PRINCIPALITY

Half-yearly financial report

2009

Principality Building Society

Half-yearly financial report

for the period ended 30 June 2009

Contents

FORWARD - LOOKING STATEMENTS

This half-yearly 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; and

(c) the interim management report includes a fair review of the information required by DTR 4.2.8.

The information for the period ended 30 June 2009 does not constitute statutory accounts as defined in section 435 of the Companies Act 2006. The auditor's report on the 2008 Annual Report and Accounts was not qualified, did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying the report and did not contain statements under section 498(2) or (3) of the Companies Act 2006.

By order of the Board,

P L Griffiths Chief Executive	W G Thomas Group Finance Director

Chief Executive's review

The Society has performed well in the first half of the year notwithstanding the most testing of conditions. Our strategy of "keeping our members' money safe" remains top of our agenda.

There seems to be little respite to the problems in the wider economy and little sign of the credit markets re-awakening. Basing our strategy on short term rapid recovery would be naive and we will continue our focus on slower growth, tight control of costs and close management of our loan books. In addition we continue to maintain strong retail funding flows to avoid high levels of exposure to the volatile wholesale markets. Our diversified model has allowed us to manage our margin, enabling us to market attractively priced retail products whilst providing for potential impairment losses and delivering a solid profit performance.

In a sector where losses and downward pressure on margins cause concern we have delivered:

- Respectable half-year pre-tax profits of £5.8m
- A strong Group net interest margin of 1.58% (year ended 31 December 2008: 1.33%)
- Balance sheet provisions of £46.8m (year ended 31 December 2008: £38.3m)
- Improvement in the cost/income ratio to 49.0% (year ended 31 December 2008: 58.0%)

Our business has performed ahead of plan with the key highlights being:

- The Society continues to have the ability to attract substantial retail savings. We are seeing strong cross sales of related products and income from this area has increased. This is a significant achievement as liquidity constraints and prudent credit criteria have dramatically reduced demand for and supply of mortgage products.
- Our Commercial Lending business has reduced our exposure to the development finance market. The quality of the book is high and impairment low.
- Impairment provisions in Nemo secured personal lending have increased due to rising unemployment and falling house prices, but we continue to compare favourably to the market. The risk/reward equation allows us to balance provisioning against wider interest spreads.
- Peter Alan, our estate agency, is well ahead of plan with good levels of weekly average sales resulting in a smaller than expected loss at the half year. Our Surveyors division within Peter Alan is also trading well, generating strong and sustainable profits.
- The launch of a Covered Bond Programme in January 2009.

The rating agencies have a very pessimistic view of sector prospects and that has been clearly demonstrated in rating downgrades. All of our ratings remain investment grade and we continue to attract adequate wholesale funding. Several external commentators suggest the rating pendulum has swung too far and we would support that view.

There are signs that rapid falls in both commercial and residential property prices are slowing. There is strong evidence that the affordability gap has closed but the absence of credit continues to curtail a more rapid and sustained growth in the property market. The key risk to the outlook remains a sustained economic downturn and the consequential effect on unemployment. Our balance sheet remains in good shape with a strong capital position and good liquidity. We have delivered on all we said we would and expect to do so again in the second half.

Consolidation in the sector continues. New mutual models are emerging and new capital instruments are available. The regulatory response to the financial crisis will also further challenge the sector as capital and liquidity hurdles rise.

We have a strong brand, loyal members and a committed workforce. We are optimistic that we can build on our solid results and look to the future with confidence.

P L Griffiths
Chief Executive
28 July 2009

Business review for the six months ended 30 June 2009

Financial position

- The pre-tax profit for the Group was £5.8m, after charging a Financial Services Compensation Scheme levy of £1.4m.
- Group net interest income increased by £14.3m on the same period last year.
- Group assets stood at £6,097.3m with £4,178.1m residential mortgages and loans.
- Tier 1 capital ratio of 11.9%, one of the highest in the sector.
- Group gross capital ratio increased by 0.3% to 8.3% of total share and deposit liabilities.
- Proportion of loans and advances to customers funded by retail savings remained strong at 92.8%.
- Liquid assets held in the form of Government stocks, short-term deposits and cash totalled £1,144.3m, equivalent to 20.6% of shares and borrowings.

Capital and profit

Capital comprises the Group's reserves, permanent interest bearing shares 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. Gross capital at 30 June 2009 was £471.9m (31 December 2008: £479.8m), the reduction being due to downward movements in fair values of our permanent interest bearing shares (PIBS), other reserves and an increase in pension scheme liabilities, offset by the after-tax profit for the period. The Group uses two ratios to measure its capital position; gross capital and free capital. As at 30 June 2009, the gross capital ratio, a measure of the Group's reserves, subscribed capital and subordinated liabilities as a percentage of total assets, was 8.3% (31 December 2008: 8.0%). The free capital ratio is the gross capital ratio plus provision for impairment losses less intangible assets and property, plant and equipment as a percentage of total assets. As at 30 June 2009, this was 8.4% (31 December 2008: 7.9%).

Changes to the actuarial assumptions for inflation and the discount rate applied to calculate the present value of future pension scheme liabilities has resulted in a net charge to reserves of £3.7m.

During the year the Group has continued to perform stress tests regularly on its capital base, and these tests, which we use within our ICAAP, have consistently demonstrated a capital surplus even allowing for extreme stress scenarios. The Group has set up provisions against the risk of losses on its loans and advances to customers and is well placed to face the challenging economic conditions ahead.

Given the economic backdrop, the Group's profit before tax for the six months to 30 June 2009 was a reasonable £5.8m despite charging a Financial Services Compensation Scheme levy of £1.4m (30 June 2008: £nil). Interest margin has improved in both Secured Personal Lending and Commercial Lending as a result of relative pricing changes reflecting the increased but diversified risk in these portfolios. Impairment provision in Secured Personal Lending has increased by £17.5m on the same period last year, although this is in line with management expectations. We have changed our insurance product offering in Secured Personal Lending which has reduced other income. There have been some signs of a recovery in the mortgage market which has had a positive impact on the Group's lending, surveying and estate agency activities.

The ratio of management expense as a percentage of total mean assets is one indication of how efficiently the Group is managing its assets. The ratio has marginally improved since the year-end from 1.04% to 0.98% which shows the Group is maintaining firm control of its cost base. This reduction in cost has been achieved without compromising operational efficiency, customer service or quality of products.

The gain of £0.1m 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. The credit is primarily due to timing differences in cash flows and interest rate reset dates between the derivative instruments and the hedged assets and liabilities. The impact can be volatile, especially so in current market conditions, but will trend to zero over time.

Funding and liabilities

Shares represent members' savings account balances within the Society. Share deposit balances, excluding accrued interest, have remained broadly flat during the first half of the year despite facing challenges in the form of rising unemployment, making it difficult for households to save and very low levels of interest rates, leading households to prioritise debt repayments over accumulating savings. There has been a strong take-up of fixed rate bonds as members seek to maximise returns in a low and uncertain interest rate environment. We face increasing levels of competition for retail savings and we will continue to be innovative in the savings marketplace to enhance our range and maintain our competitive position.

Borrowings represent funds from wholesale ('money market') sources, administered by the Group's treasury function. The overall high levels of retail savings balances and lower reliance on wholesale funding has helped the Society to decrease its funding limit to 18.5% as at 30 June 2009 (31 December 2008: 20.6%). This ratio shows the proportion of the Group's funding which is from wholesale or money market sources. The Group entered into a Covered Bond Programme on 22 January 2009 to further diversify its funding sources.

Covered Bond Programme

On 22 January 2009, the Society entered into a €3bn Covered Bond Programme which involved the formation of Principality Covered Bond LLP, a Limited Liability Partnership which is consolidated into the accounts of the Group. As at 30 June 2009, £904m of loans issued by the Society had been transferred to Principality Covered Bond LLP. These loans secure a £700m bond issued by the Society. The loans remain on the balance sheet of the Society as the risks and rewards are retained by the Society.

Assets

In line with other mortgage lenders, the Group has continued to apply prudent controls to its lending activities, particularly in relation to higher risk portfolios, to ensure that the Group can continue to deliver long-term value for its members. Therefore whilst total mortgage and loan assets have fallen by 0.5% to £4,859.9m in the six months to 30 June 2009, retail mortgage balances have increased by £11.2m.

In line with the reduction in wholesale funds, as reflected in the decrease of the funding limit, liquid assets have also fallen by £245.7m. However, mortgage balances funded by retail savings remain strong at 93%. This has resulted in the liquidity ratio, the value of liquid assets as a proportion of total shares and borrowings, falling by 3.3% since the year end to 20.6%.

Liquid assets can be readily turned into cash, should the need arise, and over 94% of the Group's liquid asset investments continue to be invested in A to AAA rated institutions with £389m held in the form of highly liquid securities such as Gilts.

Going concern

As presented in the consolidated statement of financial position, the Group meets its funding requirements mainly from retail sources supplemented from wholesale sources. The Group's forecasts and projections include scenario testing which is carried out in accordance with the Internal Capital Adequacy Assessment Process (ICAAP), which is a process required by our regulator to demonstrate appropriate levels of capital under stressed conditions. This takes account of reasonably possible changes in trading performance, and shows that the Group will be able to operate within the sources of funding currently available to it. In addition to these sources, additional contingency funding plans are in place, in particular the Covered Bond Programme.

The Group monitors its liquidity levels so as to ensure that an appropriate level of resources is maintained to meet the requirements of the business. These are assessed under a number of stressed scenarios reflecting the directors' views of different risks that might arise under the current economic conditions. The assets held for liquidity purposes are assessed and 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 effect of the recent sector down-gradings by Moody's and Fitch has been limited with only certain types of institutions withdrawing limits. However we continue to maintain a prudent liquidity level in excess of 20%.

Having considered the plans and forecasts for the Group for the next 12 months, the directors believe that there are no material uncertainties that lead to significant doubt on the Group's ability to continue in business for our members as a mutual building society for the foreseeable future. In addition, the directors consider that the overall level of capital, including Tier 1 capital of £337.1m (11.9% as a percent of risk-weighted assets) and a solvency ratio (without profits) of 16.1% is adequate. Accordingly, the financial statements continue to be prepared on a going concern basis.

Principal risks and uncertainties

The Group's principal inherent risks are described in the Risk Management report on pages 9 to 11 of the Annual Report and Accounts for 2008. Additional information on risk is also provided in the Pillar 3 disclosure available at http://www.principality.co.uk/pdf/Principality_Pillar_3_Disclosure_2008.pdf. The Chief Executive's Review comments on the principal risks and uncertainties affecting the Group for the remaining six months of the year.

W G Thomas
Group Finance Director
28 July 2009

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 2009 which comprises the condensed consolidated income statement, the condensed consolidated balance sheet, the condensed consolidated statement of recognised income and expense, the condensed consolidated cash flow statement and related notes 1 to 14. 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 them 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 Services 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 2009 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 Services Authority.

Deloitte LLP
Chartered Accountants and Statutory Auditors
Cardiff, United Kingdom
28 July 2009

Condensed consolidated statement of comprehensive income
Group Interim results for six months to 30 June 2009

	Notes	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Interest receivable and similar income	3	120.3	191.9	388.6
Interest payable and similar charges	4	(68.0)	(153.9)	(304.0)
Net interest income		52.3	38.0	84.6
Fees and commission receivable	5	7.6	13.6	24.5
Fees and commission payable	6	(0.5)	(1.8)	(2.8)
Net fee and commission income		7.1	11.8	21.7
Other operating income		0.4	0.5	0.6
Other fair value gains and losses	7	0.1	(2.6)	3.2
Net operating income		59.9	47.7	110.1
Administrative expenses	8	(26.4)	(29.2)	(57.8)
Depreciation and amortisation		(3.0)	(3.1)	(6.1)
Total operating expenses		(29.4)	(32.3)	(63.9)
Impairment provision for losses on loans and advances		(23.3)	(7.0)	(31.7)
Financial Services Compensation Scheme levy		(1.4)	-	(5.2)
Operating profit and profit before taxation		5.8	8.4	9.3
Taxation expense	9	(1.7)	(2.4)	(3.6)
Profit for the period		4.1	6.0	5.7

Condensed consolidated statement of recognised income and expense

Profit for the period/year	4.1	6.0	5.7
Actuarial (loss)/gain on retirement benefit obligations	(5.3)	-	0.7
Movement in deferred tax relating to retirement benefit obligations	1.6	-	(0.2)
	0.4	6.0	6.2

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

The accounting policies and notes on pages 9 to 16 form part of these accounts.

Condensed consolidated statement of financial position
As at 30 June 2009

Assets	Notes	As at 30.06.09 (Unaudited) £m	As at 30.06.08 (Unaudited) £m	As at 31.12.08 (Audited) £m
Liquid assets:				
Cash in hand and balances with the Bank of England		5.5	6.6	6.1
Loans and advances to credit institutions		190.1	42.6	203.6
Debt securities		948.7	1,306.6	1,180.3
		1,144.3	1,355.8	1,390.0
Derivative financial instruments		28.1	29.2	40.9
Loans and advances to customers:				
Loans fully secured on residential property		4,178.1	4,189.9	4,209.0
Other loans fully secured on land		590.8	578.3	588.5
Other loans		91.0	69.4	86.8
	10	4,859.9	4,837.6	4,884.3
Investment in joint venture		1.9	1.8	1.9
Intangible fixed assets		2.7	3.9	3.3
Property, plant and equipment		37.4	39.4	38.4
Deferred tax assets		2.4	1.2	1.0
Other assets		5.9	4.6	4.7
Prepayments and accrued income		14.7	16.0	34.2
Total assets		6,097.3	6,289.5	6,398.7
Liabilities				
Shares		4,510.5	4,251.0	4,626.4
Deposits and debt securities:				
Amounts owed to credit institutions	11	440.6	70.2	68.2
Amounts owed to other customers		320.7	1,081.8	733.9
Debt securities in issue		279.5	385.3	383.9
		1,040.8	1,537.3	1,186.0
Derivative financial instruments		35.3	12.5	70.5
Current tax liabilities		2.1	2.3	3.6
Other liabilities		8.0	16.4	7.3
Provision for liabilities and charges		8.2	2.0	6.8
Accruals and deferred income		11.3	11.2	14.4
Deferred tax liabilities		2.6	2.0	2.6
Retirement benefit obligations		6.6	2.0	1.3
Subordinated liabilities		125.9	114.4	125.9
Subscribed capital		64.6	57.6	68.9
Total liabilities		5,815.9	6,008.5	6,113.7
General reserve	12	283.9	283.3	283.5
Other reserves		(2.5)	(2.5)	1.5
Total equity and liabilities		6,097.3	6,289.5	6,398.7

The accounting policies and notes on pages 9 to 16 form part of these accounts.

Condensed consolidated statement of cash flows
for the period ended 30 June 2009

	6 months to 30.06.09 (Unaudited) £m	6 months to 30.06.08 (Unaudited) £m	Year ended 31.12.08 (Audited) £m
Net cash (outflow)/inflow from operating activities (see below)	(220.6)	233.2	175.4
Cash flows from investing activities			
Purchase of intangible assets and property, plant and equipment	(1.5)	(0.4)	(5.4)
Proceeds from sale of intangible assets and property, plant and equipment	-	(1.4)	0.4
Purchase of investment securities	(1,469.3)	(2,678.6)	(4,298.2)
Proceeds from sale and maturity of investment securities	1,695.3	2,410.6	4,162.2
Purchase of shares in joint venture	-	-	(0.6)
Increase/(decrease) in cash and cash equivalents	3.9	(36.6)	33.8
Cash and cash equivalents at beginning of period/year	104.7	70.9	70.9
Cash and cash equivalents at end of period/year	108.6	34.3	104.7
Represented by:			
Cash and balances with the Bank of England	5.5	6.6	6.1
Loans and advances to credit institutions repayable on demand	103.1	27.7	98.6
	108.6	34.3	104.7

Net cash (outflow)/inflow from operating activities

Profit before taxation	5.8	8.4	9.3
Adjusted for:			
Depreciation and amortisation	3.0	3.1	6.1
Loss on sale of property, plant and equipment	-	-	1.0
Increase in impairment losses on loans and advances to customers	8.5	6.8	18.8
Change in fair values	11.2	8.5	(38.9)
Other non cash movements	0.3	0.1	6.8
Changes in net operating assets			
Decrease/(increase)in loans and advances to credit institutions	18.0	62.9	(27.2)
Decrease/(increase) in loans and advances to customers	0.9	(287.3)	(249.8)
Decrease in other assets	0.6	6.6	2.2
Decrease/(increase) in prepayments and accrued income	19.5	(7.3)	(25.9)
(Decrease)/increase in derivative financial instruments	(22.4)	(15.9)	30.4
(Decrease)/increase in shares	(116.9)	448.3	809.2
(Decrease)/increase in deposits and debt securities	(144.8)	4.3	(355.3)
Increase/(decrease) in other liabilities	0.7	3.7	(6.7)
(Decrease)/increase in accruals and deferred income	(1.6)	(6.0)	0.6
Taxation	(3.4)	(3.0)	(5.2)
	(220.6)	233.2	175.4

Notes to the accounts
for the period ended 30 June 2009

1. Accounting policies

Basis of preparation

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

The same accounting policies are followed in this condensed set of financial statements as applied in the Group's latest annual audited financial statements, except for the impact of the adoption of the standards described below which have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union.

IFRS 8 Operating Segments (effective for annual periods beginning on or after 1 January 2009)
IFRS 8 replaces IAS14, 'Segment reporting', and requires a 'management' approach under which segment information is presented on the same basis as that used for internal reporting purposes. The segments identified under IFRS 8 do not materially differ from those disclosed under IAS 14. The standard does not change any recognition, measurement or disclosure of specific transactions in the consolidated financial statements.

IAS 1 (revised 2007) Presentation of Financial Statements (effective for annual periods beginning on or after 1 January 2009)
The revised standard has introduced a number of terminology changes (including revised titles for the consolidated financial statements) and has resulted in a number of changes in presentation and disclosure. However, the revised standard has had no impact on the reported results or financial position of the Group.

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, except for the impact of reduced prepayment levels on the effective interest rate (EIR) calculations and retirement benefit obligations.

Effective interest rate
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.

Observed changes in prepayment rates during the period, and their impact on early redemption charges during the financial instrument's 'tie-in' period, have resulted in a charge to the income statement of £0.2m. This is offset by increased interest receivable as loan and mortgage assets remain on the balance sheet for a longer average period of time. Some income statement volatility will arise where there are significant changes in customer behaviour and in particular a low interest environment where the availability of credit is restricted however EIR adjustments for early redemption charges will trend to zero over time.

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.

Changes to the actuarial assumptions for inflation and the discount rate applied to calculate the present value of future scheme liabilities has resulted in a net charge to the statement of recognised income and expense of £3.7m.

	6 months to 30.06.09 (Unaudited) %	6 months to 30.06.08 (Unaudited) %	Year ended 31.12.08 (Audited) %
Discount rate assumption	6.00	5.70	6.25
Inflation assumption	3.20	3.20	2.70
Rate of increase in pensionable salaries	3.20	3.20	2.70

Notes to the accounts
for the period ended 30 June 2009

2. Business segments

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

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

	6 months to 30.06.09 (Unaudited)					
	Retail financial services	Commercial lending	Secured personal lending	Estate agency	Consolidation adjustment	Total
	£m	£m	£m	£m	£m	£m
Interest receivable and similar income	95.3	21.7	28.9	-	(25.6)	120.3
Interest payable and similar charges	(68.0)	(15.6)	(10.0)	-	25.6	(68.0)
Net interest income	27.3	6.1	18.9	-	-	52.3
Net fee and commission income	3.1	0.5	-	3.5	-	7.1
Other operating income	0.5	-	-	-	(0.1)	0.4
Fair value gains	0.1	-	-	-	-	0.1
Net operating income	31.0	6.6	18.9	3.5	(0.1)	59.9
Administrative expenses	(20.4)	(1.0)	(4.5)	(3.6)	0.1	(29.4)
Impairment provision for losses on loans and advances	(1.5)	(2.5)	(19.3)	-	-	(23.3)
Financial Services Compensation Scheme levy	(1.4)	-	-	-	-	(1.4)
Operating profit and profit before taxation	**7.7**	**3.1**	**(4.9)**	**(0.1)**	-	**5.8**

	6 months to 30.06.08 (Unaudited)					
	Retail financial services	Commercial lending	Secured personal lending	Estate agency	Consolidation adjustment	Total
	£m	£m	£m	£m	£m	£m
Interest receivable and similar income	181.3	30.0	29.4	-	(48.8)	191.9
Interest payable and similar charges	(154.0)	(27.2)	(21.5)	-	48.8	(153.9)
Net interest income	27.3	2.8	7.9	0.0	-	38.0
Net fee and commission income	2.9	0.5	4.1	4.5	(0.2)	11.8
Other operating income	0.5	-	-	-	-	0.5
Fair value losses	(2.6)	-	-	-	-	(2.6)
Net operating income	28.1	3.3	12.0	4.5	(0.2)	47.7
Administrative expenses	(19.5)	(1.2)	(6.4)	(5.4)	0.2	(32.3)
Impairment provision for losses on loans and advances	-	(0.6)	(6.4)	-	-	(7.0)
Financial Services Compensation Scheme levy	-	-	-	-	-	-
Operating profit and profit before taxation	**8.6**	**1.5**	**(0.8)**	**(0.9)**	-	**8.4**

2. Business segments (continued)

	Year ended 31.12.08 (Audited)					
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Estate agency £m	Consolidation adjustment £m	Total £m
Interest receivable and similar income	362.4	62.5	62.0	-	(98.3)	388.6
Interest payable and similar charges	(304.0)	(55.6)	(42.7)	-	98.3	(304.0)
Net interest income	58.4	6.9	19.3	-	-	84.6
Net fee and commission income	6.1	1.0	6.2	8.5	(0.1)	21.7
Other operating income	0.6	-	-	-	-	0.6
Fair value gains	3.2	-	-	-	-	3.2
Net operating income	68.3	7.9	25.5	8.5	(0.1)	110.1
Administrative expenses	(42.7)	(1.7)	(11.8)	(9.8)	2.1	(63.9)
Impairment provision for losses on loans and advances	(1.3)	(2.2)	(28.2)	-	-	(31.7)
Financial Services Compensation Scheme levy	(5.2)	-	-	-	-	(5.2)
Operating profit and profit before taxation	**19.1**	**4.0**	**(14.5)**	**(1.3)**	**2.0**	**9.3**

	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Total assets by business segments			
Retail financial services	4,453.9	4,618.9	4,723.3
Secured personal lending	688.0	721.3	714.4
Commercial lending – secured on residential property	360.2	358.6	368.3
Commercial lending – secured on land	590.8	585.0	588.5
Estate agency	4.4	5.7	4.2
Total assets	6,097.3	6,289.5	6,398.7

The allocation of liabilities to business segments is not appropriate. 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 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
On loans fully secured on residential property	110.6	128.7	269.6
On other loans fully secured on land	12.7	21.7	37.1
On debt securities	14.8	33.9	68.4
Profit on realisation of investments	2.6	-	0.2
On other liquid assets	0.8	2.8	5.4
On derivative financial instruments	(21.2)	4.8	7.9
	120.3	191.9	388.6

The derivative arrangements in place for the Group result in a net payment of fixed interest on mortgage related derivatives. Due to the relative low rates of LIBOR over the first half of the year, net interest of £21.2m has been payable.

4. Interest payable and similar charges

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
On shares held by individuals	57.0	99.8	202.5
On other shares	0.1	0.4	0.3
On deposits and debt securities	16.4	48.1	89.4
On subscribed capital	2.1	2.3	4.5
On subordinated liabilities	3.2	3.2	6.5
On derivative financial instruments	(10.8)	0.1	0.8
	68.0	153.9	304.0

The derivative arrangements in place for the Group result in a net receipt of fixed interest on savings related derivatives. Due to the relative low rates of LIBOR over the first half of the year, net interest of £10.8m has been received.

5. Fees and commission receivable

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Insurance and related financial service products	2.4	7.4	11.8
Estate agency	2.1	2.9	5.2
Mortgage related fees	1.7	1.8	5.2
Other fees and commission	1.4	1.5	2.3
	7.6	13.6	24.5

6. Fees and commission payable

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Mortgage related fees	0.3	1.5	2.5
Other fees and commission	-	0.1	-
Bank charges	0.2	0.2	0.3
	0.5	1.8	2.8

7. Other fair value gains and losses

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Gains less losses on derivatives	5.1	15.9	(22.5)
Gains less losses on hedged items attributable to the hedged risk	(5.0)	(18.5)	25.7
	0.1	(2.6)	3.2

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.

8. Administrative expenses

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Wages and salaries	13.8	16.0	30.0
Social security costs	1.3	1.6	3.1
Other pension costs	0.8	0.7	1.3
	15.9	18.3	34.4
Other administrative expenses	10.5	10.9	23.4
	26.4	29.2	57.8

9. Tax

Tax for the six month period is charged at 29.3%, 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.

10. Loans and advances to customers

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Maturity analysis of loans and advances to customers from the date of the balance sheet:			
Repayable on demand	49.9	87.5	41.7
less than three months	103.5	100.0	104.3
Between three months and one year	235.8	263.3	225.1
Between one year and five years	1,094.7	969.5	932.7
More than five years	3,324.4	3,419.8	3,500.7
	4,808.3	4,840.1	4,804.5
Provision for impairment losses	(46.8)	(26.4)	(38.3)
Unamortised loan origination fees	38.3	42.9	43.1
Fair value adjustment for hedged risk	60.1	(19.0)	75.0
	4,859.9	4,837.6	4,884.3

On 22 January 2009, the Group entered into a Covered Bond Programme. The Programme involved the formation of Principality Covered Bond LLP, a Limited Liability Partnership which is consolidated into the accounts of the Group. The LLP provides security to issues of covered bonds made by the Society as part of the Covered Bond Programme.

As at 30 June 2009, £904m of loans issued by the Society had been transferred to Principality Covered Bond LLP. These loans secure a £700m AAA rated bond issued by the Society. The loans remain on the balance sheet of the Society as the risks and rewards are retained by the Society.

Notes to the accounts
for the period ended 30 June 2009

11. Amounts owed to credit institutions

As part of the Covered Bond Programme, and included in amounts owed to credit institutions, is £399.7m relating to securities sold under short-term agreements to repurchase.

12. Analysis of general reserve

	Group As at 30.06.09 (Unaudited) £m	Group As at 30.06.08 (Unaudited) £m	Group As at 31.12.08 (Audited) £m
Balance at 1 January	283.5	277.3	277.3
Profit for the financial period/year	4.1	6.0	5.7
Actuarial (loss)/gain on retirement benefit obligations	(5.3)	-	0.7
Movement in deferred tax relating to retirement benefit obligations	1.6	-	(0.2)
Total recognised income for the period/year	0.4	6.0	6.2
Balance at end of period/year	283.9	283.3	283.5
Reserves excluding pension liability	287.6	285.2	284.8
Pension liability	(3.7)	(1.9)	(1.3)
	283.9	283.3	283.5

13. Contingent liabilities

Financial Services Compensation Scheme levy

As described in note 39 to the 2008 Annual Report and Accounts, the Society is required to make payments to the Financial Services Compensation Scheme (FSCS) in relation to the restructuring of a number of failed financial institutions.

The Group has not been directly notified of the levies payable as a result of the claims against the Financial Services Compensation Scheme and there are a number of factors that prevent accurate calculation of this future liability. The charge for the period of £1.4m does not take account of any future claims that may arise as a result of the restructuring of Dunfermline Building Society in March 2009.

14. Financial instruments – credit risk

The classes of financial instrument which the Group is most exposed to credit risk are loans and advances to credit institutions and loans and advances to customers.

	Group		
	6 months to 30.06.09 £m (Unaudited)	6 months to 30.06.08 £m (Unaudited)	Year ended 31.12.08 £m (Audited)
Financial assets:			
Loans and advances to credit institutions	190.1	42.6	203.6
Debt securities	948.7	1,306.6	1,180.3
Loans and advances to customers	4,859.9	4,837.6	4,884.3
Derivative financial instruments:			
Interest rate swaps	30.2	22.8	32.7
Cross currency interest rate swaps	10.1	6.4	16.2
Credit Support Annex (CSA) deposits	(12.2)	-	(8.0)
	6,026.8	6,216.0	6,309.1

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

Loans and advances to credit institutions

The percentage of these exposures that are rated between A and AAA under Fitch IBCA credit ratings for 2009 is 94.1% (31 December 2008: 94.4%).

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £12.2m is held over derivative financial instruments.

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.

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.

Loans and advances to customers

(a) Residential

Loans and advances to residential customers account for 87.7% of total loans and advances to customers. Of this, 73.7% are secured by a first charge on residential property (31 December 2008: 73.4%) and 12.2% are fully secured by a second charge on residential property (31 December 2008: 12.8%).

The average index-linked loan to value (LTV) in respect of the Group's loans secured on residential property is estimated to be 66.0% (31 December 2008: 60.8%).

The Group provides loans secured on residential property across England and Wales with a 41.2% geographical concentration in Wales (31 December 2008: 41.3%).

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 1.09% (31 December 2008: 1.03%) which compares favourably with the industry average of 1.85% (CML figure as at 30 June 2009).

The Group has mortgage indemnity guarantee insurance which provides additional protection against subsequent residential loan impairment up to an agreed level after a prescribed value of "excess".

The percentage of residential lending cases fully secured by a second charge currently in arrears by number is 7.75% (31 December 2008: 6.3%), and by value is 8.79% (31 December 2008: 7.22%).

14. Financial instruments – credit risk (continued)

(b) Commercial

The percentage of these exposures that are fully secured by a first charge on land is 12.3% (31 December 2008: 12.0%).

Loans secured on commercial property are well diversified by industry type with the largest exposure to one counterparty amounting to £47.2m (31 December 2008: £48.4m) or 4.9% (31 December 2008: 5.0%) of gross balances.

Asset quality remains strong with only five commercial cases (31 December 2008: six) with arrears of more than three months but less than 12 months. Arrears balances were £1.6m (31 December 2008: £1.4m).