# Half Year Financial Statements 2013

At the heart of our communities

PRINCIPALITY
BUILDING SOCIETY

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## FORWARD-LOOKING STATEMENTS

This half-year report contains certain forward-looking statements. These statements are made by the directors in good faith based on the information available to them up to the time of their approval of this report and such statements should be treated with caution due to the inherent uncertainties, including both economic and business risk factors, underlying any such forward-looking information. Therefore actual results may differ materially from those expressed or implied by these forward-looking statements.

The directors undertake no obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

# Responsibility statement

We confirm that to the best of our knowledge:

(a) the condensed set of financial statements has been prepared in accordance with IAS 34 'Interim Financial Reporting';

(b) the interim management report includes a fair review of the information required by DTR 4.2.7 (indication of important events during the first six months and the description of principal risks and uncertainties for the remaining six months of the year); and

(c) the interim management report includes a fair review of the information required by DTR 4.2.8 (disclosure of related party transactions and changes therein).

The information for the period ended 30 June 2013 does not constitute statutory accounts as defined in the Building Societies Act 1986. The auditor's report on the 2012 Annual Report and Accounts was not qualified and did not include a reference to any matters to which the auditor drew attention by way of emphasis without qualifying the report.

By order of the Board,

Graeme H. Yorston
Group Chief Executive

Stephen Hughes
Group Finance Director

# Chief Executive's review

I am pleased to once again report another successful and well-balanced first half performance. Continued growth in our mortgage lending has grown our assets to £7bn, positioning the Society as the 6th largest building society in the UK.

## Trading Highlights

- Half year pre-tax profits of £14.7m (30 June 2012: £14.0m)
- A net interest margin of 1.53% (30 June 2012: 1.47%)
- New residential mortgage lending in Wales up 38% to £106.0m (30 June 2012: £77.0m)
- Assets increased to £7.0bn (31 December 2012: £6.7bn)
- Strong capital ratios with a Tier 1 ratio of 13.82% (31 December 2012: 13.63%)
- No 1 most recommended savings provider of high street Banks and Building Societies in Great Britain

We have a strong capital and liquidity position and I am pleased to report an increased profit in line with our balance sheet growth. Within an industry hit by low levels of trust, I believe our mutual model gives us a competitive edge and we have focussed on further differentiating this by consistently improving in the eyes of our Members and customers. Of all the banks and building societies on the high street in Great Britain we are the number one most recommended savings provider[1] and this is a fantastic achievement. Our business is focussed on delivering excellent products and services to customers when, where and how it suits them and we have made the necessary investment in technology, infrastructure and people to support this aim and capture the opportunities of multi-channel.

## Mortgage growth

Following the completion of our first draw down of £105m under the Funding for Lending scheme in May 2013, we have increased new residential mortgage lending in Wales by 38% compared with the same period last year, strengthening our appetite and commitment to deliver accessible mortgage products for homebuyers.

During the first six months of this year we have made loans available up to 95% LTV and we were the first lender in Wales to sign up to the MI Business Solutions Mortgage Indemnity Guarantee scheme (MIBS MIG), working with builders to provide a guarantee scheme to applicants who wish to purchase a new-build property with low deposits. As a result of all of our commitment we have been able to support more than 800 first-time buyers onto the property market.

Our efforts have not gone unnoticed and I am pleased to report that Principality has recently been recognised in two industry awards; Best Small Building Society/Regional Lender at the Legal and General Mortgage Club Awards and Highly Commended for 'Best Flexible Mortgage Provider' category at the Moneywise Awards – both are testimony to our commitment to providing consistent lending to borrowers.

Our focus remains on prudent growth and we will continue to work with all of our stakeholders to help to stimulate first time buyer activity, create new models for financing affordable housing and develop alternatives to home ownership that will bring us closer to a sustainable housing market.

## Balancing the needs of savers

While we have taken advantage of the Funding for Lending Scheme to support borrowers we are acutely aware of the impact that the scheme has had on savings interest rates and we continue to strike the difficult balance between protecting savers and assisting borrowers. Within a market of falling interest rates, we have experienced strong savings growth and we have welcomed over 13,000 new savers to the Society – testament to the strength of our brand. We have stayed committed to rewarding loyalty and providing consistently good rates coupled with excellent service levels. A number of our products have featured extensively in the Best Buy tables this year and I am delighted that over 6,000 Members have benefited from our competitive 18 month loyalty bond. Furthermore, we picked up the Moneyfacts award for Best Internet Account Provider.

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[1] © GfK NOP Financial Research Survey (FRS) 12 months ending June 2013, based on Net Promoter Score for savings account customers in GB c. 60,000 adults interviewed

# Chief Executive's review

### Managing regulation

Regulatory requirements continue to impact our business adding cost pressures but we are well placed to manage these. We are focused on embedding new reforms while still keeping the customer at the heart of decision-making. The recent Retail Distribution Review (RDR) which has brought about new rules on financial advice resulted in many high street providers withdrawing from this service but I am pleased to report that we have stayed committed to offering a full range of services and advice to our Members and customers.

The Mortgage Market Review (MMR) will also dramatically change the delivery of mortgage products and services to borrowers and we are working towards complying with these changes by 2014.

### Group Businesses

We continue to see the benefits of our diversified business model with Nemo, our secured personal lending subsidiary, delivering strong levels of profitability, helping to underpin continued investment in the core building society. Boosted by a better housing market than planned and coupled with a strong arrears performance, Nemo is a leading provider of secured personal loans in the marketplace.

Against the backdrop of an improved housing market, our property division has seen some success during the period with house sales up 10.5% year on year. Strengthening its lettings business, Peter Alan acquired Mead Property Management, increasing its managed portfolio by 26% and cementing its position as South Wales biggest lettings agent. For the second year running the business won The Sunday Times award for Best Wales Letting Agent of the Year. Meanwhile, we have continued to expand pa black – our distinctive homes range – extending this service to people in Newport through our Peter Alan branch.

We have supported several development projects this year, helping to assist the local economy and boost employment, but the commercial lending environment remains challenging. Whilst our own commercial book is performing relatively well when benchmarked against our peers, we remain acutely aware of the fragility within this market and we have taken a cautious approach to ensure that we have adequate provisions against further downturns in this market.

### Outlook

If we look at the figures, it would appear that the UK economy is experiencing a degree of restoration; house prices are returning to positive levels, unemployment is better than expected and GDP figures are strengthening but I am sympathetic to the concerns expressed by many commentators regarding the sustainability of the economic recovery. The current low interest rate environment, coupled with Government schemes such as the Funding for Lending Scheme have boosted the supply side of the market and created increased disposable income for households but it is likely that this will come under pressure in the long term. Much restructuring has taken place in the employment market, with people sacrificing full-time employment for part-time and in some cases taking lower paying jobs. When you overlay this picture with increasing rates and schemes drawing to a close, pressures on household incomes will mount and there could be some further challenges faced by the UK economy. Against this potential risk, we will continue to manage our business prudently, taking a conservative approach as we have always done, to protect our business over the long term.

The outlook is uncertain and every part of our business is focused on protecting and offering value for our Members and customers. I am confident that we have the right expertise and solid financial foundations to continue to make a strong business stronger.

Graeme H. Yorston
Group Chief Executive
30 July 2013

# Business review
## for the six months ended 30 June 2013

### Income statement

The Group's profit before tax for the six months ended 30 June 2013 was £14.7m (30 June 2012: £14.0m), an increase of 5.0% on last year.

### Profit

*Net interest margin*
The Group's net interest margin has improved during the year by 6 basis points (bps) to 1.53% (30 June 2012: 1.47%). The interest margin continues to benefit from higher margins earned in our secured personal lending division and enhanced by a growth in customer balances reverting to the Society's Standard Variable Rate (SVR). The introduction of the Funding for Lending Scheme (FLS) in late 2012 has helped support the interest margin as interest rates payable on savings have re-priced downwards faster than interest rates receivable on mortgages, typically because mortgages have a 'tie-in' period where rates are fixed for a period of time.

It is likely that the retail cost of funds will continue to decrease during the second half of the year.

Net interest margin has been enhanced by gains of £0.5m (30 June 2012: £0.8m), equivalent to 1bps (30 June 2012: 1bps) arising from the disposal of gilts.

*Other income*
The Group's non-interest income at £12.1m (30 June 2012: £13.1m) includes insurance income, estate agency income, property services income and income generated from a number of other complementary activities. These together generated 18.6% (30 June 2012: 21.9%) of total income. Commissions on sales of life, investment and general insurance products have declined by 25.2% on the same period last year as a result of the introduction of new regulations relating to the provision of financial advice.

An active lettings market over the first half of the year, including the acquisition of Mead Property Management, a small lettings company in the Cardiff area, has resulted in a strong performance in Peter Alan with overall income 8.2% ahead of the same period last year.

During the first half of the year, Nemo our secured personal lending subsidiary, sold further loan portfolios totalling £18.0m (30 June 2012: £26.9m) which realised a profit on disposal of £0.7m (30 June 2012: £1.0m). This is reflected in the fees and commission receivable line in the income statement.

*Administrative expenses*
On-going strategic investments to enhance the Society's technology capabilities and operational infrastructure have resulted in an increase in the ratio of operating expense as a percentage of total mean assets to 1.12% (30 June 2012: 1.05%). The cost to income ratio was 58.0% (30 June 2012: 56.6%). A significant element of this investment is necessary to meet new regulatory requirements, but also includes investment focused on improving customer service and products offered; the Board has also implemented a continuous improvement programme to drive cost efficiencies.

# Business review
## for the six months ended 30 June 2013 (continued)

*Impairment provisions for losses on loans and advances*

The charge for impairment provisions of £11.2m for the Group is £3.0m higher than that for the same period last year.

| | June 2013 £m | June 2012 £m |
|---|---|---|
| Retail financial services | 1.2 | 1.7 |
| Commercial lending | 6.3 | 4.2 |
| Secured personal lending | 3.7 | 2.3 |
| Total | 11.2 | 8.2 |

Consistent quality of lending, stable house prices, a low interest rate environment and prudent arrears management policies, have contained arrears growth in first and second charge residential lending. However post default recovery assumptions have been reviewed in the second charge residential lending portfolio and this has resulted in a provision charge of £2.2m.

Whilst the performance of the commercial lending book remains robust, with only 14 exposures greater than three months in arrears (31 December 2012: 11), the commercial lending market remains challenging with no evidence of recovery in tenant demand or capital values. The increased impairment charge for the period reflects the continuing negative sentiment towards commercial property and the uncertainty surrounding the economic outlook in the UK.

There are no arrears in respect of lending to Registered Social Landlords (30 June 2012: Nil).

*Provisions for other liabilities and charges*

Provisions of £0.4m (30 June 2012: £3.9m) have been made in respect of various customer claims. No provisions have been made during the period in relation to previous sales of payment protection insurance.

The FSCS levy provision has been adjusted to reflect the most up-to-date information with regards to the 2011/12 and 2012/13 levy years which have resulted in an increase in the provision of £1.1m.

It is expected that an additional provision in the region of £4.4m will be made at the year end in relation to the FSCS levy. This includes £2.0m in relation to capital shortfalls associated with the scheme. More information regarding the uncertainties associated with the level of the provision can be found in note 16a.

*Taxation*

The statutory rate of corporation tax was reduced to 23.00% from 1 April 2013. The Group is subject to corporation tax at a rate of 24.00% for the period 1 January to 31 March 2013, and 23.00% for the period 1 April to 31 December 2013, resulting in an effective statutory rate of corporation tax of 23.25% for the full year in 2013.

The actual effective tax rate for the Group was 25.17% (30 June 2012: 25.72%) compared with the statutory rate of tax of 23.25% (30 June 2011: 24.50%). The rate differential is mainly due to disallowable expenditure.

# Business review
## for the six months ended 30 June 2013 (continued)

### Statement of Financial Position

*Loans and advances to customers*

The Group continues to focus on the quality of business written, concentrating on affordability and LTV ratios in underwriting loans and mortgages. There has been a strong performance during the first half of 2013 in residential first charge mortgages with mortgage assets increasing by 2.3% since the end of the year to £5,720.6m. Whilst this is as a result of a deliberate strategy to grow the core Society balance sheet, the Board continues to apply prudent controls to lending, reflecting the continued uncertainty in the wider economy.

The Society is committed to supporting the housing market and during the first half of the year, lent £25.1m in 95% LTV products as it seeks to support first-time buyers in Wales. As a result, the average LTV of the residential first and second charge portfolios has increased to 65.1% (31 December 2012: 63.7%) with 73.7% of the portfolio under 80% LTV and 7.0% in negative equity based on indexed property values. Buy-to-let mortgages make up 23.7% of mortgages in the retail financial services division (31 December 2012: 24.0%).

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' lending. Where revised payment schedules are insufficient to meet normal contractual monthly instalments or where a customer fails to meet the revised payment terms, the case will continue to accrue arrears and impairment provisions will be made where appropriate. Our approach to dealing with Members and customers in financial difficulties means that we only take possession of a property as a last resort having considered all Member and customer outcomes. During the first half of the year 25 properties were taken into possession (30 June 2012: 33).

The on-going risk reduction strategy implemented for the second charge and commercial lending portfolios is reflected in the declining loan and mortgage balances for these divisions.

*Liquidity*

Liquid assets typically comprise cash deposits held with central banks and unencumbered securities that may be sold or pledged through a repurchase agreement (repo) either directly with the central banks to which the Group has access or with other market counterparties.

Since the end of the year, liquid assets have increased by 8.1% to £1,161.5m which will support mortgage lending during the second half of the year. The liquid asset buffer, as defined by the Prudential Regulatory Authority (PRA), a successor to the Financial Services Authority, includes highly liquid assets which typically comprise cash held with central banks and gilts. The proportion of liquid assets assigned to the buffer is 76.0% (31 December 2012: 74.1%) and represents a surplus of 54.8% of our buffer liquidity requirement. Of the other liquid assets not assigned to the liquid assets buffer', which typically comprise investments with other financial institutions, 3.20% (31 December 2012: 3.85%) are less than A rated under Fitch credit ratings. The Group's core liquidity ratio was 16.00% (31 December 2012: 16.23%).

The European Parliament has now approved new liquidity risk management standards and monitoring (referred to as CRD IV), which implement Basel III in Europe. Basel III includes a short-term liquidity stress metric, the Liquidity Coverage Ratio (LCR), and a longer-term stable funding metric, the Net Stable Funding Ratio (NSFR). The Group monitors compliance against these metrics and as at the half year, the LCR was estimated at 228% and the NSFR at 124% against proposed regulatory requirements of 100% for both measures. (31 December 2012: 227% and 122% respectively). Estimations are made using the Society's interpretation of the draft directive, which is due to be incorporated into the European and UK regulatory framework on 1 January 2014.

# Business review
## for the six months ended 30 June 2013 (continued)

Other than £106.6m of AAA rated Supranational Bonds issued by the European Investment Bank and the Council of Europe and effectively guaranteed by the European Union member states, the Group does not hold any direct bank exposures outside the UK. The Group has indirect exposures through bank counterparties that themselves have direct exposures to Greece, Italy, Portugal, Spain, Ireland and Cyprus. 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.

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.

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. As a result, less reliance is placed on wholesale markets. Savings balances represent 98.6% (31 December 2012: 97.7%) of all mortgage balances. The Board's focus has been to balance funding from available sources retaining funds at economic rates whilst providing value to Members.

In October 2012, the Group become a member of the FLS and in May 2013, utilised the facility resulting in additional funding of £105.0m. The Treasury Bills acquired under the FLS are capable of repo financing either directly with the market or with central banks to which the Group has direct access. Based on lending to date and expectations for the second half of 2013, the funding capacity under the scheme will be in the region of £300m to £350m. It is expected that Group will continue to utilise the FLS to the end of the Scheme in 2014.

Borrowings from wholesale sources, administered by the Group's treasury function, have increased by £46.5m since the year end. At 11.8% (31 December 2012: 11.6%) of all shares, deposits and loans, the Group's borrowings represent a low dependence on wholesale markets. Principality's strong retail brand and reputation has allowed choice over funding sources during a period when wholesale markets remain largely inaccessible. Balancing the mix of funding through wholesale markets and retail remains a key focus and the Board is committed to maintaining a prudent position.

Asset encumbrance is 14.5% (31 December 2012: 10.6%) of total assets which is well within the Board approved limit of 30.0%.

The Society's long-term debt ratings with Fitch and Moody's, at BBB+ and Ba1 respectively, remain unchanged since the end of the year.

# Business review
## for the six months ended 30 June 2013 (continued)

*Capital*

Capital comprises the Group's general reserve, permanent interest-bearing shares (subscribed capital) and subordinated liabilities. This capital is held to support the development of the business, to protect Members' deposits and provide a buffer against unexpected losses. Total capital has increased from £509.0m at the end of 2012 to £512.0m. The Core Tier 1 and Tier 1 ratios (including interim profits) have increased to 11.89% and 13.82% respectively compared to 11.67% and 13.63% as at 31 December 2012.

The Group's total solvency ratio, a measure of the Group's total capital as a proportion of the Group's risk weighted assets at the statement of financial position date, has decreased by 0.15% to 15.72% since the year end. This decrease is due to the impact of reducing eligibility of subordinated liabilities within the solvency calculation. The solvency ratio however, is well in excess of the minimum established by the PRA.

The Group currently adopts the standardised approach for the calculation of regulatory capital requirements and is in the process of applying to the PRA for permission to adopt the Internal Ratings Based (IRB) approach. This would allow the Group to use its own estimates of risk, rather than risk weightings prescribed by the PRA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.

The European Parliament has now approved new capital reforms (referred to as CRD IV), which implement Basel III in Europe. The objective of the reform package is to improve the financial services sector's ability to absorb shocks arising from financial and/or economic stress, thus reducing the potentially destabilising impact on the financial sector into the real economy. CRD IV legislation is expected to be implemented on 1 January 2014.

The key elements of CRD IV are as follows:

- Reduced Capital Resources through changes to the definition of capital and grandfathering of old instruments. Permanent Interest Bearing Shares (PIBS) and subordinated debt will be phased out over ten years from 2013. Over the period 2014-18, there will be changes and additions to capital deductions from Core Tier 1 and Tier 2 capital including pension deficit and AFS reserve.

- Increased Capital Requirements through Credit Value Adjustments and Deferred Tax Assets.

- New limits and capital buffers. Higher thresholds for all forms of capital with an increased focus on Core Tier 1.

- Introduction of the Leverage Ratio. The Basel Committee is using a period to 2017 to test a minimum Tier 1 leverage ratio of 3.0%. The Group's Tier 1 leverage ratio under Basel III rules is 5.40% (31 December 2012: 5.52%).

The actual impact of CRD IV on the Group's capital ratios is also dependent on the related European Banking Authority (EBA) technical standards and the PRA's approach to implementation in those areas for which it is responsible.

A glossary of terms can be found on pages 93 to 96 of the 2012 Annual Report and Accounts.

# Business review
## for the six months ended 30 June 2013 (continued)

### Going concern

The Group meets its funding requirements, which include the need to maintain a sufficient liquidity buffer, mainly from retail sources supplemented by an RMBS issue during 2011 and a FLS draw down during 2013. The current economic conditions create some uncertainty over the availability of short-term 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 the PRA 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 Board 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 Board consider that the overall level of capital, including Tier 1 capital of £402.9m (13.82% as a percentage of risk-weighted assets) and a solvency ratio of 15.72% is adequate.

Having considered the plans and forecasts for the Group the Board 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.

### Principal risks and uncertainties

The Group Risk Committee (GRC), which meets at least quarterly, is responsible for reviewing strategic, operational and financial risks and ensuring that appropriate action is taken to mitigate those risks. Further information on the outlook for the second half of the year is detailed in the Chief Executive's report on page 1. Additional information on risk is also provided in the Pillar 3 disclosure available at:

http://www.principality.co.uk/en/About-Us/About-Principality/Financial-Reports.aspx

The principal risks and uncertainties which have an impact on the Group's long-term performance remain those outlined on pages 13 to 18 of the 2012 Annual Report and Accounts. These risks include:

*Credit risk*
This is the risk that a customer or counterparty will fail to meet their financial obligations to the Group as they become due. The volatility and continued fragility of the national and international economy presents, amongst other things, a risk of increased unemployment and declining house prices which would impact arrears and loan loss provision levels.

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

# Business review
## for the six months ended 30 June 2013 (continued)

The Group remains cautious with regard to commercial lending which is undertaken on a prudent basis, where management has adopted a strategy geared towards reducing overall exposure to development finance and larger, single counterparty loans. The Commercial Lending Division is managed within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

The impact of the continued Eurozone crisis increases the risk of credit default in wholesale markets. A weekly review of counterparty exposures is undertaken by the Treasury Committee in order to identify and mitigate the potential likelihood of any future performance difficulties or losses based on emerging published data and market intelligence.

*Liquidity risk*
This 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.

The directors have considered the funding and liquidity risk under the heading 'Going concern' above.

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

The Group is exposed to interest rate risk, principally arising from the provision of fixed rate mortgage 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.

The Eurozone crisis along with the UK Government and Bank of England's response to mortgage lending and other economic and banking sector issues continue to create short-term volatility in market prices. Taking account of this, the Asset and Liability Committee has continued to manage the Group's market risk exposure prudently.

*Operational risk*
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 monitoring and anti-fraud controls. The Group has adopted The Standardised Approach for the calculation of regulatory capital requirements relating to operational risk. This is supported by a governance structure and risk management framework the purpose of which is to identify, assess and manage existing and emerging operational risks arising from current and planned business activities, and mitigate as far as possible the impact of unknown events.

# Business review
## for the six months ended 30 June 2013 (continued)

*Conduct risk*

The role of the Group's conduct of business function is to advise the business on, and oversee the risks that could lead to unfair treatment of customers. The Group is further developing its approach to the management of its exposure to conduct risk and this is reflected in a Board approved Retail Conduct Strategy. The Board is responsible for setting and agreeing the Group's conduct risk strategy and associated risk appetite statements.

The Group's Customer and Conduct Committee forms part of the overall governance and control framework and is responsible for ensuring adherence to the risk strategy and the conduct risk appetite statement. The Committee is responsible for the governance and oversight of conduct risk.

*Pension obligation risk*

The risk that the value of the Fund's assets, together with on-going employer and Member contributions, will be insufficient to cover the projected obligations of the Fund over time. To mitigate these risks, management, together with the Trustees of the Scheme, regularly review reports prepared by the Scheme's independent actuaries and take appropriate actions which may, for example, include adjusting the investment strategy and/or contribution levels.

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

Details of the pension obligations of the Group can be found in note 12 of the 2012 Annual Report and Accounts.

Stephen Hughes
Group Finance Director
30 July 2013

# Independent review report
## to Principality Building Society

We have been engaged by the Society to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2013 which comprises the condensed consolidated income statement, the condensed consolidated statement of comprehensive income, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows and related notes 1 to 18. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Society in accordance with International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Auditing Practices Board. Our work has been undertaken so that we might state to the Society those matters we are required to state to it in an independent review 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, for our review work, for this report, or for the conclusions we have formed.

### Directors' responsibilities

The half-yearly financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-yearly financial report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with IFRSs as adopted by the European Union. The condensed set of financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34, "Interim Financial Reporting," as adopted by the European Union.

### Our responsibility

Our responsibility is to express to the Society a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review.

### Scope of Review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

### Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2013 is not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

**Deloitte LLP**
Chartered Accountants and Statutory Auditor
Cardiff, United Kingdom
30 July 2013

# Condensed consolidated income statement

## Group Interim results for six months to 30 June 2013

| | Notes | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
|---|---|---|---|---|
| Interest receivable and similar income | 3 | 127.9 | 123.8 | 253.3 |
| Interest payable and similar charges | 4 | (75.3) | (76.1) | (154.2) |
| Net interest income | | 52.6 | 47.7 | 99.1 |
| Fees and commission receivable | 5 | 12.1 | 13.3 | 24.5 |
| Fees and commission payable | 6 | (0.5) | (0.6) | (1.2) |
| Net fee and commission income | | 11.6 | 12.7 | 23.3 |
| Other operating income | | 0.5 | 0.4 | 1.0 |
| Other fair value gains/(losses) | 7 | 0.6 | (0.7) | 0.2 |
| Net operating income | | 65.3 | 60.1 | 123.6 |
| Administrative expenses | 8 | (34.5) | (30.9) | (64.4) |
| Depreciation and amortisation | | (3.4) | (3.1) | (6.4) |
| Total operating expenses | | (37.9) | (34.0) | (70.8) |
| Impairment provision for losses on loans and advances | | (11.2) | (8.2) | (16.3) |
| Provision for liabilities and charges | 13 | (1.5) | (3.9) | (12.9) |
| Operating profit | | 14.7 | 14.0 | 23.6 |
| Other gains | 9 | - | - | 1.5 |
| Profit before tax | | 14.7 | 14.0 | 25.1 |
| Taxation expense | 10 | (3.7) | (3.6) | (6.5) |
| **Profit for the period/year** | | **11.0** | **10.4** | **18.6** |

# Condensed consolidated statement of comprehensive income

| | Notes | 6 Months to 30.06.13 £m (Unaudited) | 6 Months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
|---|---|---|---|---|
| Profit for the period/year | | 11.0 | 10.4 | 18.6 |
| **Items that will subsequently be reclassified to profit and loss:** | | | | |
| (Loss)/gain on available-for-sale assets | | (3.8) | 2.5 | 1.8 |
| Tax relating to items reclassified | | 0.9 | (0.6) | (0.4) |
| **Items that will not subsequently be reclassified to profit and loss:** | | | | |
| Actuarial loss on retirement benefit obligations | | (1.7) | (1.9) | (8.0) |
| Tax relating to items not reclassified | | 0.2 | 0.5 | 1.7 |
| **Total comprehensive income for the period/year** | | **6.6** | **10.9** | **13.7** |

All items dealt with in arriving at the profit before tax relate to continuing operations.

The accounting policies and notes on pages 16 to 29 form part of these accounts.

# Condensed consolidated statement of financial position

## As at 30 June 2013

| | Notes | As at 30.06.13 (Unaudited) £m | As at 30.06.12 (Unaudited) £m | As at 31.12.12 (Audited) £m |
|---|---|---|---|---|
| **Assets** | | | | |
| Liquid assets: | | | | |
| Cash in hand and balances with the Bank of England | | 479.8 | 362.5 | 498.2 |
| Loans and advances to credit institutions | | 141.8 | 164.1 | 128.5 |
| Debt securities | | 539.9 | 480.1 | 447.6 |
| | | 1,161.5 | 1,006.7 | 1,074.3 |
| Derivative financial instruments | | 36.4 | 47.3 | 43.6 |
| Loans and advances to customers: | | | | |
| Loans fully secured on residential property | | 5,179.7 | 4,877.4 | 5,039.2 |
| Other loans fully secured on land | | 494.9 | 525.7 | 507.3 |
| Other loans | | 46.0 | 41.2 | 45.2 |
| | 12 | 5,720.6 | 5,444.3 | 5,591.7 |
| | | | | |
| Intangible fixed assets | | 2.9 | 2.6 | 2.6 |
| Property, plant and equipment | | 47.1 | 43.2 | 46.3 |
| Deferred tax assets | | 4.3 | 3.5 | 4.3 |
| Other assets | | 8.1 | 5.0 | 6.2 |
| Prepayments and accrued income | | 10.4 | 14.0 | 15.3 |
| **Total assets** | | **6,991.3** | **6,566.6** | **6,784.3** |
| | | | | |
| **Liabilities** | | | | |
| Shares | | 5,642.0 | 5,181.6 | 5,467.0 |
| | | | | |
| Deposits and debt securities: | | | | |
| Amounts owed to credit institutions | 14 | 209.2 | 93.9 | 95.8 |
| Amounts owed to other customers | | 316.5 | 310.6 | 345.7 |
| Debt securities in issue | | 231.4 | 360.3 | 269.0 |
| | | 757.1 | 764.8 | 710.5 |
| | | | | |
| Derivative financial instruments | | 33.5 | 53.7 | 49.4 |
| Current tax liabilities | | 2.7 | 3.9 | 3.1 |
| Other liabilities | | 8.7 | 9.8 | 8.5 |
| Provision for liabilities and charges | 13 | 10.6 | 10.4 | 13.0 |
| Accruals and deferred income | | 9.2 | 8.5 | 9.8 |
| Deferred tax liabilities | | 0.6 | 0.7 | 0.8 |
| Retirement benefit obligations | | 14.9 | 12.9 | 13.2 |
| Subordinated liabilities | | 92.3 | 107.0 | 92.3 |
| Subscribed capital | | 72.8 | 75.7 | 76.4 |
| **Total liabilities** | | 6,644.4 | 6,229.0 | 6,444.0 |
| General reserve | 15 | 346.5 | 333.7 | 336.9 |
| Other reserves | | 0.4 | 3.9 | 3.4 |
| **Total equity and liabilities** | | **6,991.3** | **6,566.6** | **6,784.3** |

The accounting policies and notes on pages 16 to 29 form part of these accounts.

# Condensed consolidated statement of cash flows

## Group Interim results for six months to 30 June 2013

| | 6 months to 30.06.13 (Unaudited) £m | 6 months to 30.06.12 (Unaudited) £m | Year ended 31.12.12 (Audited) £m |
|---|---|---|---|
| **Net cash inflow/(outflow) from operating activities (see below)** | 79.8 | (79.6) | 10.3 |
| | | | |
| **Cash flows from investing activities** | | | |
| Purchase of intangible assets and property, plant and equipment | (4.7) | (2.7) | (9.1) |
| Purchase of investment securities | (289.4) | (417.8) | (694.8) |
| Proceeds from sale and maturity of investment securities | 193.2 | 349.8 | 658.7 |
| | | | |
| **Cash flows from financing activities** | | | |
| Repurchase of subordinated liabilities | - | - | (13.2) |
| | | | |
| **Decrease increase in cash and cash equivalents** | (21.1) | (150.3) | (48.1) |
| | | | |
| Cash and cash equivalents at beginning of period/year | 603.7 | 651.7 | 651.7 |
| | | | |
| **Cash and cash equivalents at end of period/year** | **582.6** | **501.4** | **603.6** |
| | | | |
| **Represented by:** | | | |
| Cash and balances with the Bank of England | 479.8 | 362.3 | 498.2 |
| Loans and advances to credit institutions repayable on demand | 102.8 | 139.1 | 105.4 |
| | 582.6 | 501.4 | 603.6 |
| | | | |
| **Net cash outflow from operating activities** | | | |
| | | | |
| Profit before taxation | 14.7 | 14.0 | 25.1 |
| **Adjusted for:** | | | |
| Depreciation and amortisation | 3.4 | 3.1 | 6.4 |
| Increase in impairment losses on loans and advances to customers | 11.2 | 8.2 | 16.3 |
| Change in fair values | 7.3 | 7.4 | 9.5 |
| Other non-cash movements | - | - | (1.6) |
| **Changes in net operating assets** | | | |
| (Increase)/Decrease in loans and advances to credit institutions not repayable on demand | (15.9) | 28.2 | 30.2 |
| (Increase) in loans and advances to customers | (158.9) | (236.2) | (395.6) |
| (Increase) in other assets | (1.9) | (0.1) | (1.2) |
| Decrease/(increase) in prepayments and accrued income | 5.0 | 1.0 | (0.3) |
| (Decrease) in derivative financial instruments | (8.8) | (5.5) | (6.1) |
| Increase in shares | 182.2 | 166.3 | 455.3 |
| Increase/(decrease) in deposits and debt securities | 47.3 | (45.4) | (100.9) |
| Increase/(decrease) in other liabilities | 0.3 | 1.2 | (0.1) |
| (Decrease) in provisions for liabilities | (2.4) | (17.8) | (13.7) |
| (Decrease) in accruals and deferred income | (0.5) | - | (0.1) |
| (Decrease) in pension fund obligations | - | (0.5) | (6.4) |
| | | | |
| **Taxation** | (3.2) | (3.5) | (6.5) |
| | | | |
| | **79.8** | **(79.6)** | **10.3** |

# Notes to the accounts

for the period ended 30 June 2013

## 1. Accounting policies

### Basis of preparation

The half-yearly report information set out in this document is unaudited and does not constitute accounts within the meaning of section 73 of the Building Societies Act 1986. The financial information for the year ended 31 December 2012 has been extracted from the Annual Accounts for that year. The Annual Accounts for the year ended 31 December 2012 have been filed with the Financial Conduct Authority (formerly the Financial Services Authority).

The Auditor's report on these Annual Accounts was unqualified and did not include any matters to which the Auditor drew attention by way of emphasis without qualifying their report.

A copy of the half-yearly financial report is placed on Principality Building Society's website. The directors are responsible for the maintenance and integrity of the information on the website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

The condensed consolidated set of financial statements included in this half-year financial report has been prepared in accordance with the Disclosure and Transparency Rules of the Financial Conduct Authority and with International Accounting Standard ("IAS") 34 'Interim Financial Reporting', as adopted by the European Union. The annual financial statements of the Group are prepared in accordance with IFRSs as adopted by the European Union.

### Changes in accounting policy

In the current financial year, the Group has adopted the amendments to IAS 1 "Presentation of items of Other Comprehensive Income", IAS 19 (revised 2011) "Employee Benefits" and IFRS 13 "Fair Value Measurement". Otherwise, the same accounting policies, presentation and methods of computation are followed in the condensed set of financial statements as applied in the Group's latest annual audited financial statements.

The amendments to IAS 1 require items of other comprehensive income to be grouped by those that will be reclassified subsequently to profit and loss and those that will never be reclassified, together with their associated income tax. The amendments have been applied retrospectively, and hence the presentation of items of comprehensive income have been restated to reflect the change. The effect of these changes is evident from the condensed consolidation statement of comprehensive income.

IAS 19 (revised 2011) and the related consequential amendments have impacted the accounting for the Group's defined benefit scheme, by replacing the interest cost and expected return on plan assets with a net interest charge on the net defined benefit liability. For the current period, the profit is £0.3m lower than it would have been prior to the adoption of IAS 19 (revised 2011). As the Group has always recognised actuarial gains and losses immediately there has been no effect on the prior year defined benefit obligation.

The impact of IFRS 13 Fair Value Measurement is to require credit risk to be incorporated into the values of all financial instruments held at fair value. As the Group's financial instruments are primarily valued at their list price or supported by underlying collateral agreements, the impact of the change is considered to be minimal. Additional disclosures as required by IFRS 13, and incorporated into IAS 34 Interim Reporting are provided in notes 11 and 18.

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

The same accounting judgements are followed in this condensed set of financial statements as applied in the Group's latest annual audited financial statements and reflect management's current estimates, except for calculations of retirement benefit obligations.

# Notes to the accounts
for the period ended 30 June 2013

## 1. Accounting policies (continued)

### Basis of preparation (continued)

*Retirement benefit obligation*
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 actuaries' assumptions used were:

| | 6 months to 30.06.13 (Unaudited) % | 6 months to 30.06.12 (Unaudited) % | Year ended 31.12.12 (Audited) % |
|---|---|---|---|
| Discount rate assumption | 4.90 | 4.25 | 4.60 |
| Inflation assumption (RPI) | 3.50 | 2.80 | 3.00 |
| Inflation assumption (CPI) | 3.00 | 2.00 | 2.60 |
| Rate of increase in pensionable salaries | 3.50 | 2.80 | 3.00 |

Details of the contingent element of the retirement benefit obligation can be found in Note 16c.

### Going concern

The directors are satisfied that the Group has sufficient resources to continue in operation for the foreseeable future, a period of not less than 18 months from the date of this report. Accordingly, they continue to adopt the going concern basis in preparing the condensed financial statements. Further information regarding the directors' assessment of Going Concern can be found in the Business Review on page 9.

## 2. Business segments

The Group operates four main business segments: retail financial services, commercial lending, secured personal lending, and property services.

Transactions between the business segments are on normal commercial terms and conditions.

| | 6 months to 30.06.13 (Unaudited) | | | | | |
|---|---|---|---|---|---|---|
| | Retail financial services | Commercial lending | Secured personal lending | Property services | Adjustment for Group transactions | Total |
| | £m | £m | £m | £m | £m | £m |
| **Net interest income** | 29.7 | 4.7 | 18.2 | - | - | 52.6 |
| Other income and charges | 4.2 | 1.0 | 2.9 | 6.1 | (1.5) | 12.7 |
| **Net operating income** | 33.9 | 5.7 | 21.1 | 6.1 | (1.5) | 65.3 |
| Administrative expenses | (26.4) | (2.1) | (5.7) | (5.2) | 1.5 | (37.9) |
| Impairment provision for losses on loans and advances | (1.2) | (6.3) | (3.7) | - | - | (11.2) |
| Provision for other liabilities and charges | (1.1) | (0.2) | (0.1) | (0.1) | - | (1.5) |
| **Operating profit/(loss)** | **5.2** | **(2.9)** | **11.6** | **0.8** | **(0.0)** | **14.7** |
| Other gains | - | - | - | - | - | - |
| **Profit before taxation** | **5.2** | **(2.9)** | **11.6** | **0.8** | **(0.0)** | **14.7** |

# Notes to the accounts
for the period ended 30 June 2013

## 2. Business segments (continued)

| | 6 months to 30.06.12 (Unaudited) | | | | | |
|---|---|---|---|---|---|---|
| | Retail financial services | Commercial lending | Secured personal lending | Property services | Adjustment for Group transactions | Total |
| | £m | £m | £m | £m | £m | £m |
| **Net interest income** | 26.1 | 4.3 | 17.3 | - | - | 47.7 |
| Other income and charges | 3.9 | 1.0 | 3.2 | 5.8 | (1.5) | 12.4 |
| **Net operating income** | 30.0 | 5.3 | 20.5 | 5.8 | (1.5) | 60.1 |
| Administrative expenses | (22.1) | (2.4) | (5.8) | (5.2) | 1.5 | (34.0) |
| Impairment provision for losses on loans and advances | (1.7) | (4.2) | (2.3) | - | - | (8.2) |
| Provision for other liabilities and charges | (1.1) | - | (2.7) | (0.1) | - | (3.9) |
| **Operating profit/(loss)** | **5.1** | **(1.3)** | **9.7** | **0.5** | **0.0** | **14.0** |
| Other gains | - | - | - | - | - | - |
| **Profit before taxation** | **5.1** | **(1.3)** | **9.7** | **0.5** | **0.0** | **14.0** |

During 2013 Group transactions have been recharged to the relevant business segment. Net adjustment for Group transactions of £2.3m and £4.6m for 30 June 2012 and 31 December 2012 respectively have been restated to reflect this change.

| | Year ended 31.12.12 (Audited) | | | | | |
|---|---|---|---|---|---|---|
| | Retail financial services | Commercial lending | Secured personal lending | Property services | Adjustment for Group transactions | Total |
| | £m | £m | £m | £m | £m | £m |
| **Net interest income** | 53.7 | 8.8 | 36.6 | - | - | 99.1 |
| Other income and charges | 9.5 | 2.0 | 3.8 | 11.8 | (2.6) | 24.5 |
| **Net operating income** | 63.2 | 10.8 | 40.4 | 11.8 | (2.6) | 123.6 |
| Administrative expenses | (46.6) | (4.8) | (11.6) | (10.4) | 2.6 | (70.8) |
| Impairment provision for losses on loans and advances | (1.8) | (11.0) | (3.5) | - | - | (16.3) |
| Provision for other liabilities and charges | (3.2) | - | (9.3) | (0.4) | - | (12.9) |
| **Operating profit/(loss)** | **11.6** | **(5.0)** | **16.0** | **1.0** | **(0.0)** | **23.6** |
| Other gains | 1.5 | - | - | - | - | 1.5 |
| **Profit before taxation** | **13.1** | **(5.0)** | **16.0** | **1.0** | **(0.0)** | **25.1** |

## 2. Business segments (continued)

| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
|---|---|---|---|
| **Total assets by business segments** | | | |
| Retail financial services | 5,521.4 | 5,053.6 | 5,298.1 |
| Secured personal lending | 588.2 | 587.8 | 582.9 |
| Commercial lending | 875.1 | 919.7 | 897.8 |
| Property services | 6.6 | 5.5 | 5.5 |
| **Total assets** | **6,991.3** | **6,566.6** | **6,784.3** |
| | | | |
| **Total liabilities and reserves by business segment** | | | |
| Retail financial services | 6,396.5 | 5,975.3 | 6,197.6 |
| Secured personal lending | 588.2 | 585.8 | 581.2 |
| Commercial lending | - | - | - |
| Property services | 6.6 | 5.5 | 5.5 |
| **Total liabilities and reserves** | **6,991.3** | **6,566.6** | **6,784.3** |

Net proceeds of funding will be used by the Group for the general purposes of its business.

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

## 3. Interest receivable and similar income

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| On loans fully secured on residential property | 124.4 | 118.1 | 243.2 |
| On other loans fully secured on land | 10.2 | 12.6 | 23.1 |
| On debt securities | 2.5 | 3.4 | 6.2 |
| Profit on realisation of investments | 0.5 | 0.9 | 3.2 |
| On other liquid assets | 1.3 | 1.1 | 2.3 |
| On derivative financial instruments | (11.0) | (12.3) | (24.7) |
| | 127.9 | 123.8 | 253.3 |

The derivative arrangements in place for the Group result in a net payment of fixed interest on mortgage related derivatives. Due to the continued low rates of LIBOR, net interest of £11.0m has been paid.

## 4. Interest payable and similar charges

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| On shares held by individuals | 71.3 | 69.0 | 142.4 |
| On other shares | 0.1 | 0.1 | - |
| On deposits and debt securities | 6.4 | 8.3 | 16.2 |
| On subscribed capital | 2.1 | 2.1 | 4.2 |
| On subordinated liabilities | 0.6 | 1.1 | 2.0 |
| On derivative financial instruments | (5.2) | (4.5) | (10.6) |
| | **75.3** | **76.1** | **154.2** |

The derivative arrangements in place for the Group result in a net receipt of fixed interest on savings related derivatives. Due to the continued low rates of LIBOR, net interest of £5.2m has been received.

## 5. Fees and commission receivable

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| Insurance and related financial service products | 4.1 | 5.0 | 7.8 |
| Estate Agency and lettings income | 2.5 | 2.4 | 5.2 |
| Mortgage related fees | 2.3 | 2.6 | 5.1 |
| Other fees and commission | 3.2 | 3.3 | 6.4 |
| | **12.1** | **13.3** | **24.5** |

## 6. Fees and commission payable

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| Mortgage related fees | 0.3 | 0.4 | 0.8 |
| Bank charges | 0.2 | 0.2 | 0.4 |
| | **0.5** | **0.6** | **1.2** |

## 7. Other fair value gains and losses

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| Gains on derivatives | 8.8 | 5.5 | 6.0 |
| Losses on hedged items attributable to the hedged risk | (8.2) | (6.2) | (5.8) |
| | **0.6** | **(0.7)** | **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.

# Notes to the accounts
for the period ended 30 June 2013

## 8. Administrative expenses

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| Wages and salaries | 18.3 | 16.9 | 35.0 |
| Social security costs | 1.8 | 1.7 | 3.4 |
| Other pension costs | 0.9 | 0.6 | 1.3 |
| | 21.0 | 19.2 | 39.7 |
| Other administrative expenses | 13.5 | 11.7 | 24.7 |
| | **34.5** | **30.9** | **64.4** |

## 9. Other gains

There have been no other gains included in the profit for the 6 months to 30 June 2013. During 2012, the Society repurchased £14.7m of subordinated liabilities at a discount. As a result, the Group benefited from a gain of £1.5m.

## 10. Taxation expense

Tax for the Group for the six month period is charged at 25.2% (30 June 2012: 25.7%), representing the best estimate of the annual effective tax rate expected for the full year, applied to the pre-tax income of the six month period. The reduction in rate is largely driven by the reduction in the UK Corporation tax rate from 24.0% to 23.0% from 1 April 2013.

## 11. Assets measured at fair value

| | Group | | |
|---|---|---|---|
| **As at 30.06.13 (Unaudited)** | £m | Level 1 £m | Level 2 £m |
| **Financial assets at fair value through profit or loss:** | | | |
| Derivative financial instruments | 36.4 | - | 36.4 |
| **Available-for-sale financial assets:** | | | |
| Debt securities | 539.9 | 539.9 | - |
| **Total** | **576.3** | **539.9** | **36.4** |

| | Group | | |
|---|---|---|---|
| **As at 30.06.12 (Unaudited)** | £m | Level 1 £m | Level 2 £m |
| **Financial assets at fair value through profit or loss:** | | | |
| Derivative financial instruments | 47.3 | - | 47.3 |
| **Available-for-sale financial assets:** | | | |
| Debt securities | 480.1 | 480.1 | - |
| **Total** | **527.4** | **480.1** | **47.3** |

# Notes to the accounts
for the period ended 30 June 2013

## 11. Assets measured at fair value (continued)

| As at 30.12.12 (Audited) | Group | | |
|---|---|---|---|
| | £m | Level 1 £m | Level 2 £m |
| **Financial assets at fair value through profit or loss:** | | | |
| Derivative financial instruments | 43.6 | - | 43.6 |
| **Available-for-sale financial assets:** | | | |
| Debt securities | 447.6 | 447.6 | - |
| **Total** | **491.2** | **447.6** | **43.6** |

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

| Level | Hierarchy for fair value disclosures |
|---|---|
| 1. | Quoted prices (unadjusted) in active markets for identical assets or liabilities. |
| 2. | Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices). |
| 3. | Inputs for the asset or liability that are not based on observable market data. There are no instruments classified as level 3 in 2013 (2012: none). |

## 12. Loans and advances to customers

| | Group | | |
|---|---|---|---|
| | As at 30.06.13 £m (Unaudited) | As at 30.06.12 £m (Unaudited) | As at 31.12.12 £m (Audited) |
| Maturity analysis of loans and advances to customers from the date of the statement of financial position: | | | |
| | | | |
| Less than three months | 192.7 | 155.8 | 163.4 |
| Between three months and one year | 279.0 | 268.1 | 316.2 |
| Between one year and five years | 984.0 | 990.4 | 952.2 |
| More than five years | 4,288.5 | 4,019.1 | 4,157.0 |
| | 5,744.2 | 5,433.4 | 5,588.8 |
| | | | |
| Provision for impairment losses | (72.6) | (65.1) | (67.1) |
| Unamortised loan origination fees | 20.4 | 24.7 | 22.5 |
| Fair value adjustment for hedged risk | 28.7 | 51.3 | 47.5 |
| | **5,720.7** | **5,444.3** | **5,591.7** |

The residential mortgage backed security issued in 2011 has an amortised value of £590.8m (31 December 2012: £657.0m). The Group holds £405.5m of the notes (31 December 2012: £422.8m).

In October 2012, the Group became a member of the FLS. In January 2013 the Group pledged £400.0m of mortgage assets with the Bank of England and in May 2013, drew down £105.0m of Treasury Bills. The Group will continue to utilise the FLS to the end of the Scheme in 2014.

# Notes to the accounts
for the period ended 30 June 2013

## 13. Provision for liabilities and charges

| | Group | | |
|---|---|---|---|
| | As at 30.06.13 (Unaudited) £m | As at 30.06.12 (Unaudited) £m | As at 31.12.12 (Audited) £m |
| At beginning of the period/year | 13.0 | 26.7 | 26.7 |
| Charge for the period/year | 1.5 | 3.9 | 12.9 |
| Utilisation | (3.9) | (20.2) | (26.6) |
| At end of the period/year | **10.6** | **10.4** | **13.0** |

Provisions for liabilities are analysed as follows:

| | Group | | |
|---|---|---|---|
| | As at 30.06.13 (Unaudited) £m | As at 30.06.12 (Unaudited) £m | As at 31.12.12 (Audited) £m |
| PPI | 2.7 | 4.2 | 6.2 |
| FSCS | 6.3 | 4.8 | 5.2 |
| Regulatory and other complaints | 1.6 | 1.4 | 1.6 |
| At end of period/year | **10.6** | **10.4** | **13.0** |

Further details of the provisions held and expected timing of payments are set out in note 16 of these Half Year Financial Statements and in note 39 to the 2012 Annual Report and Accounts.

## 14. Amounts owed to credit institutions

Included in amounts owed to credit institutions is £100.0m (31 December 2012: None) in respect of sale and repurchase agreements.

## 15. Analysis of general reserve

| | Group | | |
|---|---|---|---|
| | As at 30.06.13 (Unaudited) £m | As at 30.06.12 (Unaudited) £m | As at 31.12.12 (Audited) £m |
| Balance at beginning of the period/year | 336.9 | 324.7 | 324.7 |
| Profit for the financial period/year | 11.0 | 10.4 | 18.6 |
| Actuarial loss on retirement benefit obligations | (1.7) | (1.9) | (8.0) |
| Movement in tax relating to retirement benefit obligations | 0.2 | 0.5 | 1.7 |
| Total recognised income for the period/year | 9.5 | 9.0 | 12.3 |
| **Balance at end of period/year** | **346.5** | **333.7** | **336.9** |
| | | | |
| Reserves excluding pension liability | 361.4 | 346.6 | 350.1 |
| Pension liability | (14.9) | (12.9) | (13.2) |
| | **346.5** | **333.7** | **336.9** |

## 16. Contingent liabilities and commitments

### a) Financial Services Compensation Scheme levy

As described in note 39 to the 2012 Annual Report and Accounts, the Society is required to make payments to the FSCS in relation to the restructuring of a number of failed financial institutions.

A provision of £6.3m (31 December 2012: £5.2m) is held in respect of these levies and represents the Society's best estimate of total levies payable in July 2013 and 2014. The FSCS levy provision has been adjusted to reflect the most up-to-date information with regards to the 2012/13 and 2013/14 levy years which has resulted in an increase in the provision of £1.1m. The Society has not yet been directly notified of the levies 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. As more information becomes available, the Society will continue to review provision levels as appropriate.

Following the draft IFRIC on 'Levies Charged by Public Authorities on Entities that Operate in a Specific Market' published in May 2012, the provision for the levy in respect of the scheme year 2014/15 should be recognised at the end of the accounting period. The Group's approach at the half year has been consistent with this draft IFRIC. Based on publicly available information, the levy charge for 2013 is expected to be in the region of £4.4m which will be provided for in full at the end of the year. Included in this is £2.0m which is the second of 3 principal repayments due over the next two scheme years to repay the shortfall of the borrowings from HM Treasury.

### b) Payment protection insurance (PPI)

As described in note 39 to the 2012 Annual Report and Accounts, the Group is required under the FSA's published Policy Statement (PS10/12) to offer redress on previously sold PPI policies in the second charge lending division.

A provision of £2.7m is held in respect of this liability, with £3.6m being utilised during the first half of the year. No additional provision has been made in the first half of the year. The remediation process is expected to be complete by the end of the year with any remaining liability largely crystallised at that point.

Provisions have not been made where the Group did not have responsibility for the original sale of the product.

### c) Defined benefit pension scheme

£0.3m was injected into the Scheme during the first half of the year. The pension scheme will be subject to a triennial valuation in September. Additional payments may become due as part of any recovery plan agreed.

## 17. Related party transactions

Transactions between the Society and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note. There were no other significant related party transactions in the current or prior period which require disclosure in the half year financial report.

## 18. Financial instruments

a) 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 | | |
|---|---|---|---|---|
| | | Carrying value | | |
| | | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| **Financial assets** | | | | |
| Cash in hand and balances with Bank of England | | 479.8 | 362.5 | 498.2 |
| Loans and advances to credit institutions (excluding CSA deposits) | i. | 116.8 | 129.0 | 102.5 |
| CSA deposits | | 25.0 | 35.1 | 26.0 |
| Debt securities – available-for-sale | ii. | 539.9 | 480.1 | 447.6 |
| Derivative financial instruments | iii. | | | |
| Interest rate swaps | | 29.6 | 40.1 | 37.5 |
| Cross currency interest rate swaps | | 3.6 | 5.1 | 2.7 |
| Equity and RPI index-linked interest rate swaps | | 3.2 | 2.1 | 3.4 |
| Loans and advances to customers | iv. | 5,720.6 | 5,444.3 | 5,591.7 |
| | | **6,918.5** | **6,498.3** | **6,709.6** |
| **Financial liabilities** | | | | |
| Shares | v. | 5,642.0 | 5,181.6 | 5,467.0 |
| Amounts owed to credit institutions | vi. | 193.4 | 86.1 | 82.5 |
| CSA liabilities | vi. | 15.8 | 7.8 | 13.3 |
| Amounts owed to other customers | vi. | 316.5 | 310.6 | 345.7 |
| Debt securities in issue | | 231.4 | 360.3 | 269.0 |
| Derivative financial instruments | iii. | | | |
| Interest rate swaps | | 32.7 | 53.6 | 49.1 |
| Equity and RPI index-linked interest rate swaps | | 0.8 | 0.1 | 0.3 |
| Subordinated liabilities | vii. | 92.3 | 107.0 | 92.3 |
| Subscribed capital | vii. | 72.8 | 75.7 | 76.4 |
| | | **6,597.7** | **6,182.8** | **6,395.6** |

## 18. Financial instruments (continued)

a) Carrying values and fair values (continued)

| | Note | Group Fair value | | |
|---|---|---|---|---|
| | | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| **Financial assets** | | | | |
| Cash in hand and balances with Bank of England | | 479.8 | 362.5 | 498.2 |
| Loans and advances to credit institutions (excluding CSA deposits) | i. | 116.8 | 129.0 | 102.5 |
| CSA deposits | | 25.0 | 35.1 | 26.0 |
| Debt securities – available-for-sale | ii. | 539.9 | 480.1 | 447.6 |
| Derivative financial instruments | iii. | | | |
| Interest rate swaps | | 29.6 | 40.1 | 37.5 |
| Cross currency interest rate swaps | | 3.6 | 5.1 | 2.7 |
| Equity and RPI index-linked interest rate swaps | | 3.2 | 2.1 | 3.4 |
| Loans and advances to customers | iv. | 5,700.2 | 5,419.6 | 5,569.2 |
| | | **6,898.1** | **6,473.6** | **6,687.1** |
| **Financial liabilities** | | | | |
| Shares | v. | 5,642.0 | 5,181.6 | 5,467.0 |
| Amounts owed to credit institutions | vi. | 193.4 | 86.1 | 82.5 |
| CSA liabilities | vi. | 15.8 | 7.8 | 13.3 |
| Amounts owed to other customers | vi. | 316.5 | 310.6 | 345.7 |
| Debt securities in issue | | 229.8 | 366.3 | 271.2 |
| Derivative financial instruments | iii. | | | |
| Interest rate swaps | | 32.7 | 53.6 | 49.1 |
| Equity and RPI index-linked interest rate swaps | | 0.8 | 0.1 | 0.3 |
| Subordinated liabilities | vii. | 92.3 | 107.0 | 75.9 |
| Subscribed capital | vii. | 72.8 | 75.7 | 48.5 |
| | | **6,596.1** | **6,188.8** | **6,353.5** |

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.

## 18. Financial instruments (continued)

a) Carrying values and fair values (continued)

Fair value is the amount for which an asset could be exchanged, or a liability transferred, 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 provisions, expected levels of early repayment and discounting at current market rates.
v) The fair value of customer accounts is assumed to approximate to the amount payable at the date of the statement of financial position.
vi) 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.
vii) The fair values of subordinated liabilities and subscribed capital are obtained from market prices.

b) Credit risk

The table below shows the Group's estimated maximum exposure to credit risk for all financial assets.

**Loans and advances to credit institutions, debt securities and derivative financial instruments**

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| **Financial assets** | | | |
| Loans and advances to credit institutions | 141.8 | 164.1 | 128.5 |
| Debt securities | 539.9 | 480.1 | 447.6 |
| Loans and advances to customers | 5,720.6 | 5,444.3 | 5,591.7 |
| **Derivative financial instruments** | | | |
| Interest rate swaps and other derivatives | 36.4 | 47.3 | 43.6 |
| | **6,438.7** | **6,135.8** | **6,211.4** |

In respect of loans and advances to credit institutions, debt securities and derivative instruments the percentage of these exposures that are rated between A and AAA under Fitch ratings for 2013 is 98.1% (31 December 2012: 98.8%).

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## 18. Financial instruments (continued)

b) Credit risk (continued)

Collateral is not held over loans and advances to credit institutions and debt securities. None of these exposures were either past due or impaired and there are no assets that would otherwise be past due or impaired whose terms have been renegotiated.

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.

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. Collateral of £25.2m (31 December 2012: £13.3m) is held over derivative financial instruments.

### Loans and advances to customers

| | Group | | |
|---|---|---|---|
| | 6 months to 30.06.13 £m (Unaudited) | 6 months to 30.06.12 £m (Unaudited) | Year ended 31.12.12 £m (Audited) |
| In respect of loans and advances to customers: | | | |
| Fully secured by a first charge on residential property | 4,618.0 | 4,285.7 | 4,488.9 |
| Fully secured by a first charge on land | 494.9 | 525.7 | 478.4 |
| Fully secured by a second charge on residential property | 533.0 | 540.4 | 531.7 |
| Partially secured by a second charge on residential property | 46.0 | 41.2 | 45.2 |
| Fair value adjustments | 28.7 | 51.3 | 47.5 |
| | **5,720.6** | **5,444.3** | **5,591.7** |
| | | | |
| Retail financial services | 4,237.8 | 3,891.7 | 4,069.6 |
| Commercial loans | 875.1 | 919.7 | 897.7 |
| Secured personal lending | 579.0 | 581.6 | 576.9 |
| Fair value adjustments | 28.7 | 51.3 | 47.5 |
| | **5,720.6** | **5,444.3** | **5,591.7** |

The table shows loans and advances to customers disaggregated by security type and by loan type.

## 18. Financial instruments (continued)

b) Credit risk (continued)

*(i) Retail financial services and secured personal lending*
Loans and advances to residential customers account for 91.3% of total loans and advances to customers (31 December 2012: 91.4%). 80.7% of loans and advances to residential customers are secured by a first charge on residential property (31 December 2012: 80.3%); 9.3% are fully secured by a second charge on residential property (31 December 2012: 9.5%).

The average index-linked loan to value (LTV) in respect of the Group's loans secured by first and second charge on residential property is 65.1% (31 December 2012: 63.7%).

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 30 June 2013, approximately 32.8% of residential exposures by account and 30.9% by value were concentrated in Wales (31 December 2012: 33.5% by account and 31.6% by value).

The percentage of residential lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.75% (31 December 2012: 0.75%) which compares favourably with the industry average of 1.4% (latest available Council of Mortgage Lenders (CML) arrears and possessions data as at 31 March 2013).

The percentage of secured personal loans currently in arrears by number is 8.91% (31 December 2012: 9.25%), which by value is 11.96% (31 December 2012: 12.38%).

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.

*(ii) Commercial*
Loans secured on commercial property are diversified by industry type with the largest exposure to one counterparty amounting to £30.6m (31 December 2012: £31.5m) or 3.4% (31 December 2012: 3.4%) of gross balances.

Asset quality remains strong with total arrears balances of £0.3m (31 December 2012: £0.4m) and only 14 commercial cases (31 December 2012: 11) three months or more in arrears.

*(iii) Treasury*
The Group has no direct exposures to Greece, Italy, Portugal, Cyprus, Ireland or Spain. 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.