BASEL III PILLAR 3 DISCLOSURES

2016

Building your future

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Building Society
Cymdeithas Adeiladu

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1. Key Regulatory Metrics

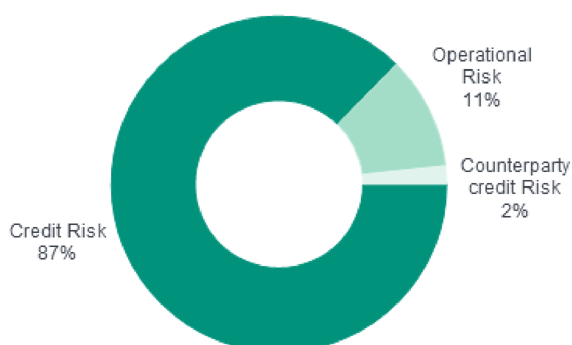
	Common Equity Tier 1 Capital £m	Common Equity Tier 1 Capital %
Dec-2016	**468.7**	**23.5**
Dec-2015	435.5	21.0
Dec-2014	375.7	18.2

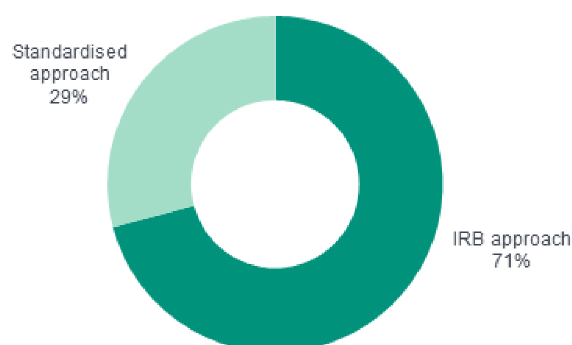
	Tier 1 Capital £m	Tier 1 Ratio %
Dec-2016	**504.7**	**25.3**
Dec-2015	477.5	23.0
Dec-2014	423.7	20.5

	Total Regulatory Capital £m	Total Capital Ratio %
Dec-2016	**528.7**	**26.5**
Dec-2015	504.7	24.3
Dec-2014	463.4	22.5

	Leverage Exposure £m	Leverage Ratio (Transitional Position) %
Dec-2016	**8,565.6**	**5.9**
Dec-2015	7,967.1	6.0
Dec-2014	7,484.4	5.7

	Leverage Exposure £m	Leverage Ratio (End State Position) %
Dec-2016	**8,565.6**	**5.5**
Dec-2015	7,967.1	5.5
Dec-2014	7,484.4	5.0





*Detail on scope of permission is covered in Section 2.3.4

2. Overview

2.1 Introduction

The Capital Requirements Directive IV (CRD IV), commonly known as Basel III, came into effect on 1 January 2014 and transitional rules are in place until 1 January 2022. This document reflects the transitional Basel III position for 31 December 2016, compared with 2015 results, also under the transitional Basel III requirements. In addition it states the position of the Society and its subsidiary undertakings (the Group) as if the final Basel III rules were applied (known as the final Basel III position).

2.2 Overview of Basel III

The Basel III framework has applied since 1 January 2014 with transitional arrangements in place until full implementation on 1 January 2022. The three pillar framework of Basel II is unchanged but there have been changes to the detailed requirements within each pillar.

- **Pillar 1** – This is the minimum capital requirement and defines rules for the calculation of credit, market and operational risk capital requirements under the following approaches:
    - **Standardised approach:** assesses capital requirements using standard industry-wide risk weightings based on a detailed classification of asset types.
    - **Internal Ratings Based approach (IRB):** assesses capital requirements using firm specific data and internal models to calculate risk weightings. The IRB approach is further sub-divided into three approaches:
        - **Advanced IRB (A-IRB):** where internal calculations of probability of default (PD), loss given default (LGD) and credit conversion factors are used to model risk exposures.
        - **Foundation IRB (F-IRB):** where internal calculations of PD, but standardised parameters for LGD and credit conversion factors are used.
        - **Specialised Lending Exposures:** where standardised parameters for risk weight and expected loss are set based on risk grade allocated.
- **Pillar 2** – This is the supervisory review process which requires firms to undertake an Individual Capital Adequacy Assessment Process (ICAAP) for Pillar 1 and other risks not captured in Pillar 1 (see Section 4.1) and to agree total capital requirements with the regulator; and
- **Pillar 3** – This outlines market discipline such as requirements for disclosure of risk and capital information as specified in the Basel rules to promote transparency and good risk management allowing the market to assess and compare the capital adequacy of firms.

The changes to the detailed requirements include more detailed Pillar 3 disclosure requirements and generic templates to be adopted over the course of the transition to allow improved comparability and transparency between institutions covered by the Basel accords.

Basel III has strengthened the rules on the quality of capital to ensure loss absorption is adequate and to allow financial institutions to deal with shocks and stresses related to financial and economic factors. Basel III requires that the quality of capital to cover Pillar 1 capital requirements is improved in terms of its ability to absorb losses, meaning that more of the Pillar 1 capital requirement must be met from Common Equity Tier 1 (CET1).

2.3 Basis of Preparation

The sole purpose of these disclosures is to give information on the basis of calculating capital requirements and on the management of risks faced by the Group. This is in accordance with the rules laid out in the Prudential Regulation Authority (PRA) Handbook and CRD IV.

All calculations that include elements of own funds are prepared in line with Basel III regulation unless explicitly stated.

2.3.1 Frequency of Disclosure

Disclosures will be issued at least annually, unless otherwise stated, all figures are as at 31 December 2016, the Group's financial year end.

2.3.2 Presentation of Risk Data

This document discloses assets in terms of exposures and capital requirements. For the purposes of this document, credit exposure is defined as the estimate of the amount at risk in the event of a default (before any recoveries) or through the decline in value of an asset. This estimate takes account of contractual commitments related to undrawn amounts. In contrast, an asset in the Group's balance sheet is reported as a drawn balance only. This is one of the reasons why exposure values in the Pillar 3 report will differ from asset values as reported in the 2016 Annual Report and Accounts prepared in accordance with International Financial Reporting Standards (IFRS).

2.3.3 Scope of Application

The Basel III Framework applies to the Group; this is enforced by the PRA and Financial Conduct Authority (FCA) through regulation. The Group is made up of the following main trading entities:

- Principality Building Society
- Nemo Personal Finance Limited

Full details of the principal subsidiary undertakings are included in note 20 to the 2016 Annual Report and Accounts.

There are no differences in the basis of consolidation for accounting and regulatory capital purposes. Full details of the basis of consolidation can be found in note 1 to the 2016 Annual Report and Accounts.

Restrictions on transfer of funds or regulatory capital

There are no legal or regulatory restrictions that constitute a material limitation on the ability of our subsidiaries to pay dividends or our ability to transfer funds or regulatory capital within the Group.

2.3.4 Scope of Permission of Internal Ratings Based Approach

The Group received approval to adopt the IRB approach for credit risk in 2013. The IRB approach has been applied to first charge Retail and Commercial portfolios from 1 October 2013. The decisions made in 2015 to cease new lending in the Group's second charge business and focus the Group's resources on the core Retail and Commercial businesses has resulted in the Group's second charge mortgages remaining on the standardised approach and being removed from the IRB roll out plan with the approval of the PRA.

The disclosures in this document cover the IRB approach and the standardised approach, which applies to the second charge retail lending, Residential Social Landlords (RSL) and treasury portfolios, together with operational risk.

2.3.5 Location of Risk Disclosures

These disclosures have been reviewed by the Audit Committee and are published on the Group's website alongside the Annual Report and Accounts (www.principality.co.uk).

2.3.6 Verification and Sign-off

These disclosures are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Group's audited Annual Report and Accounts. They are reviewed internally by the Audit Committee in accordance with the Group's policies on disclosure and its financial reporting and governance process.

2.3.7 Remuneration

The responsibilities and decision-making process for determining remuneration policy, the link between pay and performance and the design and structure of remuneration, including the performance pay plans, have been disclosed in the Report of the Remuneration Committee on pages 62-69 in the 2016 Annual Report and Accounts.

Supplementary tables have been included in **Appendix B** to meet the requirements of Pillar 3 disclosures on remuneration analysing remuneration between fixed and variable remuneration for those categories of staff whose professional activities have a material impact on the Group's risk profile.

3. Capital Resources

3.1 Total Regulatory Capital and Reconciliation to Accounting Capital

As at 31 December 2016 and throughout the year, the Group complied with the capital requirements that were in force as set out by the PRA. The following table shows the breakdown of the total available capital for the Group as at 31 December 2016 under the Basel III rules:

	Notes	Dec-2016 £m	Dec-2015 £m
General Reserves	1	476.0	447.4
AFS Reserves	2	2.4	1.6
Total Accounting Capital		**478.4**	**449.0**
Adjustments for Regulatory Capital:-			
Intangible Assets	3	(1.3)	(1.4)
Additional Value Adjustment (AVA)	4	(0.4)	(0.5)
Deferred Income	5	(0.3)	(0.6)
Provision Deductions	6	(7.7)	(11.0)
Common Equity Tier 1 Capital		**468.7**	**435.5**
Permanent Interest Bearing Shares (PIBS)	7	36.0	42.0
Additional Tier 1 Capital		**36.0**	**42.0**
Total Tier 1 Capital		**504.7**	**477.5**
Amortised Subordinated Debt	8	-	9.2
Tier 2 Allowance of Grandfathered AT1	9	24.0	18.0
Tier 2 Capital		**24.0**	**27.2**
Total Tier 2 Capital		**24.0**	**27.2**
Total Regulatory Capital Resource		**528.7**	**504.7**

Notes and General Information on Capital Resources

1 The general reserve represents the Group's accumulated profits.

Further details of the general reserve are provided in the Group's Statement of Changes in Members Interest on page 85 of the 2016 Annual Report and Accounts.

2. The Group holds unrealised gains and losses in the Available for Sale (AFS) reserve. Under CRR Article 35 unrealised gains and losses at fair value should be included in own funds.

3. Intangible assets include software development costs.

   Further details of the intangible assets are provided in note 21 to the 2016 Annual Report and Accounts.

4. Additional Value Adjustment (AVA) is the prudential valuation of all fair valued assets which, as per CRR Article 34, is deducted from CET1 capital.

5. Deferred income is income dependent on the future performance of loans sold to other institutions. We therefore deduct the income from CET1 using CRR article 3.

6. Provision deductions arise from the IRB approach. The calculation is the difference between the expected losses from IRB portfolios and the amount of collective provisions held for those same portfolios. CRR Article 36 states this deduction is taken 100% from CET 1 capital.

7. Permanent Interest Bearings Shares (PIBS) are unsecured deferred shares and rank behind the claims of all subordinated note holders, depositors, creditors and investing Members of the Society. They are being grandfathered out of Tier 1 availability as part of the Basel III transitional rules.

   Further details of the PIBS are provided in note 29 to the 2016 Annual Report and Accounts.

8. Subordinated notes are unsecured and rank behind the claims of all depositors, creditors and investing Members (other than holders of PIBS) of the Society. The subordinated notes, as a Tier 2 instrument with fewer than 5 years until maturity, started amortising out of regulatory capital over five years from July 2011 under CRR Article 64 and matured during 2016.

9. Due to the straight line amortisation of the Subordinated notes, the Group's total Tier 2 capital is below the Tier 2 grandfathered limit. CRR Article 486 allows for any Tier 1 instruments excluded from Tier 1 due to the grandfathered limit to be included within Tier 2 up to the Tier 2 grandfathering limit (See section 5.1 for more detail).

   Further details of the subordinated notes are included in note 28 to the 2016 Annual Report and Accounts.

The Group does not deduct its deferred tax assets (£1.3m) that rely on future profitability from CET1. This is in line with CRR Article 48 which states that, if such assets fall below a threshold of 10% of CET1, they need not be deducted.

4. Capital Adequacy

4.1 Capital Management

The Group uses a mixture of IRB and standardised approaches to calculate Pillar 1 minimum capital requirement as follows:

- Retail IRB – Society first charge mortgages
- Specialised Lending Exposures – Commercial lending
- Standardised – Second charge mortgages, Registered Social Landlord exposures, Treasury exposures and other assets

Details of the methodologies used are included in Section 7.

Pillar 1 capital adequacy is monitored through the Board, the Asset and Liability Committee (ALCo) and Group Risk Committee (GRC). Capital forecasts are formally reviewed and approved at least annually with Pillar 2 risks considered annually as part of the ICAAP.

The Group's minimum capital level is that which the Board considers necessary to protect unsecured creditors from loss and reflects the Group's planned activity as a whole, set in the competitive and economic environment in which it operates. The assessment of the minimum capital requirement is a combination of model outputs from its standardised and IRB systems, supplemented by the use of other risk models, together with judgement exercised by the Board.

Internal Capital Adequacy Assessment Process

The Group conducts an ICAAP to assess the Group's capital adequacy and determine the levels of capital required to support the current and future risks faced by the Group. The ICAAP covers all material risks to determine the capital requirement over a five-year horizon and includes stress scenarios which are intended to meet internal and regulatory requirements. The capital requirements are presented to the Board for approval with the most recent review being completed and approved by the Board in July 2016. The ICAAP is used by the PRA to determine and set the Group's Individual Capital Guidance (ICG) and PRA buffer, if required. The ICG was last recalibrated by the PRA after the Group's Supervisory Review and Evaluation Process (SREP) visit in 2015, and the next visit is scheduled for 2017.

The amounts and composition of the Group's capital requirements are determined by assessing the relevant Basel Pillar 1 minimum capital requirement, the requirement for other risks not included in Pillar 1, and the impact of stress and scenario tests under Pillar 2 (applied via an ICG set by the PRA).

At 31 December 2016 the Group's Pillar 2A ICG equates to 5.7% of risk weighted assets of which 3.2% has to be covered by CET 1 capital. This reflects a point-in-time (PIT) estimate by the PRA, which may change over time, of the total amount of capital that is needed by the bank. The Group is not permitted by the PRA to provide any further details regarding the individual components.

The Group manages its capital above the minimum ICG threshold, including a capital buffer (further detail in Section 5.3), at all times. Capital levels for the Group are reported to, and monitored by, the Board on a monthly basis.

Regulatory environment

The Group remains confident in its ability to address the requirements associated with the implementation of emerging regulation over the planning horizon.

In particular, the implementation of IFRS9 and potential changes to the IRB framework has been considered and continues to be monitored and assessed for impacts. The Group is satisfied that current forecast levels of capital are sufficient to meet associated requirements.

Capital Requirement

The Group's total capital requirement under Pillar 1 is calculated by applying appropriate risk weightings to each class of exposure, then applying a fixed 8% multiplier.

	Dec-2016 Average Risk Weights %	Dec-2016 £m	Dec-2015 £m
Retail financial services	12%	60.1	62.0
Secured personal lending	40%	12.3	16.1
Retail financial services-Past due items	199%	4.1	4.1
Secured personal lending-Past due items	106%	1.7	2.4
Retail exposures classes		**78.2**	**84.6**
Commercial lending - Non housing association	92%	49.1	49.7
Commercial lending - Housing association	35%	4.3	4.3
Commercial lending - Past due items*	0%	-	-
Commercial exposure classes		**53.4**	**54.0**
Financial institutions	4%	2.8	3.4
Other exposure classes		**2.8**	**3.4**
Fixed and other assets	98%	7.8	6.1
Other		**7.8**	**6.1**
Credit risk minimum capital requirement		**142.2**	**148.1**
Operational risk		17.4	17.6
CVA		0.2	0.4
Total minimum capital required		**159.8**	**166.1**
Total own funds		528.7	504.7
Excess of own funds over minimum capital requirement under Pillar 1		**368.9**	**338.6**

*Past due items for commercial specialised lending are risk weighted at 0% as prescribed by CRD IV, these loans also attract an expected loss of 50% of the balance.

4.2 Movements in RWA

During the year, the Risk Weighted Asset (RWA) impact of balance sheet growth has been more than offset by the reduction in the average risk weight of the portfolios of the Group's assets leading to an overall reduction in RWA's.

	£m
Position as at 31 December 2015	**2,076.3**
Increase due to net mortgage book growth	63.7
Increase due to net treasury book growth	14.0
Movement in risk profile	(170.7)
Change due to Other Assets	21.2
Change in impact of netting	(1.0)
Increase in Operational Risk	(2.2)
Increase of CVA	(3.7)
Position as at 31 December 2016	**1,997.6**

5. Continued Impact of Basel III

The new regulatory rules, referred to as Capital Requirement Regulation (CRD IV) took effect across Europe on 1 January 2014. The key impacts to the Group are outlined below.

5.1 Quality of Capital

The objectives of the rules are to increase the ability of financial institutions to deal with shocks and stresses related to financial and economic factors. To achieve the objectives the definition of capital has been restated and in particular includes specific requirements relating to the ability of firms to absorb losses. CET 1 is regarded as the highest quality of capital and Basel III rules state that a greater proportion of the Pillar I capital requirement must be met from CET 1 (as of 1 January 2015 4.5% of the total 8.0%).

As a result of the more stringent rules on loss absorbency, the Group's PIBS no longer qualify as Tier 1 capital. The rules allow for instruments that are no longer eligible for inclusion in Tier 1 to be grandfathered (phased) out of eligibility over the 8 years between 1 January 2014 and 1 January 2022. The Group can recognise a maximum of 60% of the carrying value of the PIBS at December 2016 and this percentage will continue to reduce by 10% per annum.

The grandfathering rules allow any Tier 1 capital that exceeds the Tier 1 capital grandfathering limit to be included as Tier 2 capital provided the maximum Tier 2 capital grandfathering limit is not exceeded. As the grandfathering limit is based on the amount of subordinated debt eligible as capital at December 2012 the Group will be able to include a portion of its PIBS as Tier 2 capital during the grandfathering period as shown in the table in **Appendix A**.

5.2 Impact

The continued impact of Basel III has been fully assessed to demonstrate that the Group will remain well capitalised. The pro-forma below shows the Group's capital position prepared in accordance with the Basel III rules to date, transitional rules for the coming year and the final position.

Common Equity Tier 1 (CET1) capital: instruments and reserves	Notes	Basel III 31.12.16 £m	Adjustments £m	Transitional Basel III Rules 01.01.17 £m	Final Basel III Rules £m
General and Other Reserves		478.4	-	478.4	478.4
Common Equity Tier 1 (CET1) capital before regulatory adjustments		**478.4**	**-**	**478.4**	**478.4**
Common Equity Tier 1 (CET1) capital: regulatory adjustments					
Additional value adjustments		(0.4)	-	(0.4)	(0.4)
Intangible assets		(1.3)	-	(1.3)	(1.3)
Negative amounts resulting from the calculation of expected loss amounts		(7.7)	-	(7.7)	(7.7)
Exposure amount of the following items which qualify for a RW of 1250%, where the institution opts for the deduction alternative		(0.3)	-	(0.3)	(0.3)
Total regulatory adjustments to Common Equity Tier 1 (CET1)		**(9.7)**	**-**	**(9.7)**	**(9.7)**
Common Equity Tier 1 (CET1) capital		**468.7**	**-**	**468.7**	**468.7**
Amount of qualifying items referred to in Article 484 (4) phased out from AT1	1	36.0	(6.0)	30.0	-
Additional Tier 1 (AT1) capital before regulatory adjustments		**36.0**	**(6.0)**	**30.0**	**-**
Additional Tier 1 (AT1) capital		**36.0**	**(6.0)**	**30.0**	**-**
Tier 1 capital (T1 = CET1 + AT1)		**504.7**	**(6.0)**	**498.7**	**468.7**
Amount of qualifying items referred to in Article 484 (5) phased out from T2		-	-	-	-
Tier 2 allowance of Grandfathered AT1	2	24.0	6.0	30.0	-
Tier 2 (T2) capital before regulatory adjustments		**24.0**	**6.0**	**30.0**	**-**
Tier 2 (T2) capital (T2 less regulatory adjustments)		**24.0**	**6.0**	**30.0**	**-**
Total capital (TC = T1 + T2)		**528.7**	**-**	**528.7**	**468.7**
Total risk weighted assets		**1,997.6**	**-**	**1,997.6**	**1,997.6**

Capital ratios and buffers	Basel III 31.12.16	Adjustments	Transitional Basel III Rules 01.01.17	Final Basel III Rules
Common Equity Tier 1 (as a percentage of total risk exposure amount)	23.5%	0.0%	23.5%	23.5%
Tier 1 (as a percentage of total risk exposure amount)	25.3%	(0.3%)	25.0%	23.5%
Total capital (as a percentage of total risk exposure amount)	26.5%	0.0%	26.5%	23.5%
Institution specific buffer requirement				
Common Equity Tier 1 available to meet buffers (as % of risk exposure amount)			12.8%	9.8%
Amounts below the thresholds for deduction (before risk weighting)				
Deferred tax assets arising from temporary differences	1.3	-	1.3	1.3
Applicable caps on the inclusion of provisions in Tier 2				
Cap on inclusion of credit risk adjustments in T2 under standardised approach	7.3	-	7.3	7.3
Cap for inclusion of credit risk adjustments in T2 under IRB approach	8.5	-	8.5	8.5
Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2014 and 1 Jan 2022)				
Current cap on AT1 instruments subject to phase out arrangements	36.0	(6.0)	30.0	-
Amount excluded from AT1 due to cap	24.0	6.0	30.0	60.0
Current cap on T2 instruments subject to phase out arrangements	38.8	(6.5)	32.3	-
Amount excluded from T2 due to cap	-	-	-	-

Notes and General Information on Basel III Impacts

1. As per the PRA's transitional provisions the Group's PIBS will grandfather out of eligibility of Tier 1 and therefore only 60% of the value at 31 December 2012 can be recognised during 2016 and 50% during 2017. See **Appendix A.**

2. Under Basel III, as per Article 487, the Group can recognise any Tier 1 capital that exceeds the Tier 1 capital grandfathering limit as Tier 2 capital, provided the maximum Tier 2 capital grandfathering limit is not exceeded. See **Appendix A.**

Given the phasing of both capital requirements and target levels, in advance of needing to comply with the fully loaded end state requirements, the Group will have the opportunity to continue to generate additional capital from earnings and take management actions to mitigate the impact of Basel III. Ineligible Additional Tier 1 and Tier 2 capital, which qualifies for grandfathering under the transitional relief, will be replaced through annual profits.

5.3 Capital Buffers

To encourage adequate build-up of loss absorbing capital that can be used in times of stress, Basel III requires the use of common equity capital buffers, expressed as a percentage of total RWA's. A Capital Conservation Buffer (CCB) of 2.5% and a Counter-Cyclical Capital Buffer (CCyB) of up to 2.5% can be applied by regulators when macroeconomic conditions dictate.

The PRA undertake SREP's to review the adequacy of the Group's capital availability and requirements for all relevant risks. The outcome of the process is reflected in the calculation of ICG and, where deemed appropriate, a PRA buffer.

The PRA buffer defines the minimum level of capital buffer over and above the minimum regulatory requirement that should be maintained in non-stressed conditions. This is designed to be mitigation against possible stress periods in the future. The PRA requires that the level of this buffer is not publically disclosed.

The amount of capital required for the CCyB was set at 0% in June 2016. This was a pre-emptive response by the Financial Policy Committee (FPC) to greater uncertainty around the UK economic outlook following the EU Referendum, providing banks with the clarity necessary to facilitate their capital planning. Further, on 30 November 2016 the FPC reaffirmed that it expects to maintain a UK CCyB rate at 0% until at least June 2017, in the absence of any material change in the outlook. All of the Group's exposures are within the UK meaning the Group is not required to hold any capital for the CCyB in relation to foreign exposures.

The CCB is transitioning into effect in yearly increments of 0.625% starting on 1 January 2016, with the entirety of the 2.5% requirement being applicable on 1 January 2019. This means that the CCB for the coming year is 1.25% as of 1st January 2017. This transition only has an impact on an institutions' overall buffer if the transitional increment (0.625%) exceeds the difference between the PRA buffer and the combined regulatory buffer.

In addition, globally systemically important banks and other systemically important banks and institutions are expected to hold a buffer of up to 2.5%. This is not currently applicable to the Group.

The available CET 1 capital as a percentage of risk weighted assets to meet these buffers when they are implemented is shown in Section 5.2.

5.4 Leverage

Basel III introduced a non-risk based leverage ratio to supplement the risk based capital requirements. The ratio shows Tier 1 capital as a proportion of on and off balance sheet assets. The ratio does not distinguish between the credit quality of loans and acts as a primary constraint to excessive lending in proportion to the capital base.

The UK leverage ratio framework requires a minimum ratio of 3%. This means that for every £1m of eligible capital the Group can hold up to £30m of assets. A Counter-Cyclical Leverage Ratio Buffer (CCLB) will be phased in under these regulations; institutions will be required to hold 35% of their firm CCyB as a CCLB, resulting in a potential minimum leverage requirement of 3.875% if the CCyB is at its maximum of 2.5%. Currently the Group is not within scope of the UK leverage framework as retail deposits do not exceed £50bn; however the Group's ratio is well above the minimum required as disclosed below.

	Notes	Dec-2016 £m	Dec-2015 £m
Total Balance Sheet as per Statutory Accounts		**8,281.2**	**7,584.4**
Adjusted for:			
Potential future credit exposure for swaps		10.2	10.4
Off balance sheet exposures with a 50% CCF-Commercial lending commitments		30.3	33.1
Off balance sheet exposures with a 100% CCF-Retail commitments		253.6	352.7
Regulatory adjustment for Goodwill and Intangibles		(1.3)	(1.4)
Regulatory adjustments for AVA		(0.4)	(0.5)
Regulatory adjustments for Deferred Income		(0.3)	(0.6)
Provision Deductions		(7.7)	(11.0)
Leverage Exposure		**8,565.6**	**7,967.1**
Tier 1 capital (end state position)		468.7	435.5
Tier 1 capital (transitional position)	1	504.7	477.5
Leverage ratio using end state Tier 1 Capital		5.47%	5.47%
Leverage ratio using transitional Tier 1 Capital	1	5.89%	5.99%

Notes and General Information on Leverage

1. The transitional position represents the Tier 1 capital and Leverage ratio at 31 December 2016 following Basel III transitional provisions.

The Group's leverage ratio has reduced slightly year on year as the growth of the Group's Tier 1 capital under the transitional position has not been proportional to the year on year balance sheet growth. The end state definition has remained flat year on year showing that the Group's CET1 capital has grown in the same proportion as the balance sheet and the reduction in year on year leverage ratio under the transitional position is due to grandfathering of the Groups PIBS.

5.5 Capital Adequacy through Transition

	Basel III 31.12.16	Transitional Basel III Rules 01.01.17	Final Basel III Rules 01.01.22
Total minimum capital required	159.8	159.8	159.8
Total own funds	528.7	528.7	468.7
Excess of own funds over minimum capital requirement under Pillar 1	**368.9**	**368.9**	**308.9**

During the year, the Bank of England provided clarity on its approach to Minimum Required Eligible Liabilities (MREL). The purpose of MREL is to ensure firms have sufficient loss absorbency, over and above capital outlined above, to ensure orderly failure, and potentially recapitalisation, of a company in the event of insolvency.

The final transition date for MREL is 1 January 2022 and the Group expects, at all times, to meet MREL requirements.

6. Risk Management Objectives and Policies

6.1 Overview

The Group is primarily a provider of financial products, mainly in the form of mortgages, secured loans and savings. These products give rise to a financial asset or liability and are termed financial instruments. As well as mortgages, secured loans and savings, the Group also uses wholesale financial instruments to invest liquid asset balances, raise wholesale funding and to manage interest rate risk arising from its operations.

The Group's principal business objective is to provide Members with the benefits of a mutual organisation through the design, manufacture and delivery of attractive savings and mortgage products. The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, conduct risk, operational risk and pension obligation risk.

Further detail on these risks can be found in Section 7 and in the Risk Management Report on pages 33-46 of the 2016 Annual Report and Accounts.

The ways in which the Group manages these risks include:

- Setting and maintaining a GRC approved Statement of Risk Appetite;
- Producing key risk information and indicators to measure and monitor risk performance;
- Using models and output from those models to help guide business strategies;
- Using Management and Board Committees to monitor and control specific risks; and
- Using limits and triggers to control portfolio composition.

6.2 Risk Appetite

The Group is a mutual organisation with no shareholders. Members are entitled to take for granted that their money is safe. The Group's GRC adopts a prudent attitude to risk when setting the risk appetite.

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

- Identify and define the types and levels of risks it is willing to accept both qualitatively and quantitatively in pursuit of strategic goals;
- Establish a framework for business decision making.

The Group's risk appetite statements are linked to the Group's strategy and are supported by a broad suite of Board risk metrics, limits and triggers, designed to cover the Group's exposure to key prudential and conduct related risks.

Reporting, limits and controls are set in a hierarchy that links the appetite for risk to strategic goals, medium-term plans and 'business as usual' activities.

The Group has decided to omit disclosing key ratios and figures relating to its risk appetite, as they are considered to be proprietary information as per CRR article 432.

6.3 Risk Management Structure

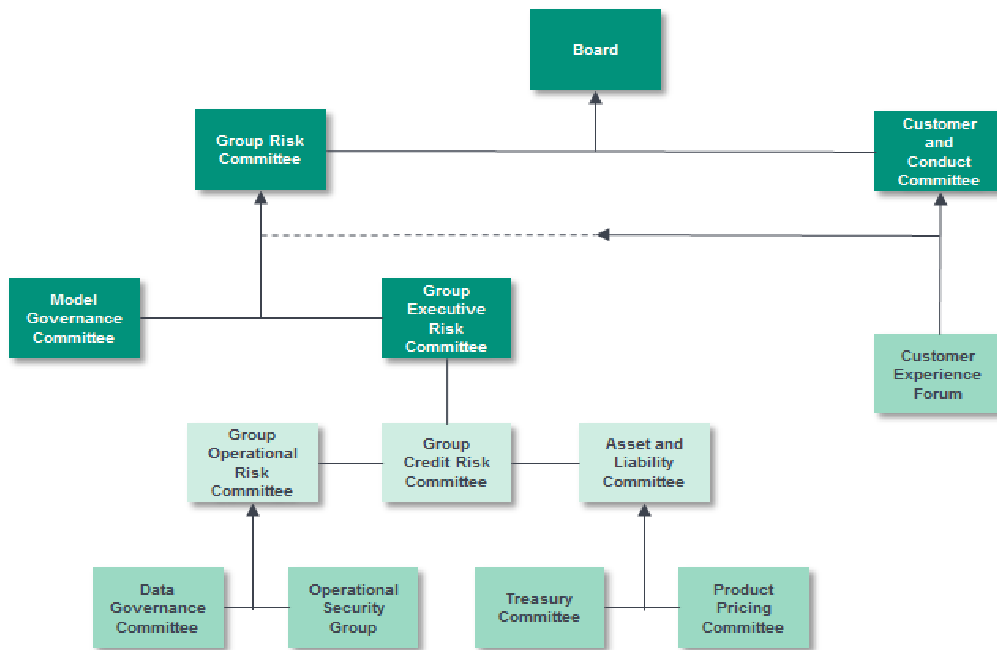
The Group adopts a 'three lines of defence' model as the risk management structure.

- **First line of defence –** primary responsibility for the identification, control, monitoring and mitigation of risk in their day-to-day activities lies with each individual across the business. These key risks are overseen by appropriate controls within an overall control environment.
- **Second line of defence –** oversight and governance will be provided by the second line of defence through independent functions within Group Risk and Compliance. The role of these functional specialists is to provide independent oversight and challenge the activities conducted in the first line.
- **Third line of defence –** the Group's Internal Audit function is responsible for providing independent assurance of the effectiveness of the risk management structure and adherence to processes in the first and second lines.

6.4 Risk Governance

The Board of Directors is responsible for the overall framework of risk governance and management for the Group. The Board is responsible for determining risk strategy and ensuring that risk is monitored and controlled effectively. It also has responsibility for establishing a clearly defined risk management structure with distinct roles and duties.

Within the risk structure set by the Board line managers are accountable for the identification, measurement and management of the risks within their areas of responsibility. Further details on risk governance are included in the Risk Management Report on pages 33-46 of the 2016 Annual Report and Accounts.



6.4.1 Board Committees

The Board focuses on strategic issues, control of the business, review of operational and management performance, oversight of subsidiary companies and maintaining a system of effective corporate governance. The Board operates through its regular meetings and five committees – Remuneration, Nomination, Audit, Customer and Conduct and Group Risk Committees.

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

Further information on Board committee Terms of Reference can be found on the website www.principality.co.uk. This includes frequency of meetings, Committee functions and reporting to/from the committee. Terms of Reference are also held internally for all committees within the Group.

6.4.2 Group Risk Committee

Chaired by a non-executive director the Group Risk Committee (GRC), has responsibility for ensuring a Group-wide co-ordinated approach towards the oversight and management of key strategic and corporate risks. It will consider and recommend to the Board matters involving the Group's risk appetite, capital and liquidity adequacy and is also responsible for maintaining an appropriate governance structure to ensure that risks across the Group are identified and managed effectively.

Group Executive Risk Committee

The Group Executive Risk Committee (GERC) was established in 2015 and is chaired by the Group Chief Executive. Its primary responsibility is for the identification, control and mitigation of risks and the oversight of all prudential and conduct risks across the Group.

Group Credit Risk Committee

The Group Credit Risk Committee (GCRC), chaired by the Group Risk Director, is responsible for monitoring and reviewing exposure to credit risks in the Group's retail and commercial loan portfolios in line with the Board approved Group Risk Appetite statement. The Chairman of the Committee reports to the Group Executive Risk Committee.

Group Operational Risk Committee

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

Model Governance Committee

The Model Governance Committee (MGC), chaired by the Group Finance Director, is responsible for oversight of models used by the Group to assess and quantify exposure to credit risk. The Chairman of the Committee reports to the Group Risk Committee.

The MGC is the designated committee for the approval and maintenance of the IRB rating system.

6.4.3 Group Management Committee

The Group Management Committee (GMC) is the principal management committee of the Group. It is chaired by the Group Chief Executive and membership includes all the Executive Directors. The functions of GMC are to agree strategy and policies for recommendation to the Board and agree new business initiatives and associated investment appraisal for submission to the Board for approval. The Committee is also responsible for overseeing strategy implementation, monitoring performance of the Society and its subsidiaries, and approving changes to administered interest rates for mortgage accounts.

Asset and Liability Committee

The Asset and Liability Committee (ALCo), chaired by the Group Finance Director, is responsible for the assessment of exposure to Treasury Counterparty credit, liquidity and market risk. Weekly monitoring is conducted by the Society's Treasury Committee, which is a subsidiary of ALCo. The minutes and actions are reviewed by the Group Executive Risk Committee. The Chairman of the Committee reports to the Group Executive Risk Committee.

Treasury Committee

The Treasury Committee is chaired by the Deputy Group Finance Director and has a delegated responsibility for monitoring the Group's Treasury Counterparty Credit Risk, Liquidity Risk and Interest Rate Risk in line with the Risk Appetite as set by the ALCo, Group Risk Committee and Board. The minutes and actions are also reviewed by ALCo.

Product Pricing Committee

The Product Pricing Committee is chaired by the Customer Director. The main function of the committee is to approve retail mortgage and savings product pricing, giving appropriate consideration to current market conditions, net interest margin and volume targets contained in the Group's business plans by reference to Board approved risk limits, and within the context of achieving fair outcomes for customers. This committee reports to ALCo and the Customer and Conduct Committee.

6.5 Stress Testing

Group-wide stress tests are an integral part of the annual business planning process and annual review of risk appetite. Tests are designed to ensure that the Group's financial position and risk profile provide sufficient resilience to withstand the impact of severe economic stress on the market (systemic stress) or firm specific stress events. Stress testing also informs the identification and calibration of early-warning triggers, management actions and contingency and recovery plans to mitigate or avoid potential stresses and vulnerabilities and as such is integral to the Group's risk management framework.

The stress testing framework also includes reverse stress testing techniques which aim to identify circumstances under which the Group's business model could be rendered unviable, leading to a significant change in business strategy. Examples include extreme macroeconomic downturn scenarios and targeted attacks on the Group (e.g. cyber threats) and these consequent impacts.

Stress testing is used to identify, assess and quantify the potential effectiveness of management actions that could be taken to mitigate the impact of a stress.

7. Principal Risk Measurement, Mitigation and Reporting

7.1 Credit Risk Overview

Credit risk is the risk that a customer or counterparty will fail to meet their financial obligations to the Group as they become due. The Group faces this risk primarily from loans to residential customers, loans to commercial customers and from the assets held by Group Treasury in order to meet liquidity requirements and for general business purposes.

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

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

Further details of credit risk governance are included in the Risk Management Report on pages 33-46 of the 2016 Annual Report and Accounts.

7.1.1 Exposures

Exposure at Default (EAD) as shown in these credit risk disclosures is defined as the exposure value under regulatory definitions for capital purposes. EAD is an estimate of the expected utilisation of a credit facility and will be equal to or greater than the currently drawn exposure excluding any Basel III defined credit risk mitigation (CRM).

	EAD Pre-CRM* As at Dec-2016	EAD Post-CRM* As at Dec-2016	RWAs As at Dec-2016	Capital Required As at Dec-2016
Retail financial services	6,299.6	6,299.6	802.2	64.2
Secured personal lending	415.9	415.9	175.7	14.0
Commercial lending	826.8	826.8	667.2	53.4
	7,542.3	**7,542.3**	**1,645.1**	**131.6**
Treasury				
Central governments or central banks	922.1	922.1	-	-
Multilateral development banks	10.1	10.1	-	-
Financial institutions	240.6	200.8	35.0	2.8
	1,172.8	**1,133.0**	**35.0**	**2.8**
Other assets	95.9	95.9	97.8	7.8
Total	**8,811.0**	**8,771.2**	**1,777.9**	**142.2**

*CRM is relevant to the Group's Financial Institutions exposure, and includes netting and collateral agreements.

The geographical distribution of these exposures at 31 December 2016 is as follows:

EAD Pre-CRM	UK £m	Other European Countries £m	Total £m
Retail financial services	6,299.6	-	6,299.6
Secured personal lending	415.9	-	415.9
Commercial lending	826.8	-	826.8
	7,542.3	**-**	**7,542.3**
Treasury			
Central governments or central banks	922.1	-	922.1
Multilateral development banks	-	10.1	10.1
Financial institutions	240.6	-	240.6
	1,162.7	**10.1**	**1,172.8**
Other Assets	95.9	-	95.9
Total	**8,800.9**	**10.1**	**8,811.0**

The following table shows the residual maturity of the exposures at 31 December 2016. The maturity of exposures is shown on a contractual basis. This does not take into account any monthly capital repayments receivable over the life of the exposure.

EAD Pre-CRM	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail financial services	31.0	243.6	6,025.0	6,299.6
Secured personal lending	44.0	370.4	1.5	415.9
Commercial lending	185.7	354.3	286.8	826.8
	260.7	**968.3**	**6,313.3**	**7,542.3**
Treasury				
Central governments or central banks	835.0	87.1	-	922.1
Multilateral development banks	10.1	-	-	10.1
Financial institutions	155.2	82.8	2.6	240.6
	1,000.3	**169.9**	**2.6**	**1,172.8**
Other assets	-	-	95.9	95.9
Total	**1,261.0**	**1,138.2**	**6,411.8**	**8,811.0**

7.1.2 Retail Financial Services Credit Risk

Credit risk is inherent in the Group's retail mortgage book. Credit risk is assessed both for the Group's existing mortgage assets and also for mortgage lending to which the Group is committed, for example through a firm commitment to lend against a mortgage offer or through a facility to increase the amount of lending on an existing mortgage.

The Group's residential mortgage portfolio is managed using a rating system which has been developed in line with the IRB approach to credit risk as described below.

The following table shows the Group's exposure to first charge retail mortgages under IRB at 31 December 2016:

PD Bands	Exposure at Default Estimate Dec-2016 £m	Exposure Weighted Average Loss Given Default Dec-2016	Average Risk Weight Dec-2016	Average Expected Loss Dec-2016
0%<=PD<0.2%	4,930.4	22.2%	6.2%	0.0%
0.2%<=PD<1%	1,166.8	29.5%	23.4%	0.1%
1%<=PD<9.3%	93.5	29.4%	72.7%	0.9%
9.3%<=PD<26.47%	43.5	25.3%	145.3%	4.3%
26.47%<=PD<44.36%	19.2	22.1%	128.0%	9.4%
44.36%<=PD<100%	20.7	24.8%	76.7%	18.2%
In default book	25.5	23.9%	199.3%	8.0%
Total	**6,299.6**	**23.7%**	**12.7%**	**0.2%**

IRB Approach Overview

The Retail IRB ratings system is used to assess the credit risk exposure of the Group and the level of regulatory capital to be held. The models are built using:

- Probability of Default (PD) – the probability of an obligor defaulting in the next 12 months;
- Exposure At Default (EAD) – an estimate of the outstanding balance if the customer does default;
- Loss Given Default (LGD) – an estimate of the outstanding balance not recovered and the costs associated with that recovery process.

Expected loss for the next 12 months is a calculated using the models listed above.

The PD model predicts the likelihood of a mortgage defaulting within the next 12 months. Default is defined as being six or more months in arrears, or earlier if the borrower displays one or more indicators that they are unlikely to make repayments. The probability of default is calculated using a combination of the credit score obtained at the point of application, the behavioural score and the arrears status of the mortgage. This approach allows for grade migration to occur as account performance is influenced by the economic cycle. The PD for retail mortgages uses a hybrid rating system that combines Point in Time (PiT) grade distributions with conservatively assessed long run default probabilities that are mapped for each grade.

The LGD and EAD models calculate 'best estimate' and 'downturn' values. The downturn values are used when calculating the Pillar 1 capital requirement.

The LGD model uses estimates of the ratio of the outstanding balance to estimated property value, the current point in the house price cycle relative to the trough of the cycle, arrears management and recovery costs and the time that would be taken to obtain possession and realise the value of the property through sale to predict the loss on sale.

The EAD value conservatively adjusts the current balance to allow for additional interest and fees that would be added to the balance prior to default. Where applicable it also includes any committed exposures, such as undrawn mortgage approvals.

The PD and LGD models were built using both internal data relating to the borrower and property, and external data obtained from credit reference agencies. Data from the 1990s was used to ensure that an appropriate long run average PD could be calculated, and that LGDs were adjusted for downturn conditions, such as those seen in the recession of the early 1990s.

Our monitoring of the IRB framework and its component models continues to show it to be powerful and appropriately conservative. The performance of the PD model is assessed by measuring the power of the model (using the GINI coefficient) and comparing the number of predicted defaults with the number of actual defaults over a 12 month period. The PD model continues to have a GINI value that meets our internal monitoring standards and conservatively over-predicts the volume of defaults.

In 2016, 28 repossessed properties were sold (2015: 49). With such a low volume of sales, an assessment of the performance of the LGD model is made acknowledging that there may be individual exceptional cases where the level of loss could not be reasonably predicted using a statistical modelling approach. With this in mind, actual loss experience has been favourable compared with the predictions of the LGD model.

The models are also used within the Society for the following purposes:

- Pricing of credit risk into mortgage products;
- Providing a risk assessment, or credit score, of the mortgage applicants which is used in the decision-making process;
- Eligibility for additional borrowing for existing customers;
- Capital planning;
- Development of IFRS9 provisions.

IRB model governance

The MGC is the designated committee through which authority to change the IRB system is obtained. The Committee receives regular management information on the performance of the individual components of the rating system and receives formal annual reviews of the accuracy, adequacy and use of the ratings system. Performance measures with trigger levels are set to ensure that any amendments or updates are made when necessary.

Independent validation of the rating models is undertaken using a combination of MGC and external resource. All model developments and material adjustments are subject to assessment against a comprehensive validation framework, which incorporates all relevant requirements from CRD IV. For each rating system, the outcome of the validation process is fully documented, and then challenged by the MGC.

The IRB models are operated by the Group Risk and Group Finance functions through an integrated capital calculation system. The system is regularly backed-up, and can be operated in an event that would require the full or partial operation of the Society's business continuity plans. The Group has a Change Control Policy which specifies how model changes are approved, type of approval required, and procedures describing how system changes are made.

Retail Credit Risk Management

A series of specific limits and thresholds have been established and reflect the Group's view of and appetite for risk in relation to the retail mortgage portfolio. These limits are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Group's retail lending risk appetite.

The Group Credit Risk Committee reviews comprehensive risk based information on a quarterly basis and has appropriate controls in place to ensure that new lending complies with the Group's stated risk appetite. Limits and triggers are reviewed regularly by GERC and GRC and annually by the Board, and adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses.

Mortgage intake is monitored daily by reference to product type, Loan to Value (LTV) and channel. Criteria are adjusted, or products withdrawn, if trends are inconsistent with risk appetite.

7.1.3 Secured Personal Lending Credit risk

The Group's subsidiary, Nemo Personal Finance Limited (Nemo), manages loans to individuals secured by way of a second charge over residential property. All customers therefore have an existing first mortgage, and a typical borrower requested finance to fund home improvements or to consolidate their debts. Depending on the borrower's status, loans were made available from £7,500 to £500,000 and were typically repayable over terms between three and twenty-five years.

During 2015 the Group undertook a comprehensive review of its strategic options which resulted in the decision to cease new lending in Nemo and focus the Group's resources on the core Retail and Commercial businesses from February 2016. The Group continues to maintain and service its existing secured lending customers through a reshaped Nemo business.

Nemo Credit Risk Management

The strategy for secured personal lending is to continue to manage the business prudently, but not take any new business onto the loan book. Management information is presented regularly to Nemo Board, Group Risk Committee and the Group Board. This ensures that the exposure and portfolio limits and arrears management performance can be reviewed in the light of emerging trends.

Credit risk under Pillar 1 is calculated using the Standardised methodology for this portfolio, and risk weightings of 35% and 75% are applied to non-defaulted exposures, depending on the LTV. At the point of application no LTV was greater than 100% although historically it has been possible for capitalised Payment Protection Insurance (PPI) premiums to raise the LTV above 100%. Defaulted exposures attract a risk weighting of between 100% and 150% depending on the LTV and the level of provisions held. Adjustments to the exposure calculated under the Effective Interest Rate methodology of IAS 39 are treated as unsecured.

7.1.4 Commercial Lending Credit Risk

Commercial lending activity is split between lending to private sector landlords and property investors, registered social landlords, and funding for commercial projects.

The Group's commercial loan portfolio comprises the following:

	Drawn commitments £m	Un-drawn commitments* £m	Total £m
Loans to Registered Social Landlords secured on residential property	150.3	4.1	154.4
Other loans secured on residential property	331.2	21.7	352.9
Loans secured on commercial property	317.6	4.5	322.1
Effective Interest Rate adjustment	(2.6)	-	(2.6)
	796.5	**30.3**	**826.8**

*after the application of the appropriate credit conversion factors

Commercial Credit Risk Management

Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Group's commercial lending risk appetite. These are subject to monthly review by GCRC and quarterly review by GRC. They are adjusted in the light of prevailing external conditions and internal experience, which reflects the profile of new business written, portfolio performance, and trends in arrears and crystallised losses. The Group remains cautious with regard to commercial lending which is undertaken on a prudent basis.

The Commercial Lending Division operates a relationship management approach. Each customer has a specific lending manager who is responsible for submitting credit applications for that customer (whether existing or new customer) and for managing the customer/lender relationship. Each lending manager is a highly experienced property lender with a strong track record gained in a traditional banking environment and/or within the division itself. Relationship managers are assigned based on experiences/seniority and on size/complexity. Exceptions to this are connections in weak or defaulted

slots where exposures are managed by an Asset Management Group given the differing challenges they might pose including levels of capital intensity.

Commercial lending exposures are underwritten against comprehensive and well established criteria which are articulated in the Division's Credit Risk Policy Statement. A risk grading framework has been developed, and the entire portfolio is risk graded. Additionally with the exception of loans to Registered Social Housing Landlords each exposure is assigned a Slot which will determine its risk weighting and in turn support underwriting decisions / sanctioning authorities alongside pricing requirements and wider portfolio management design principles.

Credit risk capital requirement for the Society's commercial lending under Pillar 1 is determined by reference to the IRB methodology and uses a Specialised Lending Exposures approach. Loans are graded and slotted according to risk and assigned a prescribed risk weight and expected loss based on the regulatory slot as illustrated in the table below.

	Remaining Maturity <2.5 years		Remaining Maturity >=2.5 years	
Slot	EAD £m	RWA %	EAD £m	RWA %
1-Strong	0.4	50.0%	15.2	70.0%
2-Good	156.9	70.0%	326.5	90.0%
3-Satisfactory	88.4	115.0%	32.1	115.0%
4-Weak	24.0	250.0%	1.5	250.0%
Non-Defaulted Total	**269.7**	**101%**	**375.3**	**92%**
5-Default	27.0	0%	0.9	0%
Totals	**296.7**	**91.6%**	**376.2**	**91.8%**

Exposures to registered social landlords and the associated effective interest rate adjustments are not included in the table above and remain on the standardised approach and are subject to a risk weighting of 35% due to historically low default nature of this sector on a UK wide basis[1].

Performance of the slotting process is monitored at the MGC.

7.1.5 Treasury Credit Risk

The Group has exposures to banks, building societies, sovereign and supra national bodies in its non-trading treasury portfolio. The Group does not operate a trading book. Exposures in the treasury portfolio are held for liquidity purposes or in the case of fair value exposures on derivatives, for hedging purposes. The Group's policy is to carry sufficient liquid assets to meet both PRA requirements in terms of liquidity buffer-eligibility, and internal requirements calculated using stress testing and having regard to seasonality within the risk exposure caused by savings maturities and other planned business events.

Treasury Credit Risk Management

The Board's policy on managing credit risk relating to treasury exposures is set out within the Group's Treasury Policy Statement (TPS). In particular, credit limits are set for individual counterparties based on external credit ratings (Moody's and/or Fitch). However other factors are taken into account such as credit default swap (CDS) levels, the current share price, the annual report and account statements, as well as associated macro-economic factors, for example sovereign CDS levels, Gross Domestic Product (GDP) and fiscal deficits. Institutions are individually assessed and approved using Board approved criteria. Limits are also in place for instrument type and country to mitigate against concentration risk arising in the treasury portfolio.

Limits and tolerance thresholds are calibrated to ensure that expected or potential losses are restricted to levels consistent with the Group's risk appetite. Treasury counterparty lines of credit are

[1] Note a ruling by the Office of National Statistics ["ONS"] has seen this sector designated as public sector which would entail a lower risk weighting but there are ongoing proposals being considered by Government / Regulators which would reverse this ruling. In light of this no change has been made to the 35% standardised risk weighting being the more conservative approach.

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

The standardised methodology is used to determine risk weights for treasury's exposures to institutions. The risk weights are based on the credit rating, obtained from Moody's and Fitch, of the counterparty to which the exposure is outstanding.

The Group's exposure to institutions includes an element attributable to derivatives. The Group uses derivatives to reduce its exposure to market risk, for example interest rate and foreign exchange risk. The Group has been transacting all new swaps via the London Clearing House (LCH) since 2014. A significant proportion of the Group's derivative book is with the LCH at December 2016 (79%). The Group currently have no plans to clear historical swaps as this is not considered to be cost effective at present.

Basel III requires the Group to calculate a Credit Valuation Adjustment (CVA) charge to capital for derivatives that have not been centrally cleared. The Group continues to use the standardised approach to CVA and the impact of this can be seen in Section 4.2. This charge to capital, albeit it small, is expected to decrease as the Group's new swaps are transacted via LCH and older swaps mature off the book.

The following tables show the exposure values of the Group's Treasury function calculated under the standardised approach broken down by credit quality step:

Central governments or central banks

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	EAD Pre-CRM £m	EAD Post-CRM £m
1	0%	Aaa to Aa3	AAA to AA-	922.1	922.1

Multilateral development banks

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	EAD Pre-CRM £m	EAD Post-CRM £m
1	0%	Aaa to Aa3	AAA to AA-	10.1	10.1

Financial Institutions

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	EAD Pre-CRM £m	EAD Post-CRM £m
1	20%	Aaa to Aa3	AAA to AA-	184.8	165.6
2	20%/50%	A1 to A3	A+ to A-	40.7	21.5
3	20%/50%	Baa1 to Baa3	BBB+ to BBB-	15.1	13.7
n/a	20%/50%	Unrated	Unrated	-	-
				240.6	**200.8**

Credit risk from derivatives and repurchase agreements are mitigated, where possible, through netting agreements whereby assets and liabilities with the same counterparty can be offset. All netting arrangements are legally documented through International Swaps and Derivatives Association (ISDA) and Global Master Repurchase Agreement (GMRA) with each counterparty. This provides the contractual framework within which dealing activities across a full range of 'Over The Counter' (OTC) products are conducted and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or other predetermined events occur.

Collateral is held or issued based on the net market valuation of the Group's derivatives with each counterparty. The collateral document is the ISDA or GMRA Credit Support Annex (CSA). The

collateral document gives the Group the power to use any collateral placed with it in the event of the failure of the counterparty. The collateral obtained for derivatives is cash denominated in Sterling.

In the event of the Group being downgraded 1 notch by the rating agencies this would result in a downgrade trigger of £3.5m of collateral becoming payable.

The exposure value of the derivatives is calculated using the standardised mark to market method and is reduced by netting benefits (offsetting amounts due to and from the same counterparty) and cash collateral obtained through the CSA. The Group has derivatives with a total nominal amount of £5,121m (2015: £4,547m) of which £5,121m (2015: £4,547m) was eligible for netting as part of the CSA.

The following table shows the total exposure and impact of netting specifically for derivatives:

	Dec-2016 £m	Dec-2015 £m
Interest rate contracts - Prior to netting	25.4	17.7
Other contracts - Prior to netting	5.0	3.6
Gross positive fair value of contracts	**30.4**	**21.3**
Netting benefits	(45.8)	(31.5)
Netted current credit exposure	**(15.4)**	**(10.2)**
Collateral used	14.7	8.7
Negative replacement costs due to netting	3.2	4.1
Potential future credit exposure	10.2	10.4
Net derivative credit exposure[†]	**12.7**	**13.0**

[†]Net derivative credit exposure is the credit exposure on derivative transactions after considering both the benefits from legally enforceable netting agreements and collateral arrangements

Below is a table which shows how the External Credit Assessment Institutions (ECAI's) ratings mapped to risk weights for the Group's exposures.

Moody's	Fitch	Credit Quality Step	Risk Weights		
			Central governments and central banks	Institutions < 3 months maturity	Institutions > 3 months maturity
Aaa to Aa3	AAA to AA-	1	0%	20%	20%
A1 to A3	A+ to A-	2	20%	20%	50%
Baa1 to Baa3	BBB+ to BBB-	3	50%	20%	50%
Ba1 to Ba3	BB+ to BB-	4	100%	50%	100%
B1 to B3	B+ to B-	5	100%	50%	100%
Caa1 and below	CCC+ and below	6	150%	150%	150%

7.1.6 Impaired Exposures, Past Due Exposures and Impairment Provisions

For accounting purposes, past due exposures, impaired exposures and impairment provisions are defined as follows:

- **Past due exposures -** An exposure is past due when a counterparty has failed to make a payment when contractually due.
- **Impaired exposures -** An exposure where the Group does not expect to collect all the contractual cash flows or to collect them when they are contractually due.
- **Impairment provisions -** Impairment provisions are a provision held on the balance sheet as a result of the raising of a charge against profit for an incurred loss. An impairment allowance may either be individual or collective.

Accounting Policy

Details of the Group's accounting policy in respect of impaired exposures and impairment provisions raised in respect of loans and receivables are provided in Note 1 of the 2016 Annual Report and Accounts on pages 91-92.

Analysis of Past Due Loans and Advances to Customers

The following table shows past due loan exposures and charges to the income and expenditure statement for the year to 31 December 2016.

	Retail financial services £m	Secured personal lending £m	Commercial lending £m	Total £m
Up to date	6,196.0	381.0	825.5	7,402.5
Past due:				
Up to 3 months	71.7	18.1	-	89.8
3 to 6 months	13.0	7.0	-	20.0
6 to 12 months	11.7	4.3	-	16.0
Over 12 months	6.1	5.1	-	11.2
Possessions	1.1	0.3	1.4	2.8
	103.6	**34.8**	**1.4**	**139.8**
Total exposures	**6,299.6**	**415.8**	**826.9**	**7,542.3**
Impairment Provisions	5.6	15.3	24.5	45.4
Charge/(Release) for the year	**0.2**	**(2.2)**	**(0.7)**	**(2.7)**

The amounts shown as past due represent the full amount of the loan outstanding, not just the amount that is past due. Past due loans, impaired loans and provisions are all UK based.

The following table summarises the movement in impairment provisions for the year ended 31 December 2016.

	Individual provision £m	Collective provision £m	Total £m
Balance at 1 January 2016	19.3	29.9	49.2
Charge for the year	(3.4)	0.7	(2.7)
Write-offs	(1.1)	-	(1.1)
Balance at 31 December 2016	**14.8**	**30.6**	**45.4**

Available for sale assets

As at 31 December 2016, none (2015: none) of the treasury portfolio exposures were either past due or impaired. There are no assets that would otherwise be past due or impaired whose terms have been renegotiated. In assessing impairment, the Group evaluates among other factors, the normal volatility in valuation, evidence of deterioration in the financial health of the investee, industry and sector performance and operational and financing cash flows.

Impairment Analysis by Geography

Other than £10.1m of AAA rated Supranational Bonds the Group does not hold any direct bank exposures outside the UK. The treasury risk function monitors exposure concentrations against a variety of criteria including counterparty and country limits and all exposures are well spread across this risk assessment framework. An assessment has been made of the Group's key counterparties regarding the potential levels of direct or indirect exposure to distressed Eurozone economies. This assessment concludes that no impairment provisions are required.

7.1.7 Credit Risk Concentrations

Policy limits have also been set to enable the management of treasury credit risk concentration. These limits are actively monitored and relate to aggregate counterparty, country and asset class exposures.

For residential mortgages, LTV concentration limits are set within policy. Geographic concentration of risk is also monitored. The Group operates across the majority of the UK, but with a moderate concentration in Wales. As at 31 December 2016, approximately 31.5% of retail and secured personal lending loan exposures by account and 28.8% by value were concentrated in Wales.

By their nature, residential mortgages comprise a large number of intrinsically highly diversified small loans and have a low volatility of credit risk outcomes.

For commercial lending, exposure to each of the principal lending categories is monitored and limits are set restricting the aggregate exposure to any single counterparty or group of closely connected counterparties. Concentration of risk within the portfolio is monitored using indicators such as maturity profile, industry sector and geography. In terms of counterparty concentration, the largest single exposure to a commercial counterparty is 3.7% of gross balances in the commercial book.

7.1.8 Credit Risk Mitigation

The Group uses a wide range of techniques to reduce credit risk associated with its lending. The most basic of these is performing an assessment of the ability of the borrower to service the proposed level of borrowing without distress. However the risk is further mitigated by obtaining security for the funds advanced.

Residential mortgages

Residential property is the Group’s main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolio. All mortgage lending activities are supported by an appropriate form of valuation using an independent firm of valuers.

Collateral values are updated at the date of each statement of financial position based on the best information publically available. Land Registry data is used in the Retail Financial Services sector with Hometrack and Nationwide data being used in the Secured Personal Lending sector. Both indices take account of the geographical location of the collateral. All residential property must be insured to cover property risks.

The value of residential property, conservatively adjusted for downturn economic conditions, is included within the calculation of LGD.

Commercial mortgages

Commercial property is the Group’s main source of collateral and means of mitigating credit risk inherent in its commercial mortgage portfolio. Collateral for the majority of commercial loans comprises first legal charges over freehold and long leasehold property but guarantees may also be taken as security. Guarantees and other off-balance sheet security are not used in the calculation of Pillar 1 capital requirements therefore the exposure values before and after credit risk mitigation are identical.

For property-based lending, supporting information such as professional valuations are an important tool to help determine the suitability of the property offered as security and, in the case of investment lending, generating the cash to cover interest and repay the advance. All valuations are undertaken by members of an approved panel of external independent valuers.

Hedging strategies are considered as part of the approval process and unless borrowers have chosen fixed rates, their exposure to interest rate movements must be deemed acceptable.
Insurance requirements are always fully considered as part of the application process and the Society ensures that appropriate insurance is taken out to protect the property.

Treasury

The credit limits for all counterparties are derived using a matrix based on external credit ratings. The limits are then calculated by reference to the general reserves of the Group, where the maximum

exposure for each institution will be determined by the external rating. Typically all banks will have a minimum rating of A-/A3 and all building societies will be assessed individually. Specific limits may not exceed 10% of the institution's equity without prior approval of the Board. Subsidiaries of any institution will be assessed as a separate entity according to its own ratings. However, in those circumstances the overall exposure cannot exceed the aggregate group limit.

7.2 Liquidity Risk

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

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

ALCo exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing. The Group conducts an Internal Liquidity Adequacy Assessment Process (ILAAP) at least annually. This is used to assess the Group's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Group.

The most recent liquidity assessment was approved by the Board in May 2016; the latest version is due for final approval by Board during June 2017. The Group's ILAAP includes stress tests that consider a range of severe scenarios and their impact on the Group, particularly with respect to retail saving outflows. The ILAAP concludes that the Group's liquidity reserves are adequate to sustain the Group over an extended severe stress during which contingent actions aimed at stabilising the situation would be deployed.

7.3 Market Risk

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

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

Interest Rate Risk

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

Another significant form of interest rate risk to which the Group is exposed is referred to as basis risk. Basis risk arises when assets linked to one interest basis are funded by liabilities linked to a different basis. For example, if a Bank of England Base Rate (BBR) tracker mortgage was funded by a LIBOR linked wholesale funding instrument then the Group would be exposed to margin compression if LIBOR increased and BBR stayed flat or even reduced.

Use of derivatives

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

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

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

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

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

Pension Obligation Risk

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

To mitigate these risks, management, together with the Trustees of the Fund, regularly review reports prepared by the Fund's independent actuaries and take appropriate actions which may, for example, include adjusting the investment strategy and/or contribution levels. In September 2012 the Society concluded a 'buy-in' arrangement in order to reduce future uncertainty regarding ongoing costs and liabilities associated with its closed defined benefit pension scheme.

Further information on the pension schemes can be found in note 11 to the 2016 Annual Report and Accounts.

Foreign Currency risk

Currency risk is the risk of a loss resulting from movements in foreign exchange rates or changes in foreign currency interest rates, particularly on the Group's non-sterling funding.

The Group has no substantial net exposure to foreign exchange rate fluctuations or changes in current interest rates and therefore currency risk is not considered to be material for the Group. When present the Group manages Currency risk through the use of derivatives, primarily in the form of cross currency swaps.

Further details of market risk governance are included in the Risk Management Report on pages 33-46 of the 2016 Annual Report and Accounts.

7.4 Conduct Risk

Conduct risk is the risk of treating customers unfairly resulting in the delivery of inappropriate outcomes. The Board has no appetite for unfair customer outcomes arising at any stage and focus efforts in those areas where conduct risk is most likely to occur, ensuring those risks are mitigated effectively.

The sustainability of the Group's business model and achievement of its longer-term strategy are dependent upon the consistent and fair treatment of customers. Furthermore, the current regulatory regime has resulted in increased scrutiny around the conduct of firms and their focus on delivering fair customer outcomes, with significant consequences for those firms that do not manage conduct risk effectively. Consequently, the Group has invested heavily in its framework and approach to managing conduct risks.

Further details of conduct risk governance are included in the Risk Management Report on pages 33-46 of the 2016 Annual Report and Accounts.

7.5 Operational Risk

The Group has adopted the standardised approach to operational risk management and applies the industry standard definition, namely: 'the risk of loss arising from inadequate or failed internal processes, people and systems or from external events'. This approach underpins the operational risks captured in the Group corporate risk registers and supports appropriate oversight of the key risk exposures facing the Group.

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

Risk appetite for all principal risk categories, including Operational Risk, is captured and for each secondary operational risk category. Each risk on the register is assessed using a 'Probability/Impact' matrix which is used to quantify, in financial terms, potential risk to the Group, before and after taking into account the effectiveness of management controls, and other forms of mitigation.

The risk registers are subject to regular review by each risk owner and Group Risk Department with the highest scoring risks for the Group as a whole reported to the Board quarterly. For individual risks which are deemed unacceptable, remedial action is taken, where such action falls within the Group's control and will include introducing or enhancing the operational controls and/or risk mitigants related to the individual risk, or taking appropriate action to eliminate the risk altogether.

The risk registers and risk assessment framework are subject to review by Group Internal Audit. The focus and prioritisation of the Internal Audit annual programme takes into account assessment of risks and controls captured in the risk registers.

The initial challenge to the risk owner's assessment and the effectiveness of management controls is provided by specialist teams forming part of the Group's 'Second Line of Defence', by reference to key risk indicators and operational loss reports. Additional oversight provided by the appropriate risk committee and GERC, particularly in relation to the Group key risk report which is submitted to the Board each quarter.

Operational losses are recorded as they arise, and reported to Group Risk Department each month. All operational losses and 'near misses' are reported to GORC on a quarterly basis. GRC will determine whether any review of internal procedures or controls is required in order to mitigate against any potential recurring operational losses.

Under the Basel Capital Accord, for the standardised approach to operational risk, gross income is regarded as a proxy for the operational risk exposure within each business line. The capital charge for operational risk is calculated separately, based upon gross income over the preceding three years.

Further details of operational risk governance are included in the Risk Management Report on pages 33–46 of the 2016 Annual Report and Accounts.

8. Securitisation

8.1 Retained Securitisation Positions

The Group currently has two Residential Mortgage Backed Security (RMBS) issuances in place as a means of raising wholesale funding. The RMBS issues involve the formation of special purpose entities (SPE's), currently Friary No.2 plc and Friary No.3 plc, which have purchased beneficial interests in separate portfolios of residential mortgages that are funded by the issue of floating rate mortgage backed securities (the Notes).

The Notes have been issued by Friary No. 2 plc and Friary No.3 plc to external counterparties and to the Group, either internally for the purposes of creating collateral to be used for funding, or externally and directly for cash via the sale of the Notes to investors outside the Group. Principality Building Society is both originator and servicer for each of the issues. Other roles fulfilled by the Group are fully described in the Friary No. 2 plc and Friary No.3 plc base prospectuses, copies of which can be found at www.euroabs.com.

The equity of Friary No.2 plc and Friary No.3 plc are not owned by the Group. However, to comply with the Building Societies Act 1986 (International Accounting Standard and Other Accounting Amendments) Order 2004 and Standing Interpretations Committee (SIC) 12, both companies are consolidated into the Group Financial Statements.

The Notes are serviceable firstly from cash flows generated by the mortgage assets and thereafter from the proceeds of the subordinated loans. The Group receives the excess spread on the transactions as deferred consideration, after Friary No.2 plc and Friary No.3 plc have met their liabilities.

As at 31 December 2016, £305.0m (2015: £386.5m) of mortgages issued by the Society had been transferred to Friary No.2 plc which remains on the statement of financial position of the Society as it retains the risks and rewards. These assets are treated as encumbered. The amortised value of the bond was £318.2m (2015: £410.6m), with £45.5m (2015: £45.5m) retained by the Group. None of the self-issued securities retained by the Group in relation to Friary No.2 plc are capable of repo financing. As at 31 December 2016, 0.67% (2015: 0.72%) of the mortgages transferred to Friary No. 2 plc were greater than 2 months in arrears.

Friary No. 3 plc was issued in February 2016. As at 31 December 2016, £410.2m of mortgages issued by the Society had been transferred to Friary No.3 plc which remains on the statement of financial position of the Society as it retains the risks and rewards. These assets are treated as encumbered. The amortised value of the bond at 31 December 2016 was £438.9m, with £54.2m A Notes, and £42.7m B Notes retained by the Group. The £54.2m A Notes of self-issued securities retained by the Group in relation to Friary No.3 plc are capable of repo financing. As at 31 December 2016, 0.23% of the mortgages transferred to Friary No. 3 plc were greater than 2 months in arrears.

As there is not considered to be a transfer of significant credit risk, the Society does not calculate risk weighted exposure amounts for any positions it holds in the securitisation which continues to be calculated in line with CRD IV requirements. Securitisation positions held by the Society are valued at Fair Value by note class. There have been no changes to the methods and key assumptions used to value the securitisation positions held.

The balances of assets subject to securitisation and notes in issue as at 31 December 2016 are as follows:

Securitisation Company	Type	Date of Securitisation	Dec-2016 Notes in Issue £m	Dec-2016 Balance £m	Dec-2015 Notes in Issue £m	Dec-2015 Balance £m
Friary No.1 plc	Residential mortgage	11 August 2011	-	-	345.4	325.9
Friary No.2 plc	Residential mortgage	9 June 2014	318.2	305.0	410.6	386.5
Friary No.3 plc	Residential mortgage	4 February 2016	438.9	410.2	-	-

Note Class	Dec-2016 Note Balance £'m	Dec-2015 Balance £'m
Friary No.1 plc		
A1	-	-
A2	-	217.4
B	-	128.0
Friary No.2 plc		
A	272.7	365.1
B	45.5	45.5
Friary No.3 plc		
A	396.2	-
B	42.7	-

The Class B Notes in respect of both issues were taken up by the Group at the time of the securitisation transaction and were effectively a credit enhancement.

Fitch and Moody's, both recognised ECAI's, rated the Notes under the securitisation. The credit risk of the underlying mortgage pool is monitored by the Credit Risk Department. The market risk associated with the Notes is monitored by the Treasury function. Interest rate swaps are in place to hedge the interest rate risk arising between the Notes and the underlying mortgage pool assets.

In October 2016, the Group became a member of the Term Funding Scheme (TFS). As at 31 December 2016 the Group had outstanding liabilities under the scheme of £250.0m (2015: £nil). The scheme allows the Group the ability to pledge mortgage assets with the Bank of England in return for cash.

In October 2012, the Group became a member of the Funding for Lending Scheme (FLS). As at 31 December 2016 the Group had outstanding liabilities under the scheme of £207.0m (2015: £207.0m). The scheme allows the Group the ability to pledge mortgage assets with the Bank of England in return for Treasury bills which are capable of repo financing either directly with the market or with the central bank.

Asset encumbrance is 19.3% (2015: 21.1%) of total assets, further details are provided in note 17 to the 2016 Annual Report and Accounts. Further information on accounting policies for securitisations are included in note 1 to the 2016 Annual Report and Accounts.

8.2 Purchased Securitisation Positions

Since May 2012 the Society has selectively purchased senior tranches of positions in RMBS. The Society's total exposure to purchased securitisation positions at 31 December 2016 was £40.9m (2015: £36.9m) based on market values, with the exposures consisting entirely of residential mortgage-backed securities. Such purchased securitisation positions provides the Society with a

diversified, capital-efficient source of investment income. Investments are undertaken within a clearly defined credit risk policy. The credit risk of the exposures underlying the purchased securitisation positions are monitored on a semi-annual basis for indications of impairment.

The aggregate fair values are calculated based on quoted market prices.

The purchased securitisation positions are all in the most senior tranches of the issued note classes of each securitisation and part of the Group's investment criteria is that that they must be Triple AAA rated at issue. The credit ratings of the purchased notes are monitored for deterioration on an ongoing basis with any Triple AAA notes being assigned a risk weighting of 20%. The following table shows the breakdown of the exposures by credit quality steps with indicative external credit assessment ratings:

Credit quality step	Ratings			Exposures			
	S&P	Moody's	Fitch	Dec-2016 Exposure Value £'m	Dec-2016 Exposure Weighted Average RW %	Dec-2015 Exposure Value £'m	Dec-2015 Exposure Weighted Average RW %
1	AAA	Aaa	AAA	40.9	20.0	36.9	20.0

The purchased securitisation positions are predominantly residential mortgage backed, with one buy-to-let mortgage backed position of £7m, which have all been originated and issued in the UK.

9. Appendix A – Grandfathering Profile & Capital Allowances

	Limits	Tier 1 Grandfather Limit	Tier 1 assigned	Tier 2 Grandfather Limit	Tier 2 assigned	Excess Tier 1 Available	Excess allowed to be classed as Tier 2	Available for inclusion in Tier 2
		£m	£m	£m	£m	£m	£m	£m
2012 Year End		60.0	60.0	92.3	64.6	n/a	n/a	n/a
01/01/2014	80%	48.0	48.0	51.7	46.2	12.0	5.5	5.5
30/06/2014	80%	48.0	48.0	51.7	36.9	12.0	14.8	12.0
31/12/2014	80%	48.0	48.0	51.7	27.7	12.0	24.0	12.0
30/06/2015	70%	42.0	42.0	45.2	18.5	18.0	26.7	18.0
31/12/2015	70%	42.0	42.0	45.2	9.2	18.0	36.0	18.0
30/06/2016	60%	36.0	36.0	38.8	0.4	24.0	38.4	24.0
31/12/2016	60%	36.0	36.0	38.8	-	24.0	38.8	24.0
30/06/2017	50%	30.0	30.0	32.3	-	30.0	32.3	30.0
31/12/2017	50%	30.0	30.0	32.3	-	30.0	32.3	30.0
30/06/2018	40%	24.0	24.0	25.8	-	36.0	25.8	25.8
31/12/2018	40%	24.0	24.0	25.8	-	36.0	25.8	25.8
30/06/2019	30%	18.0	18.0	19.4	-	42.0	19.4	19.4
31/12/2019	30%	18.0	18.0	19.4	-	42.0	19.4	19.4
30/06/2020	20%	12.0	12.0	12.9	-	48.0	12.9	12.9
31/12/2020	20%	12.0	12.0	12.9	-	48.0	12.9	12.9
30/06/2021	10%	6.0	6.0	6.5	-	54.0	6.5	6.5
31/12/2021	10%	6.0	6.0	6.5	-	54.0	6.5	6.5

10. Appendix B - Remuneration

The following table displays the 2016 remuneration for the Group's managers and members of staff deemed as 'Material Risk Takers' (MRTs), as defined by the Remuneration Code. This includes executive and non-executive directors.

The Report of the Remuneration Committee contained within the 2016 Annual Report and Accounts contains the following:

- The decision making process used for determining the remuneration policy
- The link between pay and performance
- The most important remuneration design characteristics

During the year, three severance payments totalling £392,000 were made. These amounts are included in the figures presented in the remuneration table set out below.

The total amount of deferred remuneration paid out in the year was £262,000.

Aggregate MRT Remuneration

Of the 35 beneficiaries of remuneration being paid to MRTs, 24 were in receipt of a variable remuneration during the financial year.

A summary of the remuneration paid to MRTs is as follows:

	Number of beneficiaries	Fixed remuneration £k	Variable remuneration £k	Total remuneration £k	*Outstanding deferred remuneration £k*
Group	35	4,429	739	5,168	229

11. Glossary of Terms

Term	Definition
AFS reserve	Available For Sale reserve. The valuation of our available for sale assets such as gilts and treasury bills.
AVA	Additional Value Adjustment. The prudential valuation of all fair valued assets which, as per CRR article 34, is deducted from CET1
Basel II	The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the PRA Handbook.
Basel III	The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel III became law in the EU Capital Requirements Directive IV and was implemented in the UK via the PRA/FCA Handbook on the 1st January 2014.
Basis Risk	Basis risk is the exposure arising from the imperfect correlation between re-pricing of interest rates on different assets and liabilities.
CCB	Capital Conservation Buffer. A buffer of 2.5% of Common Equity Tier 1 capital held outside periods of stress. Phased in from 2016 to 2019.
CCyB	Counter-Cyclical Capital Buffer. Based on national circumstances a buffer between 0% - 2.5% of Common Equity Tier 1 capital.
CCF	Credit Conversion Factor. An estimation of the drawdown of an undrawn facility.
CET1	Common Equity Tier 1 (CET1) replaces the Core Tier 1 expression used previously for the best quality capital. In Principality's instance this consists mainly of retained earnings.
Code Staff	Executive and non-executive directors, senior management and members of staff whose actions are deemed to have a material impact on the risk profile of the Group.
Counterparty Credit Risk	Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.
CQS (Credit Quality Steps)	A credit quality assessment scale is set out in Part III Title 2 Chapter 2 Section 1 of CRR (Applicable for Risk weights under the standardised approach to credit risk and Securitisation).
CRD IV	Capital Requirements Directive IV. This implements Basel III through national law.
Credit risk	The risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Credit risk is the largest risk category to which the Group is exposed and sub-divided as follows: retail lending, commercial lending, and Treasury credit risks.

Term	Definition
Credit risk mitigation	Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
CRR IV	Capital Requirements Regulation IV. This implements Basel III directly to firms across the EU.
CVA	Credit Valuation Adjustment. The adjustment reflects the current market value of the credit risk of the counterparty to the institution.
EAD	Exposure at Default. An estimate of the outstanding balance if the customer does default.
ECAI	External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.
FCA	Financial Conduct Authority. The financial services industry regulator in the UK for Conduct issues
FSA	Financial Services Authority. The previous financial services industry regulator in the UK superseded by the PRA and the FCA.
Guarantee	An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.
ICAAP	Internal Capital Adequacy Assessment Process. The Group's own assessment, as part of Basel III requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.
ICG	Individual Capital Guidance. The minimum amount of capital the Group should hold as set by the PRA under Basel III Pillar 2.
ILAAP	Internal Liquidity Adequacy Assessment Process. The Group's own assessment of the levels of liquidity that it needs to meet its current and financial obligations. These are assessed under normal and stressed condition.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
IRB	Internal Ratings Based approach. A Basel III approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk-sensitive than the Standardised Approach and may only be used with PRA permission.
LIBOR	London Inter Bank Offered Rate.
LGD	Loss Given Default. An estimate of the outstanding balance not recovered and the costs associated with that recovery process.

LTV	Loan To Value. A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI).
Maturity	The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.
Minimum capital requirement	The minimum amount of regulatory capital that a financial institution must hold to meet the Basel III Pillar 1 requirements for credit and operational risk.
Netting	The ability to reduce credit risk exposures by offsetting the value of any deposits against loans to the same counterparty.
MREL	Minimum Requirement for own funds and Eligible Liabilities. An amount set by regulators based on an assessment of the institution.
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
PD	Probability of Default. The probability of defaulting in the next 12 months
PIBS	Permanent Interest Bearing Shares. Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, creditors and investing members of the Group. Also known as subscribed capital.
Pillar 1	The part of the Basel III Framework which sets out the regulatory minimum capital requirements for credit and operational risk.
Pillar 2	The part of the Basel III Framework which sets out the processes by which financial institutions review their overall capital adequacy. Supervisors then evaluate how well financial institutions are assessing their risks and take appropriate actions in response to the assessments. This includes all risks (including Pillar 1 risks) - ICG is an outcome from Pillar 2.
Pillar 3	The part of the Basel III Framework which sets out the disclosure requirements for firms to publish details of their risks, capital and risk management. The aims are greater transparency and strengthening market discipline.
PPI	Payment Protection Insurance.
PRA	Prudential Regulation Authority. The financial services industry regulator in the UK for prudential risk
Provisions	Amounts set aside to cover losses associated with credit risks.

Term	Definition
RWA	Risk Weighted Assets. This is used to determine the minimum amount of capital, weighted according to risk, which must be held by the Group to reduce the risk of insolvency.
Securitisation	A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose vehicle (SPE) which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.
SPE	Special Purpose Entities. Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses an SPE set up under securitisation issue. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results. This term is used interchangeably with SPV (special purpose vehicle).
Stress testing	Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.
SREP	Supervisory Review and Evaluation Process. (CRD IV Section III, the PRA's process for reviewing the adequacy of a firm's ICAAP)
Subordinated debt	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing Members but before the claims of holders of permanent interest-bearing shares.
The Standardised Approach (credit risks)	The basic method used to calculate credit risk capital requirements under Basel III. In this approach the risk weights used in the capital calculation are determined by PRA supervisory parameters. The standardised approach is less risk-sensitive than IRB.
The Standardised Approach (operational risks)	The standardised approach to operational risk, calculated using the average of three year historical net income multiplied by a factor of 12-18%, depending on the underlying business being considered.
Total Remuneration	The sum of fixed pay, variable pay, director fees, car allowance, pension and benefits in kind.