating leases where the Group acts as lessor is £21.9m (2010: £17.5m).

| | 2011 | | 2010 | |
|-----------------------------------------------------|-------------|-------------|-------------|-------------|
| | Group | Society | Group | Society |
| | £m | £m | £m | £m |
| Land and buildings: | | | | |
| Freehold | 29.9 | 28.4 | 29.4 | 28.0 |
| Long leasehold | 0.5 | 0.3 | 0.7 | 0.5 |
| Short leasehold | 2.6 | 2.3 | 2.0 | 1.6 |
| | 33.0 | 31.0 | 32.1 | 30.1 |
| Occupied by the Society and subsidiary undertakings | 22.5 | 20.5 | 24.9 | 23.9 |

Notes to the accounts

for the year ended 31 December 2011

25. Property, plant and equipment (continued)

| | Land and buildings | | Equipment, fixtures, fittings & vehicles | | Total | |
|----------------------------|--------------------|-------------|------------------------------------------|-------------|-------------|-------------|
| | Group | Society | Group | Society | Group | Society |
| | £m | £m | £m | £m | £m | £m |
| Cost: | | | | | | |
| At 1 January 2010 | 46.7 | 42.8 | 25.5 | 17.4 | 72.2 | 60.2 |
| Additions | 5.5 | 5.4 | 4.0 | 2.7 | 9.5 | 8.1 |
| Disposals | (0.6) | (0.4) | (0.2) | - | (0.8) | (0.4) |
| At 31 December 2010 | 51.6 | 47.8 | 29.3 | 20.1 | 80.9 | 67.9 |
| Depreciation: | | | | | | |
| At 1 January 2010 | 18.3 | 16.6 | 17.3 | 11.1 | 35.6 | 27.7 |
| Charge for the year | 1.5 | 1.4 | 3.4 | 2.4 | 4.9 | 3.8 |
| Disposals | (0.3) | (0.3) | (0.2) | - | (0.5) | (0.3) |
| At 31 December 2010 | 19.5 | 17.7 | 20.5 | 13.5 | 40.0 | 31.2 |
| Net book amount: | | | | | | |
| At 31 December 2010 | 32.1 | 30.1 | 8.8 | 6.6 | 40.9 | 36.7 |
| At 31 December 2009 | 28.4 | 26.2 | 8.2 | 6.3 | 36.6 | 32.5 |

26. Other assets

| | Group | | Society | |
|-----------------------------|-------|------|---------|------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Due within one year: | | | | |
| Other | 4.9 | 3.8 | 2.9 | 3.7 |

27. Prepayments and accrued income

| | Group | | Society | |
|------------------------------------------------------|-------------|-------------|-------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Accrued interest on derivative financial instruments | 11.5 | 15.0 | 11.5 | 15.0 |
| Other | 3.5 | 3.1 | 2.5 | 2.3 |
| | 15.0 | 18.1 | 14.0 | 17.3 |

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for the year ended 31 December 2011

28. Shares

| | Group and Society | |
|---------------------------------------|-------------------|----------------|
| | 2011 | 2010 |
| | £m | £m |
| Held by individuals | 4,987.1 | 5,020.2 |
| Other shares | 4.2 | 5.4 |
| Fair value adjustment for hedged risk | 22.5 | 13.4 |
| | 5,013.8 | 5,039.0 |

The repayment of the above balances from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group and Society | |
|---------------------------------------|-------------------|----------------|
| | 2011 | 2010 |
| | £m | £m |
| Fair value adjustment for hedged risk | 22.5 | 13.4 |
| Accrued interest | 63.6 | 59.6 |
| On demand | 1,092.7 | 1,337.5 |
| Less than three months | 1,229.6 | 1,206.2 |
| Between three months and one year | 1,230.9 | 1,137.0 |
| Between one year and five years | 1,374.5 | 1,285.3 |
| | 5,013.8 | 5,039.0 |

29. Amounts owed to credit institutions

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group | | Society | |
|----------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Accrued interest | 0.1 | 0.4 | 0.1 | 0.4 |
| Credit Support Annex (CSA) liabilities | 9.1 | 5.2 | 9.1 | 5.2 |
| On demand | 2.4 | 2.8 | - | - |
| Less than three months | 56.3 | 230.0 | 81.2 | 230.0 |
| Between three months and one year | 3.0 | 7.0 | 47.0 | 7.0 |
| Between one year and five years | 2.3 | - | 137.9 | - |
| Greater than five years | 42.2 | - | 42.2 | - |
| | 115.4 | 245.4 | 317.5 | 242.6 |

30. Amounts owed to other customers

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group | | Society | |
|--------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Accrued interest | 2.9 | 1.5 | 2.9 | 1.5 |
| On demand and less than three months | 162.0 | 151.5 | 162.0 | 151.5 |
| Between three months and one year | 112.4 | 127.4 | 112.4 | 127.4 |
| Between one year and five years | 29.6 | 6.5 | 29.6 | 6.5 |
| | 306.9 | 286.9 | 306.9 | 286.9 |

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31. Debt securities in issue

| | Group | | Society | |
|---------------------------------------|--------------|-------------|-------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Certificates of deposit | 40.0 | 24.6 | 40.0 | 24.6 |
| Fixed and floating rate notes | 43.5 | 61.5 | 43.5 | 61.5 |
| Other debt securities | 302.5 | - | - | - |
| Fair value adjustment for hedged risk | 0.3 | 0.2 | 0.3 | 0.2 |
| | 386.3 | 86.3 | 83.8 | 86.3 |

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

| | Group | |
|---------------------------------------|--------------|-------------|
| | 2011 | 2010 |
| | £m | £m |
| Fair value adjustment for hedged risk | 0.3 | 0.2 |
| Accrued interest | 3.3 | 0.1 |
| Less than three months | 58.8 | 19.5 |
| Between three months and one year | 83.0 | 5.0 |
| Between one year and five years | 240.9 | 61.5 |
| | 386.3 | 86.3 |

The effective interest rates at the date of the statement of financial position were as follows:

| | | |
|-------------------------------|-------|-------|
| Certificates of deposit | 1.51% | 0.94% |
| Fixed and floating rate notes | 1.18% | 0.90% |

32. Other liabilities

| | Group | | Society | |
|------------------------------------|------------|------------|------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Due within one year: | | | | |
| Income tax | 1.0 | 0.9 | 1.0 | 0.9 |
| Other taxation and social security | 1.0 | 0.9 | 0.7 | 0.6 |
| Other creditors | 6.6 | 4.9 | 4.7 | 3.3 |
| | 8.6 | 6.7 | 6.4 | 4.8 |

33. Accruals and deferred income

| | Group | | Society | |
|----------------------------------------------|------------|-------------|------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Interest accrued on subordinated liabilities | 0.5 | 2.8 | 0.5 | 2.8 |
| Interest accrued on subscribed capital | 0.4 | 0.4 | 0.4 | 0.4 |
| Other | 9.0 | 9.5 | 8.0 | 8.2 |
| | 9.9 | 12.7 | 8.9 | 11.4 |

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for the year ended 31 December 2011

34. Deferred tax

| | Group | | Society | |
|----------------------------------------------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| At 1 January | (1.8) | (2.1) | (1.6) | (1.5) |
| Charged/(credited) to the statement of comprehensive income | 0.4 | 0.3 | 0.3 | (0.1) |
| Credited to statement of recognised income and expense on actuarial losses | (0.9) | - | (0.9) | - |
| At 31 December | (2.3) | (1.8) | (2.2) | (1.6) |

The reduction of the UK Corporation tax rate to 25% from 1 April 2012 has resulted in a deferred tax charge arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the asset is expected to reverse. The relevant charge is not material.

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

| | Group | | |
|---------------------------------------------------|------------------------------|------------|------------|
| | Accelerated tax depreciation | Other | Total |
| | £m | £m | £m |
| Deferred tax liabilities | | | |
| At 1 January 2011 | 0.1 | 1.4 | 1.5 |
| Credited to the statement of comprehensive income | (0.1) | (0.4) | (0.5) |
| At 31 December 2011 | - | 1.0 | 1.0 |

| | Group | | |
|-----------------------------------------------------------|--------------------------------|--------------|--------------|
| | Retirement benefit obligations | Other | Total |
| | £m | £m | £m |
| Deferred tax assets | | | |
| At 1 January 2011 | (2.5) | (0.8) | (3.3) |
| Credited to the statement of comprehensive income | 0.5 | 0.4 | 0.9 |
| Charged to the statement of recognised income and expense | (0.9) | - | (0.9) |
| At 31 December 2011 | (2.9) | (0.4) | (3.3) |

| | Society | | |
|---------------------------------------------------|------------------------------|------------|------------|
| | Accelerated tax depreciation | Other | Total |
| | £m | £m | £m |
| Deferred tax liabilities | | | |
| At 1 January 2011 | 0.3 | 1.2 | 1.5 |
| Credited to the statement of comprehensive income | - | (0.4) | (0.4) |
| At 31 December 2011 | 0.3 | 0.8 | 1.1 |

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for the year ended 31 December 2011

34. Deferred tax (continued)

| | Society | | |
|-----------------------------------------------------------|--------------------------------|--------------|--------------|
| | Retirement benefit obligations | Other | Total |
| | £m | £m | £m |
| Deferred tax assets | | | |
| At 1 January 2011 | (2.5) | (0.6) | (3.1) |
| Credited to the statement of comprehensive income | 0.5 | 0.2 | 0.7 |
| Charged to the statement of recognised income and expense | (0.9) | - | (0.9) |
| At 31 December 2011 | (2.9) | (0.4) | (3.3) |

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within 9 years. More information on the triennial valuation could be found in Note 12.

35. Subordinated liabilities

| | Group and Society | |
|-------------------------------------------------------------|-------------------|--------------|
| | 2011 | 2010 |
| | £m | £m |
| 5 ³ / ₈ % Subordinated Notes due 2016 | 107.0 | 110.0 |
| Unamortised premiums and issue costs | - | (0.1) |
| Fair value adjustment for hedged risk | - | 2.4 |
| | 107.0 | 112.3 |

The Society's subordinated liabilities are unsecured. The subordinated liabilities rank pari passu with each other and behind the claims against the Society of all depositors, creditors and investing members of the Society.

The Society did not exercise its option to call the subordinated liabilities on 8 July 2011. The Society has the option of calling these notes on a quarterly basis until financial maturity on 8 July 2016. From 8 July 2011, the rate of interest became LIBOR plus 1.005% reset quarterly.

In December 2011, the Society repurchased £3.0m of subordinated liabilities at a discount. As a result, whilst remaining adequately capitalised, the Group has benefited from a one-off gain of £1.0m.

In January 2010, a subsidiary of the Society repurchased £10.0m of subordinated liabilities at a discount resulting in a one-off gain of £3.1m.

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36. Subscribed capital

| | Group and Society | |
|-----------------------------------------|-------------------|-------------|
| | 2011 | 2010 |
| | £m | £m |
| 7.00% Permanent Interest-Bearing Shares | 60.0 | 60.0 |
| Unamortised issue costs | (0.7) | (0.8) |
| Fair value adjustment for hedged risk | 16.1 | 10.0 |
| | 75.4 | 69.2 |

The Permanent Interest-Bearing Shares (PIBS) are unsecured and denominated in Sterling. They were issued on 1 June 2004. Net proceeds of the issue were £58.6m.

The PIBS are repayable, at the option of the Society, in whole on 1 June 2020 or any fifth anniversary thereafter. Repaying the PIBS requires the prior consent of the Financial Services 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.

37. Analysis of general reserve

| | Group | | Society | |
|---------------------------------------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Balance at 1 January | 310.6 | 287.9 | 305.3 | 290.0 |
| Profit for the financial year | 17.4 | 23.2 | 8.3 | 15.8 |
| Actuarial loss on retirement benefit obligations | (4.2) | (0.5) | (4.2) | (0.5) |
| Movement in deferred tax relating to retirement benefit obligations | 0.9 | - | 0.9 | - |
| Total recognised income for the year | 14.1 | 22.7 | 5.0 | 15.3 |
| Balance at 31 December | 324.7 | 310.6 | 310.3 | 305.3 |
| Reserves excluding pension liability | 336.2 | 319.9 | 321.8 | 314.6 |
| Pension liability | (11.5) | (9.3) | (11.5) | (9.3) |
| | 324.7 | 310.6 | 310.3 | 305.3 |

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38. Other reserves

| | Group and Society | |
|----------------------------------------------------------------|-------------------|------------|
| | 2011 | 2010 |
| | £m | £m |
| Other reserves comprise | | |
| Revaluation reserve – available-for-sale investments | 2.0 | 0.4 |
| | | |
| Movement in other reserves | | |
| Balance at 1 January | 0.4 | 1.8 |
| Net gains/(losses) from changes in fair value, net of taxation | 1.6 | (1.4) |
| Balance at 31 December | 2.0 | 0.4 |
| | | |
| Balance at 1 January | 0.4 | 1.8 |
| Gains transferred to equity | 2.9 | 4.4 |
| Gains recycled to profit and loss on sale | (0.8) | (6.3) |
| Taxation | (0.5) | 0.5 |
| Balance at 31 December | 2.0 | 0.4 |

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39. Financial commitments and contingent liabilities

a) Financial Services Compensation Scheme levy

Based on its share of protected deposits, the Society pays levies to the Financial Services Compensation Scheme (FSCS) to enable the FSCS to meet claims against it. Since 2008 a number of institutions have been declared in default by the FSA. The FSCS has met the claims by way of loans received from HM Treasury. The terms of these loans are interest-only for the first three years and the FSCS will seek to recover the interest cost, together with ongoing management expenses, by way of annual levies on member firms over this period. The FSCS has, in turn, acquired the rights to the realisation of the assets of these financial institutions. The FSCS may have a further liability if there are insufficient funds available from the realisation of the assets of the financial institutions to fully repay the HM Treasury loans. To the extent that the loans have not been repaid in full by 31 March 2012, the FSCS will agree a schedule of repayments with HM Treasury. The FSCS will then levy the industry, including the Society, accordingly.

A provision of £1.6m (31 December 2010: £3.8m) is held in respect of these levies and represents the Society's best estimate of the final instalment of the levy for the scheme year 2011/12, payable in September 2012.

There is significant uncertainty in respect of the future operation of the scheme, levies payable beyond the expected repayment of the HM Treasury loans in March 2012 and any capital shortfalls. A further provision of £2.1m is held which represents the best estimate of the levy payable for the FSCS year end March 2013. The charge is estimated based on an interest rate of 12 month LIBOR plus 100bps applicable to the HM Treasury loans. The Society has not been directly notified of the levy payable as a result of the claims against the FSCS and there are a number of factors that prevent accurate calculation of this future liability.

b) Payment Protection Insurance (PPI)

Provisions have been made in respect of claims in relation to previous sales of Payment Protection Insurance (PPI) which, in the Group's case, relate to secured personal lending PPI products. In August 2010, the FSA released their Policy Statement PS10/12 on *The Assessment and Redress of Payment Protection Complaints*.

A further provision of £9.3m has been recognised in the year. At 31 December 2011, provisions of £21.6m are held which represents the best estimate of expected redress obligations calculated in accordance with the guidance within PS10/12, where the Group had responsibility for the original sale of the product. It is expected that this liability will crystallise over the next 12 months as we work through the remediation process and contact customers.

Provisions are only made where the Group has responsibility for the original sale of the product. No provision has been made for sales by third parties as external legal advice has concluded that it is unlikely that the Group would be liable for redress in respect of such sales.

c) Defined benefit pension scheme

The defined benefit scheme was subject to a triennial valuation by the Scheme's independent actuary on 30 September 2010, at which date there was a deficit of £8.2m. To eliminate the deficit, the Trustees and the Society have agreed that additional contributions will be paid into the scheme at a rate of £1.0m per annum.

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for the year ended 31 December 2011

39. Financial commitments and contingent liabilities (continued)

d) Commitments under non-cancellable operating leases

| | 2011 | | 2010 | |
|-------------------------------------------------------------------|-------------|-------------------------------|-------------|-------------------------------|
| | 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 | 1.8 | 0.2 | 1.7 | 0.2 |
| Due between two and five years | 6.4 | 0.3 | 6.0 | 0.4 |
| Due after five years | 6.4 | - | 7.0 | - |
| | 14.6 | 0.5 | 14.7 | 0.6 |
| Society commitments in respect of operating lease rentals: | | | | |
| Due within one year | 1.0 | 0.2 | 0.8 | 0.2 |
| Due between two and five years | 3.6 | 0.3 | 3.3 | 0.4 |
| Due after five years | 3.9 | - | 4.0 | - |
| | 8.5 | 0.5 | 8.1 | 0.6 |

Comparatives for 2010 have been restated to eliminate intra-Group rental charges.

e) Income receivable under non-cancellable operating leases

Property rental income earned during the year was £0.8m (2010: £0.4m).

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

| | Group | | Society | |
|---------------------------------------|-------------|------------|-------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Receivable within one year | 0.8 | 0.4 | 1.0 | 0.6 |
| Receivable between two and five years | 2.9 | 1.1 | 3.4 | 1.6 |
| Receivable after five years | 10.6 | 2.3 | 12.7 | 4.6 |
| | 14.3 | 3.8 | 17.1 | 6.8 |

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

f) Capital commitments

| | Group | | Society | |
|---------------------------------------------------------|-------|------|---------|------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Capital expenditure contracted for but not provided for | 1.0 | 1.0 | 1.0 | 1.0 |

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for the year ended 31 December 2011

40. Financial instruments

a) Categories of financial instruments

Financial assets and liabilities are measured on an ongoing basis either at fair value or at amortised cost.

Some of the comparative information provided in the tables on pages 85, 88 and 90 have been restated to reflect changes in internal reporting during the year. Such restatement is considered to be a better representation of this financial information.

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 analyses 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 and Society As at 31 December 2011 | Financial assets and liabilities at amortised cost | Loans and receivables | Financial assets available-for- sale | Financial assets and liabilities designated at fair value | Derivatives designated as fair value hedging instruments | Total |
|---------------------------------------------------------|----------------------------------------------------------------|--------------------------|-----------------------------------------------|-----------------------------------------------------------------------|----------------------------------------------------------------------|----------------|
| | £m | £m | £m | £m | £m | £m |
| Society assets | | | | | | |
| Cash in hand and balances with Bank of England | 532.9 | - | - | - | - | 532.9 |
| Loans and advances to credit institutions | - | 72.3 | - | - | - | 72.3 |
| Debt securities | - | - | 409.7 | - | - | 409.7 |
| Derivative financial instruments | - | - | - | 6.5 | 39.0 | 45.5 |
| Loans and advances to customers | - | 4,598.5 | - | - | - | 4,598.5 |
| Loans to and investments in subsidiaries | 1.1 | 586.4 | - | - | - | 587.5 |
| Total financial assets | 534.0 | 5,257.2 | 409.7 | 6.5 | 39.0 | 6,246.4 |
| Total non-financial assets | | | | | | 61.3 |
| Total Society assets | | | | | | 6,307.7 |
| Additional Group assets | | | | | | |
| Cash in hand and balances with Bank of England | - | - | - | - | - | - |
| Loans and advances to credit institutions | - | 99.8 | - | - | - | 99.8 |
| Loans and advances to customers | - | 621.6 | - | - | - | 621.6 |
| Elimination of loans to and investments in subsidiaries | (1.1) | (586.4) | - | - | - | (587.5) |
| Non-financial assets | | | | | | 8.1 |
| Group total assets | | | | | | 6,449.7 |

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Group and Society As at 31 December 2011 | Financial assets and liabilities at amortised cost | Loans and receivables | Financial assets available-for- sale | Financial assets and liabilities designated at fair value | Derivatives designated as fair value hedging instruments | Total |
|-----------------------------------------------|----------------------------------------------------------------|--------------------------|-----------------------------------------------|-----------------------------------------------------------------------|----------------------------------------------------------------------|----------------|
| | £m | £m | £m | £m | £m | £m |
| Society liabilities | | | | | | |
| Shares | 5,013.8 | - | - | - | - | 5,013.8 |
| Amounts owed to credit institutions | 274.8 | - | - | 42.7 | - | 317.5 |
| Amounts owed to other customers | 306.9 | - | - | - | - | 306.9 |
| Debt securities in issue | 83.8 | - | - | - | - | 83.8 |
| Derivative financial instruments | - | - | - | 0.5 | 56.9 | 57.4 |
| Subordinated liabilities | 107.0 | - | - | - | - | 107.0 |
| Subscribed capital | 75.4 | - | - | - | - | 75.4 |
| Total financial liabilities | 5,861.7 | - | - | 43.2 | 56.9 | 5,961.8 |
| Total non-financial liabilities | | | | | | 33.6 |
| General reserve and other reserves | | | | | | 312.3 |
| Total Society reserves and liabilities | | | | | | 6,307.7 |
| Additional Group liabilities | | | | | | |
| Amounts owed to credit institutions | 1.7 | - | - | - | - | 1.7 |
| Debt securities in issue | 302.5 | - | - | - | - | 302.5 |
| Elimination of loans and advances to SPEs | (203.8) | - | - | - | - | (203.8) |
| Non-financial liabilities | | | | | | 27.2 |
| General reserve and other reserves | | | | | | 14.4 |
| Group total reserves and liabilities | | | | | | 6,449.7 |

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Group and Society As at 31 December 2010 | Financial assets and liabilities at amortised cost | Loans and receivables | Financial assets available-for-sale | Financial assets and liabilities designated at fair value | Derivatives designated as fair value hedging instruments | Total |
|------------------------------------------------------------|----------------------------------------------------------------|--------------------------|-------------------------------------------|--------------------------------------------------------------------|----------------------------------------------------------------------|----------------|
| | £m | £m | £m | £m | £m | £m |
| Society assets | | | | | | |
| Cash in hand and balances with Bank of England | 320.7 | - | - | - | - | 320.7 |
| Loans and advances to credit institutions | - | 71.8 | - | - | - | 71.8 |
| Debt securities | - | - | 800.8 | - | - | 800.8 |
| Derivative financial instruments | - | - | - | 11.1 | 27.6 | 38.7 |
| Loans and advances to customers | - | 4,282.7 | - | - | - | 4,282.7 |
| Loans to and investments in subsidiaries | 1.1 | 652.6 | - | - | - | 653.7 |
| Total financial assets | 321.8 | 5,007.1 | 800.8 | 11.1 | 27.6 | 6,168.4 |
| Total non-financial assets | | | | | | 62.2 |
| Total Society assets | | | | | | 6,230.6 |
| Additional Group assets | | | | | | |
| Cash in hand and balances with Bank of England | - | - | - | - | - | - |
| Loans and advances to credit institutions | - | 1.5 | - | - | - | 1.5 |
| Loans and advances to customers | - | 677.7 | - | - | - | 677.7 |
| Elimination of loans to and investments in subsidiaries | (1.1) | (652.6) | - | - | - | (653.7) |
| Non-financial assets | | | | | | 6.0 |
| Group total assets | | | | | | 6,262.1 |

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Group and Society As at 31 December 2010 | Financial assets and liabilities at amortised cost | Loans and receivables | Financial assets available-for- sale | Financial assets and liabilities designated at fair value | Derivatives designated as fair value hedging instruments | Total |
|-----------------------------------------------|----------------------------------------------------------------|--------------------------|-----------------------------------------------|-----------------------------------------------------------------------|----------------------------------------------------------------------|----------------|
| | £m | £m | £m | £m | £m | £m |
| Society liabilities | | | | | | |
| Shares | 5,039.0 | - | - | - | - | 5,039.0 |
| Amounts owed to credit institutions | 242.6 | - | - | - | - | 242.6 |
| Amounts owed to other customers | 286.9 | - | - | - | - | 286.9 |
| Debt securities in issue | 86.3 | - | - | - | - | 86.3 |
| Derivative financial instruments | - | - | - | 0.3 | 55.4 | 55.7 |
| Subordinated liabilities | 112.3 | - | - | - | - | 112.3 |
| Subscribed capital | 69.2 | - | - | - | - | 69.2 |
| Total financial liabilities | 5,836.3 | - | - | 0.3 | 55.4 | 5,892.0 |
| Total non-financial liabilities | | | | | | 32.9 |
| General reserve and other reserves | | | | | | 305.7 |
| Total Society reserves and liabilities | | | | | | 6,230.6 |
| Additional Group liabilities | | | | | | |
| Amounts owed to credit institutions | 2.8 | - | - | - | - | 2.8 |
| Amounts owed to other customers | - | - | - | - | - | - |
| Non-financial liabilities | | | | | | 23.4 |
| General reserve and other reserves | | | | | | 5.3 |
| Group total reserves and liabilities | | | | | | 6,262.1 |

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

b) Carrying values and fair values

The table below compares carrying values and fair values of the Group's financial instruments by category. It is accompanied by an explanation of the methods used to determine fair value.

| | Note | Group | | Society | |
|--------------------------------------------------------------------|-------|----------------|----------------|----------------|----------------|
| | | 2011 | | 2011 | |
| | | Carrying value | Fair value | Carrying value | Fair value |
| | | £m | £m | £m | £m |
| Financial assets | | | | | |
| Cash in hand and balances with Bank of England | | 532.9 | 532.9 | 532.9 | 532.9 |
| Loans and advances to credit institutions (excluding CSA deposits) | i. | 121.1 | 121.1 | 21.3 | 21.3 |
| CSA deposits | | 51.0 | 51.0 | 51.0 | 51.0 |
| Debt securities – available-for-sale | ii. | 409.7 | 409.7 | 409.7 | 409.7 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | | 38.6 | 38.6 | 38.6 | 38.6 |
| Cross currency interest rate swaps | | 6.3 | 6.3 | 6.3 | 6.3 |
| Equity and RPI index-linked interest rate swaps | | 0.6 | 0.6 | 0.6 | 0.6 |
| Loans and advances to customers | iv. | 5,220.1 | 5,191.8 | 4,598.5 | 4,600.2 |
| Loans and advances to subsidiaries | | - | - | 587.5 | 587.5 |
| | | 6,380.3 | 6,352.0 | 6,246.4 | 6,248.1 |
| Financial liabilities | | | | | |
| Shares | vi. | 5,013.8 | 5,013.8 | 5,013.8 | 5,013.8 |
| Amounts owed to credit institutions | vii. | 106.3 | 106.3 | 308.4 | 308.4 |
| CSA liabilities | vii. | 9.1 | 9.1 | 9.1 | 9.1 |
| Amounts owed to other customers | vii. | 306.9 | 306.9 | 306.9 | 306.9 |
| Debt securities in issue | | 386.3 | 370.3 | 83.8 | 83.1 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | | 57.0 | 57.0 | 57.0 | 57.0 |
| Equity and RPI index-linked interest rate swaps | | 0.4 | 0.4 | 0.4 | 0.4 |
| Subordinated liabilities | viii. | 107.0 | 76.5 | 107.0 | 76.5 |
| Subscribed capital | viii. | 75.4 | 42.6 | 75.4 | 42.6 |
| | | 6,062.2 | 5,982.9 | 5,961.8 | 5,897.8 |

The credit risk of the Group's liabilities and interest accrued thereon is considered to be immaterial and as such no adjustment has been made.

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

b) Carrying values and fair values (continued)

| | Note | Group | | Society | |
|--------------------------------------------------------------------|-------|----------------|----------------|----------------|----------------|
| | | 2010 | | 2010 | |
| | | Carrying value | Fair value | Carrying value | Fair value |
| | | £m | £m | £m | £m |
| Financial assets | | | | | |
| Cash in hand and balances with Bank of England | | 320.7 | 320.7 | 320.7 | 320.7 |
| Loans and advances to credit institutions (excluding CSA deposits) | i. | 48.8 | 48.8 | 47.3 | 47.3 |
| CSA deposits | | 24.5 | 24.5 | 24.5 | 24.5 |
| Debt securities – available-for-sale | ii. | 800.8 | 800.8 | 800.8 | 800.8 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | | 28.3 | 28.3 | 28.3 | 28.3 |
| Cross currency interest rate swaps | | 10.4 | 10.4 | 10.4 | 10.4 |
| Equity and RPI index-linked interest rate swaps | | - | - | - | - |
| Loans and advances to customers | iv. | 4,960.4 | 4,925.3 | 4,282.7 | 4,285.2 |
| Loans and advances to subsidiaries | | - | - | 653.7 | 653.7 |
| | | 6,193.9 | 6,158.8 | 6,168.4 | 6,170.9 |
| Financial liabilities | | | | | |
| Shares | vi. | 5,039.0 | 5,039.0 | 5,039.0 | 5,039.0 |
| Amounts owed to credit institutions | vii. | 240.2 | 240.2 | 237.4 | 237.4 |
| CSA liabilities | vii. | 5.2 | 5.2 | 5.2 | 5.2 |
| Amounts owed to other customers | vii. | 287.0 | 287.5 | 287.0 | 287.5 |
| Debt securities in issue | | 86.3 | 84.4 | 86.3 | 84.4 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | | 55.7 | 55.7 | 55.7 | 55.7 |
| Equity and RPI index-linked interest rate swaps | | - | - | - | - |
| Subordinated liabilities | viii. | 112.3 | 72.5 | 112.3 | 72.5 |
| Subscribed capital | viii. | 69.2 | 44.9 | 69.2 | 44.9 |
| | | 5,894.9 | 5,829.4 | 5,892.1 | 5,826.6 |

The gross amount of foreign currency swaps held was €40.0m (2010: €60.0m).

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following methods and assumptions have been applied in determining fair value:

- i) The carrying amount of loans and advances to credit institutions with a maturity of under 12 months is assumed to equate to their fair value.
- ii) Debt securities classified as available-for-sale are measured at fair value by reference to market prices.
- iii) All derivatives are held for economic hedging purposes. The fair value of interest rate swaps is calculated by utilising discounted cash flow valuation models. The fair value of cross currency interest rate swaps is obtained from external counterparties.
- iv) The fair value of loans and advances to customers at a variable rate is assumed to approximate to their carrying amounts. The fair value of loans and advances to customers at a fixed rate of interest represents the discounted amount of estimated future cash flows expected to be received after taking account of expected 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 is assumed to approximate to the amount payable at the date of the statement of financial position.
- vii) The fair values of amounts owed to credit institutions, amounts owed to other customers and debt securities in issue are established by using discounted cash flow valuation models or are assumed to approximate to the amount payable at the date of the statement of financial position.
- viii) The fair value of subordinated liabilities and subscribed capital are obtained from market prices.

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

c) Credit risk

The classes of financial instruments to which the Group is most exposed to credit risk are loans and advances to customers, loans and advances to credit institutions, debt securities and financial derivatives.

The following tables show the Group's estimated maximum exposure to credit risk without taking into account any collateral held or other credit enhancements.

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.

| | Group | | Society | |
|-------------------------------------------|----------------|----------------|----------------|----------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| Financial assets | | | | |
| Loans and advances to credit institutions | 172.1 | 73.3 | 72.3 | 71.8 |
| Debt securities | 409.7 | 800.8 | 409.7 | 800.8 |
| Loans and advances to customers | 5,220.1 | 4,960.4 | 4,598.5 | 4,282.7 |
| Loans and advances to subsidiaries | - | - | 587.5 | 653.7 |
| Derivative financial instruments | | | | |
| Interest rate swaps and other derivatives | 45.5 | 33.4 | 45.5 | 33.4 |
| | 5,847.4 | 5,867.9 | 5,713.5 | 5,842.4 |

In respect of loans and advances to credit institutions, debt securities and derivative instruments:

| | Group | | Society | |
|--------------------------------------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | £m | £m | £m | £m |
| UK Government securities and amounts held with central banks | 207.7 | 683.3 | 207.7 | 683.3 |
| Supranational securities | 25.9 | 26.6 | 25.9 | 26.6 |
| UK financial institutions | 393.7 | 197.6 | 293.9 | 196.2 |
| | 627.3 | 907.5 | 527.5 | 906.1 |

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.

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for the year ended 31 December 2011

40. Financial instruments (continued)

c) Credit risk (continued)

The percentage of these exposures that are rated between A and AAA under Fitch ratings for 2011 is 97.1% (2010: 98.9%).

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £9.1m (2010: £5.2m) is held over derivative financial instruments.

The Group has a £10.0m (2010: £10.0m) exposure to Anglo Irish Bank Corporation Limited due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. This scheme is approved by the European Commission under EC Treaty state aid rules. The agreement between the Irish Government, the European Union and International Monetary Fund (IMF) for a restructuring plan in November 2010 contained guarantees for the full repayment of its senior unsecured bonds. All interest repayments to date have been met. In light of these facts, the directors do not consider this exposure impaired. The Group has no direct exposures to Greece, Italy, Portugal or Spain as at 31 December 2011.

Based on the best information available, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, the Board has concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

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.

| | Group | | Society | |
|-----------------------------------------------------------------------------------------------------------|----------------|--------------|----------------|--------------|
| | 2011 | | 2011 | |
| | £m | % | £m | % |
| In respect of loans and advances to customers: | | | | |
| Fully secured by a first charge on residential property | 4,032.6 | 77.2 | 4,032.6 | 87.7 |
| Fully secured by a first charge on land | 510.7 | 9.8 | 510.7 | 11.1 |
| Fully secured by a second charge on residential property | 576.4 | 10.9 | - | - |
| Partially secured by a second charge on residential property | 45.2 | 1.0 | - | - |
| Fair value adjustments | 55.2 | 1.1 | 55.2 | 1.2 |
| | 5,220.1 | 100.0 | 4,598.5 | 100.0 |
| Retail financial services | 3,630.3 | 69.5 | 3,630.3 | 78.9 |
| Commercial loans | 913.0 | 17.5 | 913.0 | 19.9 |
| Secured personal loans | 621.6 | 11.9 | - | - |
| Fair value adjustments | 55.2 | 1.1 | 55.2 | 1.2 |
| | 5,220.1 | 100.0 | 4,598.5 | 100.0 |
| Using the retail credit risk grading system, retail lending can be distributed as follows: | | | | |
| Fully secured by a first charge on residential property or land | | | | |
| Satisfactory | 2,981.9 | 82.1 | 2,981.9 | 82.1 |
| Watch list | 575.4 | 15.9 | 575.4 | 15.9 |
| Special mention but not impaired | 73.0 | 2.0 | 73.0 | 2.0 |
| | 3,630.3 | 100.0 | 3,630.3 | 100.0 |
| Using the commercial credit risk grading system, commercial lending can be distributed as follows: | | | | |
| Satisfactory | 822.3 | 90.1 | 822.3 | 90.1 |
| Watch list | 90.7 | 9.9 | 90.7 | 9.9 |
| | 913.0 | 100.0 | 913.0 | 100.0 |
| Secured by a second charge on residential property | | | | |
| Personal loans - employed | 523.6 | 84.2 | - | - |
| Personal loans - self-employed | 98.0 | 15.8 | - | - |
| | 621.6 | 100.0 | - | - |
| | | | | |
| Total loans and advances to customers (excluding fair value) | 5,164.9 | | 4,543.3 | |

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

c) Credit risk (continued)

| | Group | | Society | |
|-----------------------------------------------------------------------------------------------------------|----------------|--------------|----------------|--------------|
| | 2010 | | 2010 | |
| | £m | % | £m | % |
| In respect of loans and advances to customers: | | | | |
| Fully secured by a first charge on residential property | 3,659.6 | 73.9 | 3,659.6 | 85.5 |
| Fully secured by a first charge on land | 571.5 | 11.5 | 571.5 | 13.3 |
| Fully secured by a second charge on residential property | 626.9 | 12.6 | - | - |
| Partially secured by a second charge on residential property | 50.8 | 1.0 | - | - |
| Fair value adjustments | 51.6 | 1.0 | 51.6 | 1.2 |
| | 4,960.4 | 100.0 | 4,282.7 | 100.0 |
| Retail financial services | 3,293.2 | 66.4 | 3,293.2 | 76.9 |
| Commercial loans | 937.9 | 18.9 | 937.9 | 21.9 |
| Secured personal loans | 677.7 | 13.7 | - | - |
| Fair value adjustments | 51.6 | 1.0 | 51.6 | 1.2 |
| | 4,960.4 | 100.0 | 4,282.7 | 100.0 |
| Using the retail credit risk grading system, retail lending can be distributed as follows: | | | | |
| Fully secured by a first charge on residential property or land | | | | |
| Satisfactory | 2,703.7 | 82.1 | 2,703.7 | 82.1 |
| Watch list | 517.0 | 15.7 | 517.0 | 15.7 |
| Special mention but not impaired | 72.5 | 2.2 | 72.5 | 2.2 |
| | 3,293.2 | 100.0 | 3,293.2 | 100.0 |
| Using the commercial credit risk grading system, commercial lending can be distributed as follows: | | | | |
| Satisfactory | 875.8 | 93.4 | 875.8 | 93.4 |
| Watch list | 62.1 | 6.6 | 62.1 | 6.6 |
| | 937.9 | 100.0 | 937.9 | 100.0 |
| Secured by a second charge on residential property | | | | |
| Personal loans - employed | 584.2 | 86.2 | - | - |
| Personal loans - self-employed | 93.5 | 13.8 | - | - |
| | 677.7 | 100.0 | - | - |
| | | | | |
| Total loans and advances to customers (excluding fair value) | 4,908.8 | | 4,231.1 | |

The average index-linked loan to value (LTV) in respect of the Group's loans secured on residential property including mortgages under offer is estimated to be 62.6% (2010: 61.6%). Index-linked LTV banding is shown below:

| | Group | | Society | |
|---------------------------------|--------------|--------------|--------------|--------------|
| | 2011 | 2010 | 2011 | 2010 |
| | % | % | % | % |
| Less than 70% | 58.0 | 59.4 | 64.1 | 67.1 |
| More than 70% but less than 80% | 17.1 | 14.8 | 16.3 | 14.3 |
| More than 80% but less than 90% | 10.8 | 10.7 | 10.0 | 9.4 |
| More than 90% | 14.1 | 15.1 | 9.6 | 9.2 |
| | 100.0 | 100.0 | 100.0 | 100.0 |

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

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for the year ended 31 December 2011

40. Financial instruments (continued)

c) Credit risk (continued)

The Group provides loans secured on residential property across England and Wales and the Society, as a regional building society, has a geographical concentration in Wales. As at 31 December 2011, approximately 34.2% (2010: 37.3%) of retail and secured personal loans exposures by account and 34.9% (2010: 37.5%) by value were concentrated in Wales.

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.98% (2010: 1.04%) which compares favourably with the industry average of 1.44% (CML arrears and possession data at 30 September 2011).

Total arrears balances on residential lending fully secured by a first charge were £1.4m (2010: £1.6m) and there are 140 (2010: 197) residential cases six months or more in arrears.

The percentage of secured personal loans currently in arrears by number is 9.38% (2010: 9.25%), which by value is 12.19% (2010: 11.39%).

The table below provides further information on the Group's loans secured on residential property by payment due status:

| | Group | | Group | |
|-----------------------------------|----------------|--------------|----------------|--------------|
| | 2011 | | 2010 | |
| | £m | % | £m | % |
| Current | 4,072.0 | 95.9 | 3,782.6 | 95.4 |
| Past due up to 3 months | 99.2 | 2.3 | 108.9 | 2.7 |
| Past due 3 months up to 6 months | 34.4 | 0.8 | 33.7 | 0.8 |
| Past due 6 months up to 12 months | 22.8 | 0.5 | 23.8 | 0.6 |
| Past due over 12 months | 17.3 | 0.4 | 17.4 | 0.4 |
| Possessions | 6.3 | 0.1 | 4.5 | 0.1 |
| | 4,252.0 | 100.0 | 3,970.9 | 100.0 |

| | Society | | Society | |
|-----------------------------------|----------------|--------------|----------------|--------------|
| | 2011 | | 2010 | |
| | £m | % | £m | % |
| Current | 3,507.3 | 96.6 | 3,170.1 | 96.2 |
| Past due up to 3 months | 71.8 | 2.0 | 72.0 | 2.2 |
| Past due 3 months up to 6 months | 26.7 | 0.7 | 25.8 | 0.8 |
| Past due 6 months up to 12 months | 14.9 | 0.4 | 15.8 | 0.5 |
| Past due over 12 months | 3.2 | 0.1 | 5.0 | 0.2 |
| Possessions | 6.3 | 0.2 | 4.5 | 0.1 |
| | 3,630.2 | 100.0 | 3,293.2 | 100.0 |

Based on indexed valuations the total collateral held against lending secured against residential property is estimated to be £9,444.2m (2010: £9,016.6m).

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £7.9m (2010: £7.1m) 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.

Difficult economic conditions have continued throughout 2011. We continue to uphold our mutual values exploring all reasonable and appropriate account management and forbearance options for borrowers experiencing financial difficulty.

The Group offers a range of account management and forbearance options for borrowers. In the event of short-term difficulty the Group operates temporary reductions in payments and 'rehabilitation' tools for borrowers in arrears or pre-delinquency. Actions may include granting a revised payment schedule, a temporary transfer to interest-only, arrangements for the borrower to underpay and changing the payment date or payment method.

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40. Financial instruments (continued)

c) Credit risk (continued)

Longer-term forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. During the year 204 accounts have been capitalised with balances of £9.0m. Capitalisation of arrears requires a qualifying period, typically six months, or a number of qualifying payments being met prior to the restructure. Any restructure will result in cases being classified and reported as up to date. We extended the term of 101 mortgages and loans during the year with balances of £4.5m.

Where suitable, the secured personal lending division will agree to release the legal charge on properties which fall into negative equity, thereby facilitating a vendor controlled sale and the achievement of their most advantageous selling price. We may subsequently seek to reach agreement for payment of the unsecured shortfall with the borrowers. To date there have been 25 successful cases during the year with balances of £0.8m. Reduced settlement figures have been accepted on five secured accounts with balances of £0.2m.

All account management and forbearance options are considered based on the borrower's financial circumstances, agreed subject to set criteria and reviewed on a case-by-case basis. We will seek to agree a course of action following a comprehensive financial fact find. This may include establishing that a borrower is seeking or has received independent advice or guidance from one of a number of Advice Agencies.

Repossession of a property is the last resort and will only take place once all alternatives have been reviewed and there are no other solutions available. 73 properties were taken into possession during 2011 (2010: 62) with balances of £9.6m. Law of Property Act (LPA) receivers were appointed for 18 (2010: 17) Buy-to-Let properties with balances of £1.6m.

37 (2010: 19) borrowers with balances of £1.4m were able to remain in their homes under a Mortgage Rescue Scheme and we continue to work with the Welsh Assembly Government, Local Authorities and debt advice agencies in Wales and England to ensure all options are available.

The underlying performance of previous capitalisations, interest-only concessions and arrangements to underpay are reflected in the provisioning methodology and are not individually or collectively material. There is no observable evidence to suggest that term extensions have different risk characteristics from other performing mortgages, therefore no specific provision treatment is applied.

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40. Financial instruments (continued)

c) Credit risk (continued)

| | Group and Society | | | |
|--------------------------------------------------------------------------------|-------------------|--------------|--------------|--------------|
| | 2011 | | 2010 | |
| | £m | % | £m | % |
| Commercial loans – Registered Social Landlords secured on residential property | 150.9 | 16.5 | 135.4 | 14.4 |
| Commercial loans – other | 762.1 | 83.5 | 802.5 | 85.6 |
| | 913.0 | 100.0 | 937.9 | 100.0 |

Loans secured on commercial property are well diversified by industry type with the largest exposure to one counterparty amounting to £36.9m (2010: £40.6m) or 4.0% (2010: 4.2%) of gross balances. Asset quality remains strong with total arrears balances of £0.5m and only 11 commercial cases three months or more in arrears.

Interest has been suspended on nine commercial accounts (2010: six) and amounts to £0.4m (2010: £0.3m) with balances of £15.6m (2010: £10.3m).

The average index-linked loan to value (LTV) in respect of the Group's commercial loans is estimated to be 78.6% (2010: 77.1%). 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/counterparty as well as geographical location.

The total collateral held against commercial loans is estimated to be £1,415.6m (2010: £1,412.5m). 90.4% of collateral is categorised as primary or secondary. These internal categorisations of collateral take account of the quality of the property, the quality of the tenant (if tenanted), the terms of the lease and the demand or alternative use for properties of that type. These categorisations are not intended necessarily to reflect whether the property itself is primary, secondary or tertiary.

The table below provides further information on commercial loans and advances by payment due status:

| | Group and Society | | | |
|-----------------------------------|-------------------|--------------|--------------|--------------|
| | 2011 | | 2010 | |
| | £m | % | £m | % |
| Current | 898.2 | 98.4 | 923.3 | 98.4 |
| Past due up to 3 months | 2.4 | 0.3 | 7.1 | 0.8 |
| Past due 3 months up to 6 months | 1.3 | 0.1 | - | - |
| Past due 6 months up to 12 months | 5.5 | 0.6 | 3.3 | 0.3 |
| Past due over 12 months | - | - | - | - |
| LPA Receivers Appointed | 5.6 | 0.6 | 4.2 | 0.5 |
| | 913.0 | 100.0 | 937.9 | 100.0 |

In some cases of 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 2011, 17 accounts with balances totalling £58.3m in value were granted forbearance concessions. The potential for losses on these accounts is assessed and considered in the level of overall provisions held against the Commercial Lending portfolio.

Loans and advances to subsidiaries are unsecured obligations and have no fixed repayment date. None of these exposures was either past due or impaired.

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

d) Liquidity risk

For each material class of non-derivative financial liability a maturity analysis is provided in Notes 28 to 31, which represents contractual maturities. In practice, customer deposits will be repaid later than on the contractual date on which repayment can be required. The following is an analysis of gross contractual principal cash flows payable under financial liabilities, excluding accrued interest and fair value adjustments:

| | Total | Undefined maturity | Up to 3 months | 3-12 months | 1-5 years | More than 5 years |
|-----------------------------------------------------------------------------------|----------------|--------------------|----------------|----------------|----------------|-------------------|
| | £m | £m | £m | £m | £m | £m |
| Group | | | | | | |
| As at 31 December 2011 | | | | | | |
| Non-derivative liabilities | | | | | | |
| Shares | 4,927.8 | - | 2,322.3 | 1,230.9 | 1,374.6 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 805.0 | 9.1 | 289.5 | 198.4 | 265.9 | 42.1 |
| Subordinated liabilities | 107.0 | - | - | - | 107.0 | - |
| Subscribed capital | 60.0 | - | - | - | - | 60.0 |
| | 5,899.8 | 9.1 | 2,611.8 | 1,429.3 | 1,747.5 | 102.1 |
| Society | | | | | | |
| As at 31 December 2011 | | | | | | |
| Non-derivative liabilities | | | | | | |
| Shares | 4,927.8 | - | 2,322.3 | 1,230.9 | 1,374.6 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 704.6 | 9.1 | 275.2 | 177.3 | 200.9 | 42.1 |
| Subordinated liabilities | 107.0 | - | - | - | 107.0 | - |
| Subscribed capital | 60.0 | - | - | - | - | 60.0 |
| | 5,799.4 | 9.1 | 2,597.5 | 1,408.2 | 1,682.5 | 102.1 |
| Group and Society | | | | | | |
| As at 31 December 2011 | | | | | | |
| Derivative liabilities | | | | | | |
| Interest rate swaps | 57.0 | - | 0.4 | 4.7 | 21.9 | 30.0 |
| Cross currency interest rate swaps | - | - | - | - | - | - |
| Equity and RPI index-linked interest rate swaps | 0.4 | - | - | - | - | 0.4 |
| | 57.4 | - | 0.4 | 4.7 | 21.9 | 30.4 |

The Group's liquidity risk management strategy is outlined in the Risk Management Report on pages 15 to 19.

The balances in the above table will not agree directly to the balances in the consolidated statement of financial position as the table incorporates all cash flows on an undiscounted basis related to both principal as well as future interest payments based on rates prevailing at the date of the statement of financial position.

For information on annual commitments under non-cancellable operating leases see Note 39.

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

d) Liquidity risk (continued)

| | Total | Undefined maturity | Up to 3 months | 3-12 months | 1-5 years | More than 5 years |
|-----------------------------------------------------------------------------------|----------------|--------------------|----------------|----------------|----------------|-------------------|
| | £m | £m | £m | £m | £m | £m |
| Group | | | | | | |
| As at 31 December 2010 | | | | | | |
| Non-derivative liabilities | | | | | | |
| Shares | 4,965.9 | - | 2,543.6 | 1,137.0 | 1,285.3 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 616.4 | 5.2 | 403.8 | 139.4 | 68.0 | - |
| Subordinated liabilities | 110.0 | - | - | - | - | 110.0 |
| Subscribed capital | 60.0 | - | - | - | - | 60.0 |
| | 5,752.3 | 5.2 | 2,947.4 | 1,276.4 | 1,353.3 | 170.0 |
| Society | | | | | | |
| As at 31 December 2010 | | | | | | |
| Non-derivative liabilities | | | | | | |
| Shares | 4,965.9 | - | 2,543.6 | 1,137.0 | 1,285.3 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 613.6 | 5.2 | 401.0 | 139.4 | 68.0 | - |
| Subordinated liabilities | 110.0 | - | - | - | - | 110.0 |
| Subscribed capital | 60.0 | - | - | - | - | 60.0 |
| | 5,749.5 | 5.2 | 2,944.6 | 1,276.4 | 1,353.3 | 170.0 |
| Group and Society | | | | | | |
| As at 31 December 2010 | | | | | | |
| Derivative liabilities | | | | | | |
| Interest rate swaps | 55.7 | - | 0.7 | 4.0 | 35.6 | 15.4 |
| Cross currency interest rate swaps | - | - | - | - | - | - |
| Equity and RPI index-linked interest rate swaps | - | - | - | - | - | - |
| | 55.7 | - | 0.7 | 4.0 | 35.6 | 15.4 |

Notes to the accounts

for the year ended 31 December 2011

40. Financial instruments (continued)

e) Market risk

Market risk can be sub-divided into interest rate risk and currency risk.

Interest rate risk

Interest rate risk refers to the sensitivity of net interest income to the periodic re-pricing of assets and liabilities and the imperfect correlation caused by basis risk. The Group's exposure to interest rate risk in terms of the net risk after taking account of management's action to hedge inherent exposures is measured using interest rate gap analysis. In this method each of the Group's financial instruments including on and off the statement of financial position assets and liabilities is assigned to future time periods on the basis of their contractual maturity or contractual re-pricing arrangements. In calculating the net exposure for each future period, account is also taken of those assets and liabilities with embedded optionality, such as pipeline and prepayment risk on fixed rate mortgages. If there was a 1% parallel upward shift in interest rates the adverse impact on reserves would be £4.5m (2010: £4.2m).

Currency risk

After taking into account the effect of cross currency swaps the Group has no material exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates.

Notes to the accounts

for the year ended 31 December 2011

41. Related party transactions

The remuneration of the directors (including non-executive directors), who are the key management personnel of the Group, is set out in the Report of the Remuneration Committee on page 33.

Loans to and shares held by directors

There was an aggregate of £0.4m (2010: £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 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 20 April 2012.

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 £0.2m (2010: £1.2m).

Directors' transactions

There were no other transactions with directors during the year. During 2010, a £75k payment was made to one director as part compensation in relation to remediation costs for a property purchased as part of relocation where defects had not been identified during the building survey.

Transactions with Group companies

The Society undertook the following transactions with Group companies during the year:

| | Interest received from Society | Interest paid to Society | Fees received from Society | Fees paid to Society | Rent received from Society | Rent paid to Society |
|------------------------------------|--------------------------------|--------------------------|----------------------------|----------------------|----------------------------|----------------------|
| | £m | £m | £m | £m | £m | £m |
| Year ended 31 December 2011 | | | | | | |
| Nemo Personal Finance Limited | - | 16.0 | - | 0.2 | - | - |
| Peter Alan Limited | - | - | - | - | - | 0.2 |
| | - | 16.0 | - | 0.2 | - | 0.2 |
| Year ended 31 December 2010 | | | | | | |
| Nemo Personal Finance Limited | - | 14.1 | - | 0.1 | - | - |
| Peter Alan Limited | - | - | - | - | - | 0.2 |
| | - | 14.1 | - | 0.1 | - | 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 |
|-------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | 2011 | 2011 | 2010 | 2010 |
| | £m | £m | £m | £m |
| Nemo Personal Finance Limited | 584.8 | - | 651.3 | - |
| Peter Alan Limited | 1.6 | - | 1.2 | - |
| | 586.4 | - | 652.5 | - |

Annual Business Statement

for the year ended 31 December 2011

1. Statutory percentages

| | At 31 December 2011 | At 31 December 2010 | Statutory limit |
|-------------------|---------------------|---------------------|-----------------|
| | % | % | % |
| The lending limit | 11.6 | 13.2 | 25.0 |
| The funding limit | 14.0 | 11.0 | 50.0 |

The percentages are calculated in accordance with, and the statutory limits are those prescribed by, Sections 6 and 7 of the Building Societies Act 1986 (as substituted by the Building Societies Act 1997) and are based on the consolidated statement of financial position.

The lending limit is the proportion of business assets not in the form of loans fully secured on residential property.

The funding limit is the proportion of shares and borrowings not in the form of customer accounts held by individuals.

Business assets are the total assets of the Society and its subsidiary undertakings as shown in the statement of financial position plus provision for loan impairment, less fixed assets and liquid assets.

Loans fully secured on residential property are the amount of principal owed by borrowers and interest accrued not yet payable. This is the amount shown in the statement of financial position plus provision for loan impairment and minus unamortised loan origination fees.

2. Other percentages

| | 2011 | 2010 |
|--------------------------------------------------|-------|-------|
| | % | % |
| As a percentage of shares and borrowings: | | |
| Gross capital | 8.75 | 8.71 |
| Free capital | 9.04 | 8.93 |
| Liquid assets | 19.14 | 21.12 |
| As a percentage of mean total assets: | | |
| Profit after taxation | 0.27 | 0.37 |
| Management expenses | 1.04 | 1.00 |

Gross capital represents retained earnings, subscribed capital and subordinated liabilities as shown in the consolidated statement of financial position.

Free capital is gross capital plus provision for impairment losses less intangible assets and property, plant and equipment.

Liquid assets represent the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.

Mean total assets represent the average of the total assets in the consolidated statement of financial position at the beginning and end of the year.

Management expenses represent the aggregate of administrative expenses, depreciation and amortisation.

Annual Business Statement

for the year ended 31 December 2011

3. Directors

Details of directors are contained on pages 21 and 22.

Details of directors' service contracts are included in the Report of the Remuneration Committee on page 34.

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

Managers

David Cunningham-Jones

Peter Hughes

Susan Lane

Michael Jones

Elaine Morris

Steven Hughes

Julie-Ann Haines

Stuart Deane

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

Peter Alan Limited

Managing Director:

Andrew Barry

Nemo Personal Finance Limited

Managing Directors:

Phillip E. Jones

Samuel F. Marshall

Glossary

ALCO

Asset and Liability Committee.

Arrears

A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan payment is overdue. Such a customer can also be said to be in a state of delinquency.

Basel II

The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.

Basel III

In December 2010, the Basel Committee on Banking Supervision issued the Basel III rules text, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity. The standards will be phased in gradually from 2013.

BIPRU

The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.

Buffer eligible liquid assets

Includes high quality debt securities issued by a government or central bank, securities issued by a designated multilateral development bank or reserves in the form of sight deposits with a central bank in an EEA State or Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.

Commercial lending

Loans secured on commercial property and loans to Registered Social Landlords.

Commercial Paper (CP)

An unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date.

Commercial property

Includes office buildings, industrial property, medical centres, hotels, retail stores, shopping centres, multifamily housing buildings, warehouses, garages and industrial properties.

Contractual maturity

The final payment date of a loan or other financial instrument, at which point the entire remaining outstanding principal and interest is due to be repaid.

Core liquidity ratio

Buffer eligible liquid assets as a proportion of savings, deposits and loans.

Core Tier 1 capital

Tier 1 capital (see definition below) less permanent interest-bearing shares (PIBS).

Core Tier 1 capital ratio

Core Tier 1 capital as a proportion of risk-weighted assets.

Cost income ratio

A ratio that represents the proportion of management expenses (i.e. administrative expenses, depreciation and amortisation) to total income.

Coverage ratio

Impairment allowances (provisions) as a percentage of the loans and advances to which they relate.

Covered bonds

Debt securities backed by a portfolio of mortgages that is segregated from the issuer's other assets solely for the benefit of the holders of the covered bonds.

Credit default swap

An arrangement where the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of the protection. A credit default swap is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.

Credit risk

The risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Credit risk is the largest risk category to which the Group is exposed and sub-divided as follows: retail lending, commercial lending, and Treasury credit risks.

Credit risk mitigation

Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.

Credit Valuation Adjustment (CVA)

An adjustment that represents an estimate of the change to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures.

Debt restructuring

The changing of the terms and provisions of outstanding debt agreements. Restructuring may be done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as debt or interest charge alteration.

Debt securities

Assets representing certificates of indebtedness of credit institutions, public bodies or other undertakings excluding those issued by central banks.

Debt securities in issue

Transferable certificates of indebtedness of the Group to the bearer of the certificates. These are liabilities of the Group and include certificates of deposit.

Defined benefit pension scheme

A scheme that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary.

Defined contribution pension scheme

A scheme into which the Group and the employee pay fixed contributions without any further obligation to pay further contributions.

Delinquency

See Arrears.

Glossary (continued)

ECAI

External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.

Economic capital

An internal assessment of the amount of capital required to protect against potential unexpected future losses arising from business activities, across a defined time horizon and confidence interval.

Effective Interest Rate method (EIR)

The method used to measure the carrying value of a financial asset or a liability. EIR allocates associated interest income or expense to produce a level yield, either to maturity or to the next re-pricing date.

Euro Medium Term Notes (EMTN)

Euro notes issued by corporates across a range of maturities. EMTNs are frequently issued by corporates under EMTN programmes whereby notes are offered on a regular and continuous basis to investors.

Expected Loss (EL)

A Basel II calculation to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.

Exposure

The maximum loss that a financial institution might suffer if a borrower, counterparty or group fails to meet their obligations or if assets and off-statement of financial positions have to be realised.

Exposure At Default (EAD)

A Basel II parameter used to estimate the amount outstanding at the time of default.

FSA

Financial Services Authority. The financial services industry regulator in the UK.

Final salary pension arrangements

A defined benefit pension arrangement where the pension payable to the employee is based on final pensionable salary prior to retirement.

Financial Services Compensation Scheme (FSCS)

The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the FSA is obliged to pay an annual levy, which goes towards its running costs and compensation payments.

Forbearance strategies

Strategies to assist borrowers in financial difficulty, such as extending loan terms, temporarily converting loans to an interest-only basis and agreeing a temporary reduction in payments. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.

Free capital

The aggregate of gross capital and provisions for collective impairment losses on loans and advances to customers less property, plant and equipment and intangible assets.

Funding limit

The proportion of shares and borrowings not in the form of customer accounts held by individuals.

GORC

Group Operational Risk Committee.

GRC

Group Risk Committee.

Gross capital

The aggregate of general reserve, revaluation reserve, available-for-sale reserve, subscribed capital and subordinated liabilities.

Guarantee

An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.

Individual Liquidity Adequacy Assessment (ILAA)

The Group's own assessment of the levels of liquidity that it needs to meet its current and expected financial obligations. These are assessed under normal and stressed conditions.

Impaired loans

A loan is impaired if there is objective evidence that an impairment event has occurred, and that the event has an impact on the estimated future cash flows of the loan which can be reliably estimated. Impairment may be caused by a single event, or a combination of events. Impairment events include redundancy or marital breakdown.

Impairment allowances

Provisions held against assets on the statement of financial position. The provisions represent management's best estimate of losses incurred in the loan portfolio at the statement of financial position date.

Indexed LTV (Loan to Value)

A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

Individually/collectively assessed impairment allowances

Impairment is measured individually for assets that are individually significant to the Group, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available. Collective assessment also covers losses that have occurred but are not yet individually identified on loans subject to individual assessment.

Individual Liquidity Guidance (ILG)

Guidance from the FSA on the quantity of a firm's liquidity resources and the firm's funding profile.

Internal Capital Adequacy Assessment Process (ICAAP)

The Group's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.

International Swaps and Derivatives Association (ISDA) master agreement

A standardised contract developed by ISDA and used to enter into bilateral 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.

Glossary (continued)

IPD index

Measures the returns on property investments in the UK.

Lending limit

The proportion of business assets not in the form of loans fully secured on residential property.

Level 1 fair values

Fair value derived from unadjusted quoted prices in active markets for identical assets or liabilities, e.g. G10 government securities.

Level 2 fair values

Fair value derived from inputs other than quoted prices that are observable for the asset or liability, either directly (i.e. a price) or indirectly (i.e. derived from prices), e.g. most investment grade and liquid bonds, asset backed securities, certain collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and OTC derivatives.

Level 3 fair values

Fair value derived from inputs for the asset or liability that are not based on observable market data (unobservable inputs), e.g. private equity investments, derivatives including an equity element, deposits including an equity element, some CDOs and certain asset backed securities and bonds.

Leverage ratio

As currently proposed under Basel III rules, it is a supplementary measure of risk-adjusted capital requirements, defined as the ratio of Tier 1 capital to total exposures. Total exposures include on and off statement of financial position items (after netting derivatives).

LIBOR

London Inter Bank Offered Rate.

Liquid assets

Cash or other assets that can be readily converted to cash without loss of value.

Liquidity Coverage Ratio (LCR)

As currently proposed under Basel III rules, this is a liquidity metric which aims to ensure that a firm maintains an adequate level of liquidity to meet its needs for a 30-calendar day time horizon under a severe stress scenario.

Liquidity and funding risk

The risk that the Group is not able to meet its financial obligations as they fall due or can secure them only at excessive cost.

Loan to deposit ratio

Represents loans and advances to customers divided by the aggregate of shares, other deposits and amounts due to customers.

Loan To Value ratio (LTV)

A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

Loans past due/past due loans

Loans are past due when a counterparty has failed to make a payment when contractually due.

Loss Given Default (LGD)

A Basel II parameter used to estimate the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.

Management expenses

The aggregate of administrative expenses, depreciation and amortisation.

Management expense ratio

Management expenses as a proportion of total average assets.

Market risk

The potential losses or decrease in value of the Group statement of financial position as a result of adverse market movements. Specific types of market risk include interest rate risk (banking book), swap spread risk and currency risk.

Maturity

The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.

Member

A person aged 18 or over who has a share investment or a mortgage loan with the Society over £100 during the year.

Negative equity mortgages

Negative equity occurs when the value of the property purchased using the mortgage is less than the balance outstanding on the loan. Negative equity is the difference between the current value of the property and the outstanding balance on the loan.

Net interest income

The sum of the amount earned on assets (a combination of retail lending, commercial lending and liquid assets) less liabilities (savings products and borrowings).

Net interest margin

Net interest income as a proportion of total average assets.

Net Stable Funding Ratio (NSFR)

A liquidity ratio, currently proposed under Basel III, to calculate the proportion of long term assets that are funded by stable, long term funding sources (customer deposits and long term wholesale funding).

Non-standard lending

Consists of Buy-to-Let and other non standard mortgages.

Operational risk

The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.

Overnight Indexed Swap rate (OIS)

A rate reflecting the overnight interest typically earned or paid in respect of collateral exchanged. OIS can be used in valuing collateralised interest rate derivatives, though this approach has not been adopted by the Group to date.

Over-The-Counter (OTC)

A bilateral transaction (e.g. derivatives) that is not exchange traded and valued using valuation models.

Own credit adjustment

Adjustment for the effect of the Group's credit standing on the fair value of its financial liabilities. This is sometimes referred to as a debit valuation adjustment.

Permanent Interest-Bearing Shares (PIBS)

Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, creditors and investing members of the Group. Also known as subscribed capital.

Prime residential mortgages

Prime mortgages are mainstream residential loans, which typically have a higher credit quality and fit standard underwriting processes. As such, they are likely to have a good credit history, and pass a standard affordability assessment at the point of origination.

Glossary (continued)

Probability of Default (PD)

A Basel II parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.

Regulatory capital

The capital held by the Group, determined in accordance with rules established by the FSA. The regulatory capital base comprises Tier 1 and Tier 2 capital (see below).

Renegotiated loans

Loans and advances may be renegotiated either as part of an ongoing customer relationship with a creditworthy customer or in response to a borrower's financial difficulties. In the latter case, the renegotiated loan may no longer be treated as past due or impaired if there is no change to the estimated future flows. Individually significant loans whose terms have been renegotiated are subject to ongoing review to determine if they remain past due or impaired.

Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)

A repurchase agreement that allows a borrower to use a financial security as collateral for a cash loan. In a repo, the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the counterparty to the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo.

Residential Mortgage Backed Securities (RMBS)

A category of asset backed security that represents interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).

Retail loans

Loans to individuals rather than institutions, including residential mortgage lending and consumer banking.

Risk appetite

The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's Members whilst achieving business objectives.

Risk-Weighted Assets (RWA)

The value of assets, after adjustment, under the Basel II capital rules to reflect the degree of risk they represent.

Return On Capital (ROC)

Profit after tax as a percentage of average gross capital (general reserve, revaluation reserve, available-for-sale reserve, PIBS and subordinated liabilities). Profit after tax excludes the interest cost of PIBS and subordinated liabilities.

Securitisation

A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.

Shares

Funds deposited by a person in a retail savings or current account with the Society. Such funds are recorded as liabilities for the Society.

Shares and borrowings

The total of shares, deposits from banks, other deposits, amounts due to customers and debt securities in issue.

Solvency ratio

A component of regulatory capital measuring of the Group's total capital as a proportion of the Group's risk-weighted assets.

Special Purpose Entities (SPE)

Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses SPEs set up under securitisation activities. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results. This term is used interchangeably with SPV (Special Purpose Vehicle).

Standardised approach

The basic method used to calculate credit risk capital requirements under Basel II. In this approach the risk weights used in the capital calculation are determined by FSA supervisory parameters. The standardised approach is less risk-sensitive than IRB.

Stress testing

Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.

Subscribed capital

See Permanent Interest-Bearing Shares (PIBS).

Subordinated debt/liabilities

A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors and investing Members but before the claims of holders of permanent interest-bearing shares (PIBS).

Sub prime

Loans to borrowers that typically have weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and discharged bankruptcies. They may also display higher risk characteristics as measured by credit scores, or other criteria indicating heightened risk of default.

Standard Variable Rate (SVR)

The rate of interest on which mortgage pricing is based.

Tier 1 capital

A component of regulatory capital comprising general reserves from retained profits, permanent interest-bearing shares (PIBS), less goodwill, intangible assets and other regulatory adjustments.

Tier 1 capital ratio

Tier 1 capital as a proportion of risk-weighted assets.

Tier 2 capital

A further component of regulatory capital comprising subordinated debt and the collective impairment allowance (for exposures treated on a Basel II Standardised basis), less certain regulatory deductions.

Value At Risk (VAR)

A technique that estimates the potential loss that could occur on risk positions as a result of future movements in market rates and prices over a specified time horizon and to a given level of statistical confidence.

Branch Addresses

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