

# 2015

Stronger and better, today and tomorrow

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## 1. Key Regulatory Metrics

|                 | Common Equity Tier 1 Capital<br>£m | Common Equity Tier 1 Capital<br>% |
|-----------------|------------------------------------|-----------------------------------|
| <b>Dec-2015</b> | <b>435.5</b>                       | <b>21.0</b>                       |
| Dec-2014        | 375.7                              | 18.2                              |
| Dec-2013        | 357.7                              | 16.9                              |

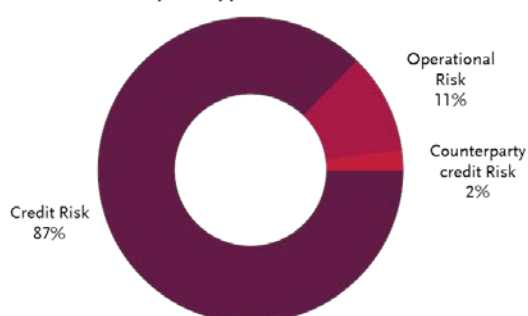
|                 | Tier 1 Capital<br>£m | Tier 1 Ratio<br>% |
|-----------------|----------------------|-------------------|
| <b>Dec-2015</b> | <b>477.5</b>         | <b>23.0</b>       |
| Dec-2014        | 423.7                | 20.5              |
| Dec-2013        | 397.7                | 18.7              |

|                 | Total Regulatory Capital<br>£m | Total Capital Ratio<br>% |
|-----------------|--------------------------------|--------------------------|
| <b>Dec-2015</b> | <b>504.7</b>                   | <b>24.3</b>              |
| Dec-2014        | 463.4                          | 22.5                     |
| Dec-2013        | 429.0                          | 20.2                     |

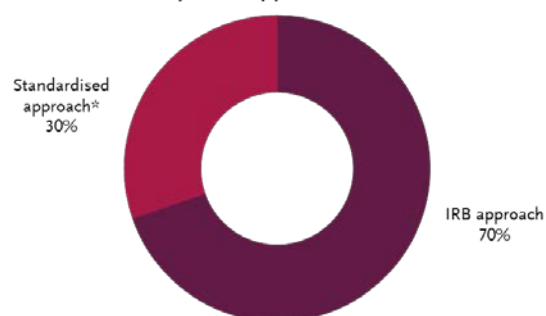
|                 | Leverage Exposure<br>£m | Leverage Ratio<br>(Transitional Position)<br>% |
|-----------------|-------------------------|--|
| <b>Dec-2015</b> | <b>7,967.1</b>          | <b>6.0</b>                                     |
| Dec-2014        | 7,484.4                 | 5.7  |
| Dec-2013        | 7,375.9                 | 5.4  |

|                 | Leverage Exposure<br>£m | Leverage Ratio<br>(End State Position)<br>% |
|-----------------|-------------------------|---|
| <b>Dec-2015</b> | <b>7,967.1</b>          | <b>5.5</b>                                  |
| Dec-2014        | 7,484.4                 | 5.0   |
| Dec-2013        | 7,375.9                 | 4.6   |

RWAs by risk type - December 2015



Credit risk RWAs by Basel approach - December 2015



\*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 there are transitional rules in place until 1 January 2022. This document reflects the transitional Basel III position for 31 December 2015, compared with 2014 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 other risks (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 I 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 current Basel regulation unless explicitly stated.

#### 2.3.1 Frequency of Disclosure

Disclosures will be issued at least annually, on the Principality internet site [www.principality.co.uk](http://www.principality.co.uk), based on the most recent published Annual Report and Accounts. Unless otherwise stated, all figures are as at 31 December 2015, 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 2015 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 2015 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 2015 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 in 2013 for credit risk. The IRB approach has been applied to first charge Retail and Commercial portfolios from 1 October 2013 with the second charge mortgage book currently on a roll out plan. 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.

The Group does not currently have approval to use the IRB approach for its second charge mortgages, but it anticipates that the impact of this approval would be to increase the risk weightings applied to those assets when compared to the standardised approach, and as such it would have an adverse impact on both the CET1 and Solvency ratios. However, the Group would still comfortably meet all regulatory requirements for capital adequacy.

### 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](http://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 53-59 in the 2015 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 2015 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 2015 under the Basel III rules:

|   | Notes | Dec-2015<br>£m | Dec-2014<br>£m |
|---|-------|----------------|----------------|
| General Reserves                            | 1     | 447.4          | 408.7          |
| AFS Reserves                                |       | 1.6            | 2.6            |
| <b>Total Accounting Capital</b>             |       | <b>449.0</b>   | <b>411.3</b>   |
| <i>Adjustments for Regulatory Capital:-</i> |       |                |                |
| Available For Sales (AFS) Reserve           | 2     | -              | (2.6)          |
| Intangible Assets                           | 4     | (1.4)          | (1.7)          |
| Additional Value Adjustment (AVA)           | 7     | (0.5)          | (0.5)          |
| Deferred Income                             | 8     | (0.6)          | (1.0)          |
| Provision Deductions                        | 9     | (11.0)         | (29.8)         |
| <b>Common Equity Tier 1 Capital</b>         |       | <b>435.5</b>   | <b>375.7</b>   |
| Permanent Interest Bearing Shares (PIBS)    | 3     | 42.0           | 48.0           |
| <b>Additional Tier 1 Capital</b>            |       | <b>42.0</b>    | <b>48.0</b>    |
| <b>Total Tier 1 Capital</b>                 |       | <b>477.5</b>   | <b>423.7</b>   |
| Amortised Subordinated Debt                 | 5     | 9.2            | 27.7           |
| Tier 2 Allowance of Grandfathered AT1       | 6     | 18.0           | 12.0           |
| <b>Tier 2 Capital</b>                       |       | <b>27.2</b>    | <b>39.7</b>    |
| <b>Total Tier 2 Capital</b>                 |       | <b>27.2</b>    | <b>39.7</b>    |
| <b>Total Regulatory Capital Resource</b>    |       | <b>504.7</b>   | <b>463.4</b>   |

#### Notes and General Information on Capital Resources

- 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 in the 2015 Annual Report and Accounts.
- The Group holds unrealised gains and losses in the AFS reserve. Under CRR Article 35 unrealised gains and losses at fair value should be included in own funds. However, under Basel III transitional rules during 2014 AFS reserves could only be included if they showed a loss. This transitional rule ended as of 1 January 2015 and therefore AFS reserves are excluded from regulatory capital in 2014 but included for 2015.
- 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 2015 Annual Report and Accounts.
- Intangible assets include software development costs.

Further details of the intangible assets are provided in note 21 to the 2015 Annual Report and Accounts.

5. 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.
6. Due to the straight line amortisation of our 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 2015 Annual Report and Accounts.

7. Additional Value Adjustment (AVA) is the prudential valuation of all fair valued assets which, as per CRR Article 34, is deducted from CET1 capital.
8. Deferred income is income dependent on the future performance of loans sold to other institutions. We therefore deduct the income from CET1 as per CRR article 3.
9. Provision deductions arise from the IRB approach. The calculation is the difference between the expected losses from IRB portfolios and the amount of specific and collective provisions held for those same portfolios. CRR Article 36 states this deduction is taken 100% from CET 1 capital.

The Group does not deduct its deferred tax assets that rely on future profitability (£0.3m) 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

During August 2013 the PRA granted the Group permission to use the IRB approach. The Group currently uses a mixture of standardised and IRB 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 monthly with capital forecasts formally reviewed and approved at least annually. Pillar 2 risks are considered annually as part of the ICAAP. Actual capital levels are presented monthly to the Board and the Asset and Liability Committee (ALCo).

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 June 2015. The ICAAP is used by the PRA to determine and set the Group's Individual Capital Guidance (ICG). The ICG was recalibrated by the PRA after the Group's SREP visit in June 2015, and the next ICAAP is due to be submitted to the Board during June 2016

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). 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.



## 4.2 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-2015<br>Average<br>Risk<br>Weights<br>% | Dec-2015<br>£m | Dec-2014<br>£m |
|--|---|----------------|----------------|
| Retail financial services  | 13%   | 62.0           | 57.5           |
| Secured personal lending   | 40%   | 16.1           | 16.4           |
| Retail financial services-Past due items                                   | 216%  | 4.1            | 4.6            |
| Secured personal lending-Past due items                                    | 106%  | 2.4            | 3.2            |
| <b>Retail exposures classes</b>  |   | <b>84.6</b>    | <b>81.7</b>    |
| Commercial lending - Non housing association                               | 100%  | 49.7           | 50.6           |
| Commercial lending - Housing association                                   | 35%   | 4.3            | 4.6            |
| Commercial lending - Past due items*                                       | 0%  | -              | -              |
| <b>Commercial exposure classes</b>   |   | <b>54.0</b>    | <b>55.2</b>    |
| Financial institutions   | 4%  | 3.4            | 4.3            |
| <b>Other exposure classes</b>  |   | <b>3.4</b>     | <b>4.3</b>     |
| Fixed and other assets   | 98%   | 6.1            | 6.8            |
| <b>Other</b>   |   | <b>6.1</b>     | <b>6.8</b>     |
| <b>Credit risk minimum capital requirement</b>                             |   | <b>148.1</b>   | <b>148.0</b>   |
| Operational risk   |   | 17.6           | 16.7           |
| CVA  |   | 0.4            | 0.4            |
| <b>Total minimum capital required</b>                                      |   | <b>166.1</b>   | <b>165.1</b>   |
| Total own funds  |   | 504.7          | 463.4          |
| <b>Excess of own funds over minimum capital requirement under Pillar 1</b> |   | <b>338.6</b>   | <b>298.3</b>   |

\*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.

#### 4.3 Movements in RWA

|   | £m             |
|---|----------------|
| <b>Position as at 31 December 2014</b>      | <b>2,063.5</b> |
| Increase due to net mortgage book growth    | 96.1           |
| Decrease due to net treasury book reduction | (12.8)         |
| Movement in risk profile                    | (78.0)         |
| Change due to Other Assets                  | (8.5)          |
| Change in impact of netting                 | 4.8            |
| Increase in Operational Risk                | 11.0           |
| Increase of CVA                             | 0.2            |
| <b>Position as at 31 December 2015</b>      | <b>2,076.3</b> |

## 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 Permanent Interest Bearing Shares (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 70% of the carrying value of the PIBS at December 2015 and this percentage will continue to reduce by 10% per year.

The Group's subordinated debt does not qualify for inclusion as Tier 2 capital and could be similarly grandfathered. However the Group's subordinated debt is already being amortised on a straight line basis due to the maturity of the instrument in July 2016. 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.

| <b>Common Equity Tier 1 (CET1) capital: instruments and reserves</b>   | <b>Notes</b> | <b>Basel III<br/>31.12.15<br/>£m</b> | <b>Adjustments<br/>£m</b> | <b>Transitional<br/>Basel III<br/>Rules<br/>01.01.16<br/>£m</b> | <b>Final<br/>Basel III<br/>Rules<br/>01.01.22<br/>£m</b> |
|--|--------------|--------------------------------------|---------------------------|---|--|
| General and Other Reserves   |              | 449.0                                | -                         | 449.0   | 449.0  |
| <b>Common Equity Tier 1 (CET1) capital before regulatory adjustments</b>   |              | <b>449.0</b>                         | <b>-</b>                  | <b>449.0</b>  | <b>449.0</b>   |
| <b>Common Equity Tier 1 (CET1) capital: regulatory adjustments</b>   |              |                                      |                           |   |  |
| Additional value adjustments   |              | (0.5)                                | -                         | (0.5)   | (0.5)  |
| Intangible assets  |              | (1.4)                                | -                         | (1.4)   | (1.4)  |
| Unrealised (Losses)/Gains from Available for Sale Assets   |              | -                                    | -                         | -   | -  |
| Negative amounts resulting from the calculation of expected loss amounts   |              | (11.0)                               | -                         | (11.0)  | (11.0)   |
| Exposure amount of the following items which qualify for a RW of 1250%, where the institution opts for the deduction alternative |              | (0.6)                                | -                         | (0.6)   | (0.6)  |
| <b>Total regulatory adjustments to Common Equity Tier 1 (CET1)</b>   |              | <b>(13.5)</b>                        | <b>-</b>                  | <b>(13.5)</b>   | <b>(13.5)</b>  |
| <b>Common Equity Tier 1 (CET1) capital</b>   |              | <b>435.5</b>                         | <b>-</b>                  | <b>435.5</b>  | <b>435.5</b>   |
| Amount of qualifying items referred to in Article 484 (4) phased out from AT1  | 1            | 42.0                                 | (6.0)                     | 36.0  | -  |
| <b>Additional Tier 1 (AT1) capital before regulatory adjustments</b>   |              | <b>42.0</b>                          | <b>(6.0)</b>              | <b>36.0</b>   | <b>-</b>   |
| <b>Additional Tier 1 (AT1) capital</b>   |              | <b>42.0</b>                          | <b>(6.0)</b>              | <b>36.0</b>   | <b>-</b>   |
| <b>Tier 1 capital (T1 = CET1 + AT1)</b>  |              | <b>477.5</b>                         | <b>(6.0)</b>              | <b>471.5</b>  | <b>435.5</b>   |
| Amount of qualifying items referred to in Article 484 (5) phased out from T2   |              | 9.2                                  | (0.0)                     | 9.2   | -  |
| Tier 2 allowance of Grandfathered AT1  | 2            | 18.0                                 | 6.0                       | 24.0  | -  |
| <b>Tier 2 (T2) capital before regulatory adjustments</b>   |              | <b>27.2</b>                          | <b>6.0</b>                | <b>33.2</b>   | <b>-</b>   |
| <b>Tier 2 (T2) capital (T2 less regulatory adjustments)</b>  |              | <b>27.2</b>                          | <b>6.0</b>                | <b>33.2</b>   | <b>-</b>   |
| <b>Total capital (TC = T1 + T2)</b>  |              | <b>504.7</b>                         | <b>(0.0)</b>              | <b>504.7</b>  | <b>435.5</b>   |
| <b>Total risk weighted assets</b>  |              | <b>2,076.3</b>                       | <b>-</b>                  | <b>2,076.3</b>  | <b>2,076.3</b>   |

|  | Basel III<br>31.12.15 | Adjustments | Transitional<br>Basel III<br>Rules<br>01.01.16 | Final<br>Basel III<br>Rules<br>01.01.22 |
|--|-----------------------|-------------|--|---|
| <b>Capital ratios and buffers</b>  |                       |             |  |   |
| Common Equity Tier 1 (as a percentage of total risk exposure amount)   | 21.0%                 | 0.0%        | 21.0%  | 21.0%                                   |
| Tier 1 (as a percentage of total risk exposure amount)   | 23.0%                 | -0.3%       | 22.7%  | 21.0%                                   |
| Total capital (as a percentage of total risk exposure amount)  | 24.3%                 | 0.0%        | 24.3%  | 21.0%                                   |
| Institution specific buffer requirement  |                       |             |  |   |
| Common Equity Tier 1 available to meet buffers (as % of risk exposure amount)                                    |                       |             | 10.6%  | 7.3%                                    |
| <b>Amounts below the thresholds for deduction (before risk weighting)</b>  |                       |             |  |   |
| Deferred tax assets arising from temporary differences   | 0.3                   | -           | 0.3  | 0.3                                     |
| <b>Applicable caps on the inclusion of provisions in Tier 2</b>  |                       |             |  |   |
| Cap on inclusion of credit risk adjustments in T2 under standardised approach                                    | 7.9                   | -           | 7.9  | 7.9                                     |
| Cap for inclusion of credit risk adjustments in T2 under IRB approach  | 8.7                   | -           | 8.7  | 8.7                                     |
| <b>Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2014 and 1 Jan 2022)</b> |                       |             |  |   |
| Current cap on AT1 instruments subject to phase out arrangements   | 42.0                  | (6.0)       | 36.0   | -                                       |
| Amount excluded from AT1 due to cap  | 18.0                  | 6.0         | 24.0   | 60.0                                    |
| Current cap on T2 instruments subject to phase out arrangements  | 45.2                  | (6.5)       | 38.8   | -                                       |
| Amount excluded from T2 due to cap   | -                     | -           | -  | 9.2                                     |

### 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 70% of the value at 31 December 2012 can be recognised during 2015 and 60% during 2016. 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. As the Group's subordinated debt is amortising on a straight line basis due to the maturity in June 2016 it creates an allowance the Group can utilise. 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. 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 amount of capital required for the CCyB is determined by the Financial Policy Committee (FPC) and on the 1 December 2015 the CCyB was held at 0% for the UK. 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 where the country has a CCyB over 0%.

Starting on 1 January 2016 the CCB will be transitioned in to effect in 0.625% yearly increments, with the entirety of the 2.5% requirement applied on 1 January 2019.

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 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 £33m 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-2015<br>£m | Dec-2014<br>£m |
|---|-------|----------------|----------------|
| <b>Total Balance Sheet as per Statutory Accounts</b>  |       | <b>7,584.4</b> | <b>7,265.0</b> |
| <b>Adjusted for:</b>                                  |       |                |                |
| Potential future credit exposure for swaps            |       | 10.4           | 11.3           |
| Off balance sheet exposures with a 50% CCF-Commercial |       | 33.1           | 27.8           |
| Off balance sheet exposures with a 100% CCF-Retail    |       | 352.7          | 213.3          |
| Regulatory adjustment for Goodwill and Intangibles    |       | (1.4)          | (1.7)          |
| Regulatory adjustments for AVA                        |       | (0.5)          | (0.5)          |
| Regulatory adjustments for Deferred Income            |       | (0.6)          | (1.0)          |
| Provision Deductions                                  |       | (11.0)         | (29.8)         |
| <b>Leverage Exposure</b>                              |       | <b>7,967.1</b> | <b>7,484.4</b> |
| Tier 1 capital (end state position)                   |       | 435.5          | 375.7          |
| Tier 1 capital (transitional position)                | 1     | 477.5          | 423.7          |
| Leverage ratio using end state Tier 1 Capital         |       | 5.47%          | 5.02%          |
| Leverage ratio using transitional Tier 1 Capital      | 1     | 5.99%          | 5.66%          |

#### Notes and General Information on Leverage

1. The transitional position represents the Tier 1 capital and Leverage ratio at 31 December 2015 following Basel III transitional provisions.

The Group's leverage ratio has improved year on year as the proportional growth of the Group's Tier 1 capital has exceeded proportional year on year balance sheet growth.

#### 5.5 Capital Adequacy through Transition

|   | Basel III<br>31.12.15 | Transitional<br>Basel III<br>Rules<br>01.01.16 | Final<br>Basel III<br>Rules<br>01.01.22 |
|---|-----------------------|--|---|
| Total minimum capital required                  | 166.1                 | 166.1  | 166.1                                   |
| Total own funds                                 | 504.7                 | 504.7  | 435.5                                   |
| <b>Excess of own funds over minimum capital</b> | <b>338.6</b>          | <b>338.6</b>                                   | <b>269.4</b>                            |

## 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 27–40 of the 2015 Annual Report and Accounts.

The ways in which the Group manages these risks include:

- Setting and maintaining a Board 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 and is the custodian of its Members' long term financial interests. The Members are entitled to take for granted that their money is safe. The Group's Board adopts a prudent attitude to risk when setting its risk appetite.

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

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

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

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

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

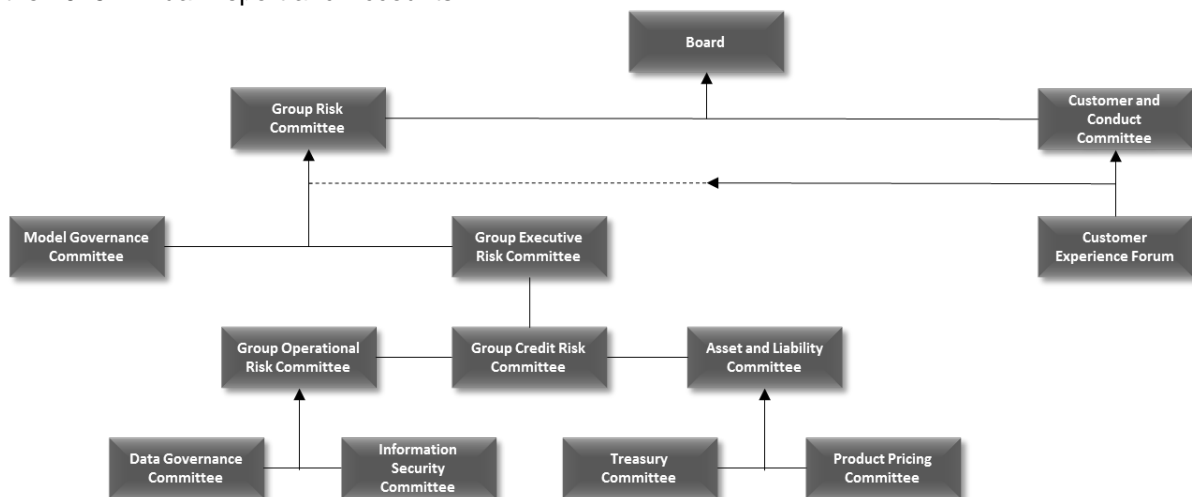
The Group adopts a ‘three lines of defence’ model as the risk management structure.

- **First line of defence** – primary responsibility for the identification, control, monitoring and mitigation of risk lies with operational areas across each business area.
- **Second line of defence** – oversight and governance will be provided by the second line of defence through specialist support functions such as Group Risk and additionally through Risk Committees. The role of these functional specialists is to maintain and review policies, establish limits and qualitative standards which are consistent with the Group’s risk appetite, monitor and report on compliance with those limits and standards, and generally to perform an oversight role in relation to the management of risk.
- **Third line of defence** – the Group’s internal audit function is responsible for providing independent review of the effectiveness of the risk management structure and adherence to processes in the first and second lines.

## 6.4 Risk Governance

The responsibility for the overall framework of risk governance and management lies with the Board of Directors. The Board is responsible for determining risk strategy, setting the Group’s risk appetite and ensuring that risk is monitored and controlled effectively. It is also responsible for establishing a clearly defined risk management structure with distinct roles and responsibilities. Within that structure, line managers are responsible 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 27-40 of the 2015 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) 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](http://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) is responsible for considering and recommending the Group's risk appetite, capital and liquidity adequacy to the Board. It is responsible for maintaining an appropriate governance structure to ensure that risks across the Group are identified and managed effectively and for monitoring and reviewing internal and external risks including the assessment and quantification of all material risks to support current and future estimation of regulatory capital and liquidity requirements.

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

### Group Credit Risk Committee

The Group Credit Risk Committee (GCRC) is a management committee, chaired by the Group Risk Director. The Committee is responsible for the management of the Group's Retail and Commercial credit risk in line with the Board approved Group Risk Appetite statement. The functions of the committee include review and approval of the Group's credit risk policies together with the development of detailed limits and triggers for credit risks within the Group's overall risk appetite and for monitoring credit risk exposures. The Chairman of the Committee reports on the Committee's activities to the Group Risk Committee.

### Group Operational Risk Committee

The Group Operational Risk Committee (GORC) is a management committee, chaired by the Group Risk Director. The Committee is responsible for the Operational Risk Framework and its implementation. The duties of the committee include the development and implementation of a robust operational risk framework and operational risk policies together with oversight of the key operational risk exposures facing the Group. The Chairman of the Committee reports on the Committee's activities to the Group Risk Committee. The Group Information Security Committee and Data Governance Committees report into the GORC and are responsible for providing specific oversight of these two key risks.

### Model Governance Committee

The Model Governance Committee (MGC) is chaired by the Group Finance Director. The committee provides oversight of the models used by the Group to assess and quantify exposure to credit, liquidity and market risk. The main function of the committee is to review the construct and operation of models and modelling tools used across the Group to assess and quantify exposure to credit risk and ensure they are fit for purpose. Formal minutes are submitted to the Group Risk Committee.

The MGC is the designated committee for the approval 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. This 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) is chaired by the Group Finance Director. Its functions include monitoring the interest rate characteristics of retail, commercial and wholesale assets and liabilities, ensuring that the Group's liquidity meets the statutory obligations and remains within limits approved by the Board, monitoring the credit risk of assets held for liquidity purposes and monitoring the performance of the funding and liquid asset portfolios. The minutes and actions are reviewed by the Board, GMC and Group Risk Committee.

### **Treasury Committee**

The Treasury Committee is chaired by the Group Finance Director. The committee has 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 (new business and retention products) giving appropriate consideration to current market conditions and operational constraints. The committee aims to achieve net interest margin and volume targets contained in the Group's business plans, 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 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 (e.g. a Brexit) and also targeted attacks on the Group (e.g. cyber threats).

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. Credit risk arises 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 Group Risk Committee (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 27-40 of the 2015 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*   | EAD Post-CRM*  | RWAs           | Capital Required |
|--------------------------------------|----------------|----------------|----------------|------------------|
|                                      | As at Dec-2015 | As at Dec-2015 | As at Dec-2015 | As at Dec-2015   |
| Retail financial services            | 5,775.2        | 5,775.2        | 826.0          | 66.1             |
| Secured personal lending             | 529.4          | 529.4          | 230.6          | 18.5             |
| Commercial lending                   | 813.5          | 813.5          | 675.2          | 54.0             |
|                                      | <b>7,118.1</b> | <b>7,118.1</b> | <b>1,731.8</b> | <b>138.6</b>     |
| <b>Treasury</b>                      |                |                |                |                  |
| Central governments or central banks | 705.2          | 705.2          | -              | -                |
| Multilateral development banks       | 51.0           | 51.0           | -              | -                |
| Financial institutions               | 255.6          | 225.1          | 42.3           | 3.4              |
|                                      | <b>1,011.8</b> | <b>981.3</b>   | <b>42.3</b>    | <b>3.4</b>       |
| Other assets                         | 78.3           | 78.3           | 76.7           | 6.1              |
| <b>Total</b>                         | <b>8,208.2</b> | <b>8,177.7</b> | <b>1,850.8</b> | <b>148.1</b>     |

\*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 2015 is as follows:

| <b>EAD Pre-CRM</b>                   | <b>UK<br/>£m</b> | <b>Other<br/>£m</b> | <b>Total<br/>£m</b> |
|--------------------------------------|------------------|---------------------|---------------------|
| Retail financial services            | 5,775.2          | -                   | 5,775.2             |
| Secured personal lending             | 529.4            | -                   | 529.4               |
| Commercial lending                   | 813.5            | -                   | 813.5               |
|                                      | <b>7,118.1</b>   | <b>-</b>            | <b>7,118.1</b>      |
| <b>Treasury</b>                      |                  |                     |                     |
| Central governments or central banks | 705.2            | -                   | 705.2               |
| Multilateral development banks       | -                | 51.0                | 51.0                |
| Financial institutions               | 255.6            | -                   | 255.6               |
|                                      | <b>960.8</b>     | <b>51.0</b>         | <b>1,011.8</b>      |
| Other Assets                         | 78.3             | -                   | 78.3                |
| <b>Total</b>                         | <b>8,157.2</b>   | <b>51.0</b>         | <b>8,208.2</b>      |

The following table shows the residual maturity of the exposures at 31 December 2015. 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.

| <b>EAD Pre-CRM</b>                   | <b>Up to 12<br/>months<br/>£m</b> | <b>1-5 years<br/>£m</b> | <b>More than 5<br/>years<br/>£m</b> | <b>Total<br/>£m</b> |
|--------------------------------------|-----------------------------------|-------------------------|-------------------------------------|---------------------|
| Retail financial services            | 27.9                              | 236.6                   | 5,510.7                             | 5,775.2             |
| Secured personal lending             | 1.6                               | 48.4                    | 479.4                               | 529.4               |
| Commercial lending                   | 199.2                             | 311.9                   | 302.4                               | 813.5               |
|                                      | <b>228.7</b>                      | <b>596.9</b>            | <b>6,292.5</b>                      | <b>7,118.1</b>      |
| <b>Treasury</b>                      |                                   |                         |                                     |                     |
| Central governments or central banks | 467.1                             | 238.1                   | -                                   | 705.2               |
| Multilateral development banks       | 40.9                              | 10.1                    | -                                   | 51.0                |
| Financial institutions               | 186.0                             | 63.4                    | 6.2                                 | 255.6               |
|                                      | <b>694.0</b>                      | <b>311.6</b>            | <b>6.2</b>                          | <b>1,011.8</b>      |
| Other assets                         | -                                 | -                       | 78.3                                | 78.3                |
| <b>Total</b>                         | <b>922.7</b>                      | <b>908.5</b>            | <b>6,377.0</b>                      | <b>8,208.2</b>      |

## 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 loan 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 2015:

| PD Bands         | Exposure at Default Estimate<br>Dec-2015<br>£m | Exposure Weighted Average Loss Given Default<br>Dec-2015 | Average Risk Weight<br>Dec-2015 | Average Expected Loss<br>Dec-2015 |
|------------------|--|--|---------------------------------|-----------------------------------|
| 0%≤PD<0.2%       | 4,440.5  | 23.6%  | 6.7%                            | 0.0%                              |
| 0.2%≤PD<1%       | 1,118.1  | 30.2%  | 24.0%                           | 0.1%                              |
| 1%≤PD<9.3%       | 103.1  | 29.9%  | 76.6%                           | 1.0%                              |
| 9.3%≤PD<26.47%   | 54.9   | 27.8%  | 159.6%                          | 4.7%                              |
| 26.47%≤PD<44.36% | 17.2   | 28.7%  | 166.3%                          | 12.2%                             |
| 44.36%≤PD<100%   | 17.7   | 28.1%  | 87.8%                           | 20.6%                             |
| In default book  | 23.7   | 27.2%  | 215.9%                          | 9.9%                              |
| <b>Total</b>     | <b>5,775.2</b>                                 | <b>25.1%</b>   | <b>14.3%</b>                    | <b>0.3%</b>                       |

### 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 function of 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 there are other indicators that the borrower is unlikely to repay. 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 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 property value, the current point in the house price cycle relative to the trough of the cycle, collections costs and the time that would be taken to take 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 the balance will also be increased by any available undrawn balance. 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.

During 2015, 49 repossessed properties were sold (42 of these were non-BTL). The actual losses on these properties were lower than the best estimates. This favourable loss experience arose as a result of the forced sale discount being substantially lower than the modelled value.

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;
- Capital planning.

### **IRB model governance**

The MGC is the designated committee through which authority to change the IRB Ratings 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 function 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, and procedures describing how physical systems 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 Board's retail lending risk appetite. The Group Credit Risk Committee reviews comprehensive risk based information on a monthly basis and has appropriate controls in place to ensure that new lending complies with the Board's stated risk appetite. Limits and triggers are reviewed regularly by Group Risk Committee 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 are repayable over terms between three and twenty-five years.

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

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

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

#### **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.

The secured personal lending portfolio is on the Group's roll out plan to migrate to the IRB approach subject to PRA approval.



## 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<br>£m | Un-drawn commitments*<br>£m | Total<br>£m  |
|--|-------------------------|-----------------------------|--------------|
| Loans to Registered Social Landlords secured on residential property | 149.8                   | 4.7                         | 154.5        |
| Other loans secured on residential property                          | 308.5                   | 23.9                        | 332.4        |
| Loans secured on commercial property                                 | 324.2                   | 4.5                         | 328.7        |
| Effective Interest Rate adjustment                                   | (2.1)                   | -                           | (2.1)        |
|  | <b>780.4</b>            | <b>33.1</b>                 | <b>813.5</b> |

\*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 Board'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. Exceptions to this are connections in weak or defaulted slots where invariably exposures are managed by an Asset Management Team 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 Policy Manual. 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.

| Slot                       | Remaining Maturity <2.5 |              | Remaining Maturity >=2.5 |              |
|----------------------------|-------------------------|--------------|--------------------------|--------------|
|                            | EAD<br>£m               | RWA<br>%     | EAD<br>£m                | RWA<br>%     |
| 1-Strong                   | 8.0                     | 50.0%        | 14.0                     | 70.0%        |
| 2-Good                     | 140.3                   | 70.0%        | 291.4                    | 90.0%        |
| 3-Satisfactory             | 84.0                    | 115.0%       | 48.5                     | 115.0%       |
| 4-Weak                     | 36.0                    | 250.0%       | 1.9                      | 250.0%       |
| <b>Non-Defaulted Total</b> | <b>268.3</b>            | <b>108%</b>  | <b>355.8</b>             | <b>93%</b>   |
| 5-Default                  | 34.7                    | 0%           | 0.6                      | 0%           |
| <b>Totals</b>              | <b>303.0</b>            | <b>95.3%</b> | <b>356.4</b>             | <b>93.3%</b> |

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%.

### 7.1.5 Treasury Credit Risk

The Group has exposures to banks, building societies, sovereign and supra national bodies in its non-trading book 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 Board's risk appetite. Treasury counterparty lines of credit are reviewed on a weekly basis by the Treasury Committee and on a monthly basis by ALCo. This entails an analysis of the 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 2015 (69%).

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<br>£m | EAD Post-CRM<br>£m |
|---------------------|----------------|-----------------|-----------------|-------------------|--------------------|
| 1                   | 0%             | Aaa to Aa3      | AAA to AA-      | 705.2             | 705.2              |

#### Multilateral development banks

| Credit quality step | Risk weighting | Moody's ratings | Fitch's ratings | EAD Pre-CRM<br>£m | EAD Post-CRM<br>£m |
|---------------------|----------------|-----------------|-----------------|-------------------|--------------------|
| 1                   | 0%             | Aaa to Aa3      | AAA to AA-      | 51.0              | 51.0               |

## Financial Institutions

| Credit quality step | Risk weighting | Moody's ratings | Fitch's ratings | EAD Pre-CRM<br>£m | EAD Post-CRM<br>£m |
|---------------------|----------------|-----------------|-----------------|-------------------|--------------------|
| 1                   | 20%            | Aaa to Aa3      | AAA to AA-      | 124.3             | 112.5              |
| 2                   | 20%/50%        | A1 to A3        | A+ to A-        | 10.5              | 4.9                |
| 3                   | 20%/50%        | Baa1 to Baa3    | BBB+ to BBB-    | 120.8             | 107.7              |
| n/a                 | 20%/50%        | Unrated         | Unrated         | -                 | -                  |
|                     |                |                 |                 | <b>255.6</b>      | <b>225.1</b>       |

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 market valuation of the Group's derivatives with a 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 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 £4,547m (2014: £4,361m) of which £4,547m (2014: £4,361m) was eligible for netting as part of the CSA.

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

|   | Dec-2015<br>£m | Dec-2014<br>£m |
|---|----------------|----------------|
| Interest rate contracts - Prior to netting        | 17.7           | 26.2           |
| Cross currency contracts - Prior to netting       | -              | 2.0            |
| Other contracts - Prior to netting                | 3.6            | 2.7            |
| <b>Gross positive fair value of contracts</b>     | <b>21.3</b>    | <b>30.9</b>    |
| Netting benefits                                  | (31.5)         | (39.7)         |
| <b>Netted current credit exposure</b>             | <b>(10.2)</b>  | <b>(8.8)</b>   |
| Collateral used                                   | 8.7            | 7.2            |
| Negative replacement costs due to netting         | 4.1            | 2.3            |
| Potential future credit exposure                  | 10.4           | 11.3           |
| <b>Net derivative credit exposure<sup>†</sup></b> | <b>13.0</b>    | <b>12.0</b>    |

<sup>†</sup>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 2015 Annual Report and Accounts on pages 79-80.

#### 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 2015.

|                                      | Retail financial services<br>£m | Secured personal lending<br>£m | Commercial lending<br>£m | Total<br>£m    |
|--------------------------------------|---------------------------------|--------------------------------|--------------------------|----------------|
| Up to date                           | 5,668.6                         | 482.7                          | 806.8                    | 6,958.1        |
| <b>Past due:</b>                     |                                 |                                |                          |                |
| Up to 3 months                       | 75.7                            | 22.8                           | 1.3                      | 99.8           |
| 3 to 6 months                        | 13.0                            | 9.8                            | -                        | 22.8           |
| 6 to 12 months                       | 11.6                            | 6.4                            | -                        | 18.0           |
| Over 12 months                       | 4.2                             | 7.7                            | -                        | 11.9           |
| Possessions                          | 2.1                             | -                              | 5.4                      | 7.5            |
|                                      | <b>106.6</b>                    | <b>46.7</b>                    | <b>6.7</b>               | <b>160.0</b>   |
| <b>Total exposures</b>               | <b>5,775.2</b>                  | <b>529.4</b>                   | <b>813.5</b>             | <b>7,118.1</b> |
| Provisions                           | 6.3                             | 18.2                           | 24.7                     | 49.2           |
| <b>Charge/(Release) for the year</b> | <b>1.2</b>                      | <b>(1.4)</b>                   | <b>5.0</b>               | <b>4.8</b>     |

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 2015.

|                                    | Individual provision<br>£m | Collective provision<br>£m | Total<br>£m |
|------------------------------------|----------------------------|----------------------------|-------------|
| Balance at 1 January 2015          | 36.6                       | 26.1                       | 62.7        |
| Charge for the year                | 1.0                        | 3.8                        | 4.8         |
| Write-offs                         | (18.3)                     | -                          | (18.3)      |
| <b>Balance at 31 December 2015</b> | <b>19.3</b>                | <b>29.9</b>                | <b>49.2</b> |

### Available for sale assets

As at 31 December 2015, none (2014: 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 £51.0m 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 concentration in Wales. As at 31 December 2015, approximately 29.9% of retail and secured personal lending loan exposures by account and 27.5% 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 3.8% 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 for mortgages located both within and outside of Wales.

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 Loss Given Default (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 Individual 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 June 2015; the latest version, which will be prepared under the new ILAAP rules, is due for final approval by Board in May 2016. 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 element's 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, Asset and Liability Committee (ALCo), Group Management Committee (GMC) and Group Risk Committee (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 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 2015 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 27-40 of the 2015 Annual Report and Accounts.

## 7.4 Conduct Risk

Conduct risk is the risk of the Principality Group treating its customers unfairly resulting in the delivery of inappropriate outcomes. The Board has no appetite for unfair customer outcomes arising at any stage and focus on its efforts in those areas where conduct risk is most likely to occur to ensure 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 27-40 of the 2015 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 prudential risk categories is expressed by the Board by reference to the most significant net risks recorded in the Group's risk registers. Each risk on the risk 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 is linked to an assessment of the risk registers and highest scoring risks.

The effectiveness of management controls are reviewed by the Group Risk Director, the Group Operational Risk Manager and specialist teams forming part of the Group's 'Second Line of Defence' by reference to key risk indicators and operational loss reports. Initial challenge, where appropriate, to the risk owners' assessment is provided by Group Risk and subsequently by GMC prior to completion of 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 Group Operational Risk Committee (GORC) on a quarterly basis. Group Risk Committee 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 27–40 of the 2015 Annual Report and Accounts.

## 8. Securitisation

### 8.1 Retained Securitisation Positions

The Group has entered into two Residential Mortgage Backed Security (RMBS) issues as a means of raising wholesale funding. The RMBS issues involved the formation of two special purpose entities (SPE's), Friary No.1 plc and Friary No.2 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.1 plc and Friary No. 2 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.1 plc and Friary No. 2 plc base prospectuses, copies of which can be found at [www.euroabs.com](http://www.euroabs.com).

The equity of both Friary No.1 plc and Friary No.2 plc is 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.1 plc and Friary No.2 plc have met their liabilities.

As at 31 December 2015, £325.9m (2014: £394.5m) of mortgages issued by the Society had been transferred to Friary No.1 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 £345.4m (2014: £410.5m), with £259.2m (2014: £288.6m) retained by the Group. £131.2m (2014: £170.6m) of these self-issued securities are capable of repo financing either directly with the market or with central banks to which the Group has access. As at 31 December 2015, 1.13% (2014: 1.4%) of the mortgages transferred to Friary No. 1 plc were greater than 2 months in arrears.

As at 31 December 2015, £386.5m (2014: £467.5m) 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 £410.6m (2014: £494.7m), with £45.5m (2014: £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 2015, 0.72% (2014: 0.25%) of the mortgages transferred to Friary No. 2 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 2015 are as follows:

| Securitisation Company | Type                 | Date of Securitisation | Dec-2015 Notes in Issue<br>£m | Dec-2015 Balance<br>£m | Dec-2014 Notes in Issue<br>£m | Dec-2014 Balance<br>£m |
|------------------------|----------------------|------------------------|-------------------------------|------------------------|-------------------------------|------------------------|
| Friary No.1 plc        | Residential mortgage | 11 August 2011         | 345.4                         | 325.9                  | 410.5                         | 394.5                  |
| Friary No.2 plc        | Residential mortgage | 9 June 2014            | 410.6                         | 386.5                  | 494.7                         | 467.5                  |

| Note Class             | Dec-2015<br>Balance<br>£'m | Dec-2014<br>Balance<br>£'m |
|------------------------|----------------------------|----------------------------|
| <b>Friary No.1 plc</b> |                            |                            |
| A1                     | -                          | -                          |
| A2                     | 217.4                      | 282.5                      |
| B                      | 128.0                      | 128.0                      |
| <b>Friary No.2 plc</b> |                            |                            |
| A                      | 365.1                      | 449.2                      |
| B                      | 45.5                       | 45.5                       |

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 2012, the Group became a member of the FLS. As at 31 December 2015 the Group had outstanding liabilities under the scheme of £207.0m (2014: £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 21.1% (2014: 19.0%) of total assets, further details are provided in note 17 to the 2015 Annual Report and Accounts. Further information on accounting policies for securitisations are included in note 1 to the 2015 Annual Report and Accounts.

## 8.2 Purchased Securitisation Positions

Since May 2012 the Society has selectively purchased senior tranches of positions in Residential Mortgage Backed Securities (RMBS). The Society's total exposure to purchased securitisation positions at 31 December 2015 was £36.9m (2014: £31.3m) 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-2015 Exposure Value<br>£'m | Dec-2015 Exposure Weighted Average RW<br>% | Dec-2014 Exposure Value<br>£'m | Dec-2014 Exposure Weighted Average RW<br>% |
| 1                   | AAA     | Aaa     | AAA   | 36.9                           | 20.0                                       | 31.3                           | 20.0                                       |

The purchased securitisation positions are all residential mortgages which have all been originated and issued in the UK.

## 9. Appendix A – Grandfathering Profile & Capital Allowances

|                      | Limits | Tier 1 Grandfather Limit<br>£m | Tier 1 assigned<br>£m | Tier 2 Grandfather Limit<br>£m | Tier 2 assigned<br>£m | Excess Tier 1 Available<br>£m | Excess allowed to be classed as Tier 2<br>£m | Available for inclusion in Tier 2<br>£m |
|----------------------|--------|--------------------------------|-----------------------|--------------------------------|-----------------------|-------------------------------|--|---|
| <b>2012 Year End</b> |        | 60.0                           | 60.0                  | 92.3                           | 64.6                  | n/a                           | n/a  | n/a                                     |
| <b>01/01/2014</b>    | 80%    | 48.0                           | 48.0                  | 51.7                           | 46.2                  | 12.0                          | 5.5  | 5.5                                     |
| <b>30/06/2014</b>    | 80%    | 48.0                           | 48.0                  | 51.7                           | 36.9                  | 12.0                          | 14.8   | 12.0                                    |
| <b>31/12/2014</b>    | 80%    | 48.0                           | 48.0                  | 51.7                           | 27.7                  | 12.0                          | 24.0   | 12.0                                    |
| <b>01/01/2015</b>    | 70%    | 42.0                           | 42.0                  | 45.2                           | 27.7                  | 18.0                          | 17.5   | 17.5                                    |
| <b>30/06/2015</b>    | 70%    | 42.0                           | 42.0                  | 45.2                           | 18.5                  | 18.0                          | 26.7   | 18.0                                    |
| <b>31/12/2015</b>    | 70%    | 42.0                           | 42.0                  | 45.2                           | 9.2                   | 18.0                          | 36.0   | 18.0                                    |
| <b>01/01/2016</b>    | 60%    | 36.0                           | 36.0                  | 38.8                           | 9.2                   | 24.0                          | 29.6   | 24.0                                    |
| <b>30/06/2016</b>    | 60%    | 36.0                           | 36.0                  | 38.8                           | 0.4                   | 24.0                          | 38.4   | 24.0                                    |
| <b>31/12/2016</b>    | 60%    | 36.0                           | 36.0                  | 38.8                           | -                     | 24.0                          | 38.8   | 24.0                                    |
| <b>01/01/2017</b>    | 50%    | 30.0                           | 30.0                  | 32.3                           | -                     | 30.0                          | 32.3   | 30.0                                    |
| <b>30/06/2017</b>    | 50%    | 30.0                           | 30.0                  | 32.3                           | -                     | 30.0                          | 32.3   | 30.0                                    |
| <b>31/12/2017</b>    | 50%    | 30.0                           | 30.0                  | 32.3                           | -                     | 30.0                          | 32.3   | 30.0                                    |
| <b>01/01/2018</b>    | 40%    | 24.0                           | 24.0                  | 25.8                           | -                     | 36.0                          | 25.8   | 25.8                                    |
| <b>30/06/2018</b>    | 40%    | 24.0                           | 24.0                  | 25.8                           | -                     | 36.0                          | 25.8   | 25.8                                    |
| <b>31/12/2018</b>    | 40%    | 24.0                           | 24.0                  | 25.8                           | -                     | 36.0                          | 25.8   | 25.8                                    |
| <b>01/01/2019</b>    | 30%    | 18.0                           | 18.0                  | 19.4                           | -                     | 42.0                          | 19.4   | 19.4                                    |
| <b>30/06/2019</b>    | 30%    | 18.0                           | 18.0                  | 19.4                           | -                     | 42.0                          | 19.4   | 19.4                                    |
| <b>31/12/2019</b>    | 30%    | 18.0                           | 18.0                  | 19.4                           | -                     | 42.0                          | 19.4   | 19.4                                    |
| <b>01/01/2020</b>    | 20%    | 12.0                           | 12.0                  | 12.9                           | -                     | 48.0                          | 12.9   | 12.9                                    |
| <b>30/06/2020</b>    | 20%    | 12.0                           | 12.0                  | 12.9                           | -                     | 48.0                          | 12.9   | 12.9                                    |
| <b>31/12/2020</b>    | 20%    | 12.0                           | 12.0                  | 12.9                           | -                     | 48.0                          | 12.9   | 12.9                                    |
| <b>01/01/2021</b>    | 10%    | 6.0                            | 6.0                   | 6.5                            | -                     | 54.0                          | 6.5  | 6.5                                     |
| <b>30/06/2021</b>    | 10%    | 6.0                            | 6.0                   | 6.5                            | -                     | 54.0                          | 6.5  | 6.5                                     |
| <b>31/12/2021</b>    | 10%    | 6.0                            | 6.0                   | 6.5                            | -                     | 54.0                          | 6.5  | 6.5                                     |

## 10. Appendix B - Remuneration

The following table displays the 2015 remuneration for the Group's managers and members of staff whose actions have a material impact on the risk profile of the Group (Code Staff). This includes executive and non-executive directors.

The Report of the Remuneration Committee contained within the 2015 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 one severance payment of £27,000 was made.

### Aggregate Code Staff Remuneration

Details of remuneration paid to code staff are as follows:

|              | Number of beneficiaries | Fixed remuneration<br>£k | Variable remuneration<br>£k | Total remuneration<br>£k | Outstanding deferred remuneration<br>£k |
|--------------|-------------------------|--------------------------|-----------------------------|--------------------------|---|
| <b>Group</b> | 33                      | 4,223                    | 746                         | 4,969                    | 258                                     |

## 11. Glossary of Terms

|                                   |   |
|-----------------------------------|---|
| <b>AFS reserve</b>                | Available For Sale reserve. The valuation of our available for sale assets such as gilts and treasury bills.  |
| <b>AVA</b>                        | Additional Value Adjustment. The prudential valuation of all fair valued assets which, as per CRR article 34, is deducted from CET1   |
| <b>Basel II</b>                   | 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.   |
| <b>Basel III</b>                  | 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 1 <sup>st</sup> January 2014. |
| <b>Basis Risk</b>                 | Basis risk is the exposure arising from the imperfect correlation between re-pricing of interest rates on different assets and liabilities.   |
| <b>CCB</b>                        | 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.  |
| <b>CCyB</b>                       | Counter-Cyclical Capital Buffer. Based on national circumstances a buffer between 0% - 2.5% of Common Equity Tier 1 capital.  |
| <b>CCF</b>                        | Credit Conversion Factor. An estimation of the drawdown of an undrawn facility.   |
| <b>CET1</b>                       | 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.   |
| <b>Code Staff</b>                 | 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.  |
| <b>Counterparty Credit Risk</b>   | Counterparty credit risk is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.  |
| <b>CQS (Credit Quality Steps)</b> | 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).  |
| <b>CRD IV</b>                     | Capital Requirements Directive IV. This implements Basel III through national law.  |
| <b>Credit risk</b>                | 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.   |

|                               |  |
|-------------------------------|--|
| <b>Credit risk mitigation</b> | 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. |
| <b>CRR IV</b>                 | Capital Requirements Regulation IV. This implements Basel III directly to firms across the EU.   |
| <b>CVA</b>                    | Credit Valuation Adjustment. The adjustment reflects the current market value of the credit risk of the counterparty to the institution.   |
| <b>EAD</b>                    | Exposure at Default. An estimate of the outstanding balance if the customer does default.  |
| <b>ECAI</b>                   | 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.  |
| <b>FCA</b>                    | Financial Conduct Authority. The financial services industry regulator in the UK for Conduct issues  |
| <b>FSA</b>                    | Financial Services Authority. The previous financial services industry regulator in the UK superseded by the PRA and the FCA.  |
| <b>Guarantee</b>              | An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.  |
| <b>ICAAP</b>                  | 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.                    |
| <b>ICG</b>                    | Individual Capital Guidance. The minimum amount of capital the Group should hold as set by the PRA under Basel III Pillar 2.   |
| <b>ILAAP</b>                  | Individual 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.   |
| <b>Interest rate risk</b>     | Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.   |
| <b>IRB</b>                    | 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.  |
| <b>LIBOR</b>                  | London Inter Bank Offered Rate.  |
| <b>LGD</b>                    | Loss Given Default. An estimate of the outstanding balance not recovered and the costs associated with that recovery process.  |

|                                    |  |
|------------------------------------|--|
| <b>LTV</b>                         | 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)).   |
| <b>Maturity</b>                    | 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.   |
| <b>Minimum capital requirement</b> | 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.   |
| <b>Netting</b>                     | The ability to reduce credit risk exposures by offsetting the value of any deposits against loans to the same counterparty.  |
| <b>Operational risk</b>            | The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.  |
| <b>PD</b>                          | Probability of Default. The probability of defaulting in the next 12 months  |
| <b>PIBS</b>                        | 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.  |
| <b>Pillar 1</b>                    | The part of the Basel III Framework which sets out the regulatory minimum capital requirements for credit and operational risk.  |
| <b>Pillar 2</b>                    | 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. |
| <b>Pillar 3</b>                    | 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.  |
| <b>PPI</b>                         | Payment Protection Insurance.  |
| <b>PRA</b>                         | Prudential Regulation Authority. The financial services industry regulator in the UK for prudential risk   |
| <b>Provisions</b>                  | Amounts set aside to cover losses associated with credit risks.  |



|  |  |
|--|--|
| <b>Securitisation</b>                                | 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.   |
| <b>SPE</b>   | 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). |
| <b>Stress testing</b>                                | Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.  |
| <b>SREP</b>  | Supervisory Review and Evaluation Process. (CRD IV Section III, the PRA's process for reviewing the adequacy of a firm's ICAAP)  |
| <b>Subordinated debt</b>                             | 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.  |
| <b>The Standardised Approach (credit risks)</b>      | 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.  |
| <b>The Standardised Approach (operational risks)</b> | 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.   |
| <b>Total Remuneration</b>                            | The sum of fixed pay, variable pay, director fees, car allowance, pension and benefits in kind.  |