BASEL III PILLAR 3
DISCLOSURES

2017







Building your future

Principality
Building Society
Cymdeithas Adeiladu

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Contents

1. Key Regulatory Metrics

	Common Equity Tier 1 Capital £m	Common Equity Tier 1 Capital %
Dec-2017	**511.1**	**26.1**
Dec-2016	468.7	23.5
Dec-2015	435.5	21.0

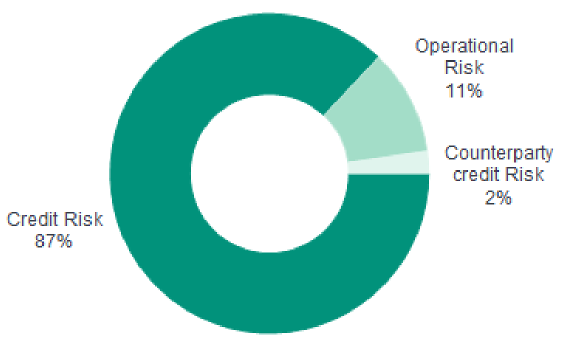
	Tier 1 Capital £m	Tier 1 Ratio %
Dec-2017	**541.1**	**27.7**
Dec-2016	504.7	25.3
Dec-2015	477.5	23.0

	Total Regulatory Capital £m	Total Capital Ratio %
Dec-2017	**571.1**	**29.2**
Dec-2016	528.7	26.5
Dec-2015	504.7	24.3

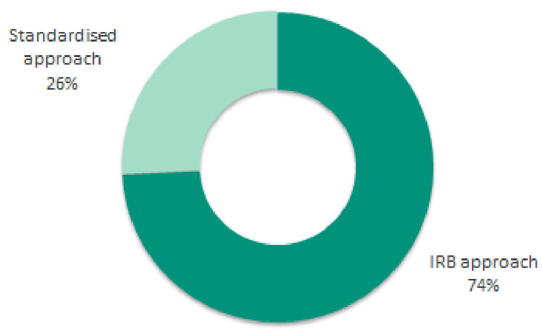
	Leverage Exposure £m	Leverage Ratio (Transitional Position) %
Dec-2017	**9,615.2**	**5.6**
Dec-2016	8,565.6	5.9
Dec-2015	7,967.1	6.0

	Leverage Exposure £m	Leverage Ratio (End State Position) %
Dec-2017	**9,615.2**	**5.3**
Dec-2016	8,565.6	5.5
Dec-2015	7,967.1	5.5

RWAs by risk type - December 2017



Credit Risk RWA's by Basel Approach - December 2017



*Detail on scope of permission is covered in Section 2.3.4

2. Overview

2.1 Introduction

The Capital Requirements Directive IV (CRD IV), commonly known as Basel III, came into effect on 1 January 2014 and transitional rules are in place until 1 January 2022. This document is prepared under the transitional Basel III rules for the year ending 31 December 2017, compared with 2016 results, also prepared under the transitional Basel III requirements. Additionally the document states the position of the core building society and its subsidiary undertakings (the Society) 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 prescribed 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 prescribed standardised parameters for LGD and credit conversion factors are used.
        - **Specialised Lending Exposures:** where prescribed standardised parameters for risk weight and expected loss are set based on risk grade allocated.
- **Pillar 2** – This is the supervisory review process which requires firms to undertake an Individual Capital Adequacy Assessment Process (ICAAP) for Pillar 1 and other risks not captured in Pillar 1 (see Section 4.1) and to agree total capital requirements with the regulator; and
- **Pillar 3** – This outlines market discipline such as requirements for disclosure of risk and capital information as specified in the Basel rules to promote transparency and good risk management allowing the market to assess and compare the capital adequacy of firms.

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

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

2.3 Basis of Preparation

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

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

2.3.1 Frequency of Disclosure

Disclosures are issued at least annually, unless otherwise stated, all figures are as at 31 December 2017, the Society'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 Society's balance sheet is reported as a drawn balance only. This is one of the reasons that exposure values in the Pillar 3 report will differ from asset values as reported in the 2017 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 Society; this is enforced by the PRA and Financial Conduct Authority (FCA) through regulation. The Society is made up of the following trading entities:

- Principality Building Society
- Nemo Personal Finance Limited

Full details of the principal subsidiary undertakings are included in note 20 to the 2017 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 2017 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 Society.

2.3.4 Scope of Permission of Internal Ratings Based Approach

The Society received approval to adopt the IRB approach for credit risk in 2013. The IRB approach has been applied to first charge Retail and Commercial portfolios from 1 October 2013. The decision made during 2015 to cease new lending in Nemo Personal Finance Limited the Society's second charge business and focus the Society's resources on the core Retail and Commercial businesses has resulted in the Society's second charge mortgages remaining on the standardised with the approval of the PRA.

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

2.3.5 Location of Risk Disclosures

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

2.3.6 Verification and Sign-off

These disclosures are not subject to external audit except where they are equivalent to those prepared under accounting requirements for inclusion in the Society's audited Annual Report and

Accounts. They are reviewed internally by the Audit Committee in accordance with the Society's policies on disclosure and its financial reporting and governance process.

2.3.7 Remuneration

The responsibilities and decision-making process for determining remuneration policy, the link between pay and performance and the design and structure of remuneration, including the performance pay plans, have been disclosed in the Report of the Remuneration Committee on pages 62-68 in the 2017 Annual Report and Accounts.

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

3. Capital Resources

3.1 Total Regulatory Capital and Reconciliation to Accounting Capital

As at 31 December 2017 and throughout the year, the Society complied with the capital requirements set out by the PRA. The following table shows the breakdown of the total available capital for the Society under the Basel III rules:

	Notes	Dec-2017 £m	Dec-2016 £m
General Reserves	1	519.3	476.0
AFS Reserves	2	1.1	2.4
Total Accounting Capital		**520.4**	**478.4**
Adjustments for Regulatory Capital:-			
Intangible Assets	3	(0.8)	(1.3)
Additional Value Adjustment (AVA)	4	(0.1)	(0.4)
Deferred Income	5	(0.1)	(0.3)
Provision Deductions	6	(8.3)	(7.7)
Common Equity Tier 1 Capital		**511.1**	**468.7**
Permanent Interest Bearing Shares (PIBS)	7	30.0	36.0
Additional Tier 1 Capital		**30.0**	**36.0**
Total Tier 1 Capital		**541.1**	**504.7**
Tier 2 Allowance of Grandfathered AT1	8	**30.0**	**24.0**
Tier 2 Capital		**30.0**	**24.0**
Total Tier 2 Capital		**30.0**	**24.0**
Total Regulatory Capital Resource		**571.1**	**528.7**

Notes and General Information on Capital Resources

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

Further details of the general reserve are provided in the Society's Statement of Changes in Members Interest on page 84 of the 2017 Annual Report and Accounts.

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

3. Intangible assets include software development costs.

Further details of the intangible assets are provided in note 21 to the 2017 Annual Report and Accounts.

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

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

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

7. Permanent Interest Bearings Shares (PIBS) are unsecured deferred shares and rank behind the claims of all subordinated note holders, depositors, creditors and investing Members of the Society. They are no longer eligible as Tier 1 Capital under Basel III and 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 2017 Annual Report and Accounts.

8. Due to the maturity of the Society's Subordinated notes, the Society'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).

The Society does not deduct its deferred tax assets (£1.1m) that rely on future profitability from CET1. This is in line with CRR Article 48 which states that, if such assets fall below a threshold of 10% of CET1, they need not be deducted.

4. Capital Adequacy

4.1 Capital Management

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

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

Details of the methodologies used are included in Section 7.

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

The Society's minimum capital level is that which the Board considers necessary to protect unsecured creditors from loss and reflects the Society'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 Society conducts an ICAAP to assess the Society's capital adequacy and determine the levels of capital required to support the current and future risks faced by the Society. The ICAAP covers all material risks to determine the impact of 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 2017. The ICAAP is used by the PRA to determine and set the Society's Total Capital Requirement (TCR) and PRA buffer, if required. The TCR was last recalibrated by the PRA after the Society's Supervisory Review and Evaluation Process (SREP) visit in 2017, with the recalibration from the visit in late 2017 coming into effect in January 2018.

The amounts and composition of the Society'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 a TCR set by the PRA).

At 31 December 2017 the Society's Pillar 1 and 2A TCR as a proportion of RWA equates to 13.8% of risk weighted assets of which 7.7% has to be covered by CET 1 capital. This reflects a point-in-time (PIT) estimate by the PRA, which may change over time, of the total amount of capital that is needed by the Society. The Society is not permitted by the PRA to provide any further details regarding the individual components in respect of Pillar 2A.

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

Regulatory environment

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

In particular, the implementation of potential changes to the IRB framework, capital floors and revisions to the methodology of standardised calculations have been considered and continue to be monitored and assessed for impacts as more details are made available by the regulatory bodies. The Society is satisfied that current forecast levels of capital are sufficient to meet associated requirements.

IFRS9

In line with accounting requirements from the 1 January 2018 the Society will calculate provisions under IFRS9 in place of IAS39. The PRA has advised that all financial institutions should make use of a transitional adjustment to smooth the potential impact and volatility of the new provisioning method; the Society will make use of the transition. The Society's total provisions on implementation of IFRS9 increased from £30.3m to £33.0m, the impact of IFRS9 on capital resources of the society is minimal, further information on IFRS9 is available on pages 87-90 in the 2017 Annual Report and Accounts.

Capital Requirement

The Society'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-2017 Average Risk Weights %	Dec-2017 £m	Dec-2016 £m
Retail financial services	11%	66.5	60.1
Secured personal lending	39%	9.6	12.3
Retail financial services-Past due items	203%	3.2	4.1
Secured personal lending-Past due items	105%	0.9	1.7
Retail exposures classes		**80.2**	**78.2**
Commercial lending - Non housing association	89%	46.4	49.1
Commercial lending - Housing association	35%	4.4	4.3
Commercial lending - Past due items*	0%	-	-
Commercial exposure classes		**50.8**	**53.4**
Financial institutions	3%	3.5	2.8
Other exposure classes		**3.5**	**2.8**
Fixed and other assets	99%	4.9	7.8
Other		**4.9**	**7.8**
Credit risk minimum capital requirement		**139.4**	**142.2**
Operational risk		16.8	17.4
CVA		0.2	0.2
Total minimum capital required		**156.4**	**159.8**
Total own funds		571.1	528.7
Excess of own funds over minimum capital requirement under Pillar 1		**414.7**	**368.9**

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

4.2 Movements in RWA

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

	£m
Position as at 31 December 2016	**1,997.6**
Increase due to net mortgage book growth	94.3
Increase due to net treasury book growth	11.9
Movement in risk profile	(110.1)
Change due to Other Assets	(36.7)
Change in impact of netting	5.0
Decrease in Operational Risk	(7.4)
Increase of CVA	0.8
Position as at 31 December 2017	**1,955.4**

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 Society 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 was 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 Society's PIBS no longer qualify as Tier 1 capital. The rules allow for instruments that are no longer eligible for inclusion in Tier 1 to be grandfathered (phased) out of eligibility over the 8 years between 1 January 2014 and 1 January 2022. During 2017 the Society can recognise a maximum of 50% of the eligible value of the PIBS at December 2012 and this percentage will continue to reduce by 10% per annum.

The grandfathering rules allow any Tier 1 capital that exceeds the Tier 1 capital grandfathering limit to be included as Tier 2 capital provided the maximum Tier 2 capital grandfathering limit is not exceeded. As the grandfathering limit for the Society is based on the amount of subordinated debt eligible as capital at December 2012 the Society 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 Society will remain well capitalised. The table below shows the Society's capital position prepared in accordance with the Basel III rules to date, transitional rules for the coming year and the final position.

Common Equity Tier 1 (CET1) capital: instruments and reserves	Notes	Basel III 31.12.2017 £m	Adjustments £m	Transitional Basel III Rules 01.01.18 £m	Final Basel III Rules £m
General and Other Reserves		520.4	-	520.4	520.4
Common Equity Tier 1 (CET1) capital before regulatory adjustments		**520.4**	**-**	**520.4**	**520.4**
Common Equity Tier 1 (CET1) capital: regulatory adjustments					
Additional value adjustments		(0.1)	-	(0.1)	(0.1)
Intangible assets		(0.8)	-	(0.8)	(0.8)
Negative amounts resulting from the calculation of expected loss amounts		(8.3)	-	(8.3)	(8.3)
Exposure amount of the following items which qualify for a RW of 1250%, where the institution opts for the deduction alternative		(0.1)	-	(0.1)	(0.1)
Total regulatory adjustments to Common Equity Tier 1 (CET1)		**(9.3)**	**-**	**(9.3)**	**(9.3)**
Common Equity Tier 1 (CET1) capital		**511.1**	**-**	**511.1**	**511.1**
Amount of qualifying items referred to in Article 484 (4) phased out from AT1	1	30.0	(6.0)	24.0	-
Additional Tier 1 (AT1) capital before regulatory adjustments		**30.0**	**(6.0)**	**24.0**	**-**
Additional Tier 1 (AT1) capital		**30.0**	**(6.0)**	**24.0**	**-**
Tier 1 capital (T1 = CET1 + AT1)		**541.1**	**(6.0)**	**535.1**	**511.1**
Amount of qualifying items referred to in Article 484 (5) phased out from T2		-	-	-	-
Tier 2 allowance of Grandfathered AT1	2	30.0	(4.2)	25.8	-
Tier 2 (T2) capital before regulatory adjustments		**30.0**	**(4.2)**	**25.8**	**-**
Tier 2 (T2) capital (T2 less regulatory adjustments)		**30.0**	**(4.2)**	**25.8**	**-**
Total capital (TC = T1 + T2)		**571.1**	**(10.2)**	**560.9**	**511.1**
Total risk weighted assets		**1,955.4**	**-**	**1,955.4**	**1,955.4**

Capital ratios and buffers	Basel III 31.12.2017	Adjustments	Transitional Basel III Rules 01.01.18	Final Basel III Rules
Common Equity Tier 1 (as a percentage of total risk exposure amount)	26.1%	0.0%	26.1%	26.1%
Tier 1 (as a percentage of total risk exposure amount)	27.7%	(0.3%)	27.4%	26.1%
Total capital (as a percentage of total risk exposure amount)	29.2%	(0.5%)	28.7%	26.1%
Institution specific buffer requirement				
Common Equity Tier 1 available to meet buffers (as % of risk exposure amount)			14.9%	12.4%
Amounts below the thresholds for deduction (before risk weighting)				
Deferred tax assets arising from temporary differences	1.1	-	1.1	1.1
Applicable caps on the inclusion of provisions in Tier 2				
Cap on inclusion of credit risk adjustments in T2 under standardised	6.3	-	6.3	6.3
Cap for inclusion of credit risk adjustments in T2 under IRB approach	8.7	-	8.7	8.7
Capital instruments subject to phase-out arrangements (only applicable between 1 Jan 2014 and 1 Jan 2022)				
Current cap on AT1 instruments subject to phase out arrangements	30.0	(6.0)	24.0	-
Amount excluded from AT1 due to cap	30.0	6.0	36.0	60.0
Current cap on T2 instruments subject to phase out arrangements	32.3	(6.5)	25.8	-
Amount excluded from T2 due to cap	-	(10.2)	(10.2)	-

Notes and General Information on Basel III Impacts

1. As per the PRA's transitional provisions the Society's PIBS will grandfather out of eligibility for Tier 1 and therefore only 50% of the value eligible at 31 December 2012 can be recognised during 2017 and 40% during 2018. See **Appendix A.**

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

Given the phasing of both capital requirements and target levels, in advance of needing to comply with the fully loaded end state requirements, the Society has and will have the opportunity to continue to generate additional capital from earnings and take management actions to mitigate the impact of Basel III. Ineligible Tier 1 capital, which qualifies for grandfathering under the transitional relief, can 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 CET1 capital buffers, expressed as a percentage of total RWA's. A Capital Conservation Buffer (CCB) of 2.5% and a Counter-Cyclical Capital Buffer (CCyB) of up to 2.5% can be applied by regulators when macroeconomic conditions dictate.

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

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

The amount of capital required for the CCyB was set at 0% in June 2016 and currently remains at this level. This was a response by the Financial Policy Committee (FPC) to greater uncertainty relating to the UK economic outlook following the EU Referendum, providing banks with the clarity necessary to facilitate their capital planning. During June 2017 the FPC reaffirmed that it will raise UK CCyB rate to 0.5% with a 12 month lead time to the implementation date of June 2018. The FPC confirmed in November 2017 that they had agreed on a further 0.5% rise to the UK CCyB, again with a 12 month notice period to allow institutions to build up their CET1 capital.

The UK CCyB will therefore be 1% by the end of 2018, the FPC have previously stated that they expect to set a CCyB in the region of 1% when risks are judged to be neither subdued nor elevated in the UK economy.

All of the Society's exposures are domiciled within the UK meaning the Society is not required to hold any capital for the CCyB in relation to foreign exposures.

The CCB is transitioning into effect in yearly increments of 0.625% starting on 1 January 2016, with the entirety of the 2.5% requirement being applicable on 1 January 2019. This means that the CCB for the coming year is 1.875% as of 1 January 2018. This transition only has an impact on an institution's overall buffer if the transitional increment (0.625%) exceeds the difference between the PRA buffer and the combined regulatory buffer.

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

The available CET1 capital as a percentage of risk weighted assets to meet these buffers when they are implemented is shown in Section 5.2.

Due to the nature of the Society's capital structure, predominately high quality CET1, the Society currently operates with an excess over the regulatory minima and continues to be able to meet comfortably minimum requirements over the longer term planning horizon.

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.

During 2017 the PRA's UK leverage ratio framework was amended to allow institutions within its scope to exclude Bank of England assets from their leverage calculations, however as a result the PRA also adjusted the minimum ratio from 3% to 3.25%. This means that for every £1m of eligible capital institutions can hold up to £32.5m 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 4.125% if the CCyB is at its maximum of 2.5%.

The change to leverage calculation has not been reflected in European regulation and central bank exposures must still be included with the minimum ratio remaining at 3%. Currently the Society is not within scope of the UK leverage framework as retail deposits do not exceed £50bn; however the Society's ratio is well above the minimum requirements as disclosed below.

	Notes	Dec-2017 £m	Dec-2016 £m
Total Balance Sheet as per Statutory Accounts		**9,262.6**	**8,281.2**
Adjusted for:			
Potential future credit exposure for swaps		20.3	10.2
Off balance sheet exposures with a 50% CCF-Commercial lending commitments		34.7	30.3
Off balance sheet exposures with a 100% CCF-Retail commitments		306.9	253.6
Regulatory adjustment for Goodwill and Intangibles		(0.8)	(1.3)
Regulatory adjustments for AVA		(0.1)	(0.4)
Regulatory adjustments for Deferred Income		(0.1)	(0.3)
Provision Deductions		(8.3)	(7.7)
Leverage Exposure		**9,615.2**	**8,565.6**
Tier 1 capital (end state position)		511.1	468.7
Tier 1 capital (transitional position)	1	541.1	504.7
Leverage ratio using end state Tier 1 Capital		5.32%	5.47%
Leverage ratio using transitional Tier 1 Capital	1	5.63%	5.89%
UK Leverage ratio framework using end state Tier 1 Capital	2	6.01%	-
UK Leverage ratio framework using transitional Tier 1 Capital	1,2	6.36%	-

Notes and General Information on Leverage

1. The transitional position represents the Tier 1 capital and Leverage ratio at 31 December 2017 following Basel III transitional provisions.
2. The UK position shows the leverage ratio with Bank of England assets (£1.1bn) excluded from the Leverage Exposure measure as per the UK leverage ratio framework.

5.5 Capital Adequacy through transition

	Basel III 31.12.17	Transitional Basel III Rules 01.01.18	Final Basel III Rules 01.01.22
Total minimum capital required	156.4	156.4	156.4
Total own funds	571.1	560.9	511.1
Excess of own funds over minimum capital requirement under Pillar 1	**414.7**	**404.5**	**354.7**

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

The final transition date for MREL is 1 January 2022 and the Society expects, at all times, to meet MREL requirements over the Society's planning horizon.

6. Risk Management Objectives and Policies

6.1 Overview

The Society 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 Society also uses wholesale financial instruments to invest liquid asset balances, raise wholesale funding and to manage interest rate risk arising from its operations.

The Society'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 Society is exposed include business risk (including reputational risk), credit risk, liquidity risk, market risk, conduct risk, operational risk, solvency risk and legal and regulatory risk.

Further detail on these risks can be found in Section 7 and in the Risk Management Report on pages 46-57 of the 2017 Annual Report and Accounts.

The ways in which the Society 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 exposure to specific risks; and
- Using limits and triggers to control portfolio composition.

6.2 Risk Appetite

The Society is a mutual organisation with no shareholders. Members are entitled to take for granted that their money is safe. The Board Risk Committee (BRC) adopts a prudent attitude to risk when setting the risk appetite.

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

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

The Society 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 Society adopts a 'three lines of defence' model ensuring clear independence of responsibilities for risk control, oversight and governance. This is summarised below:

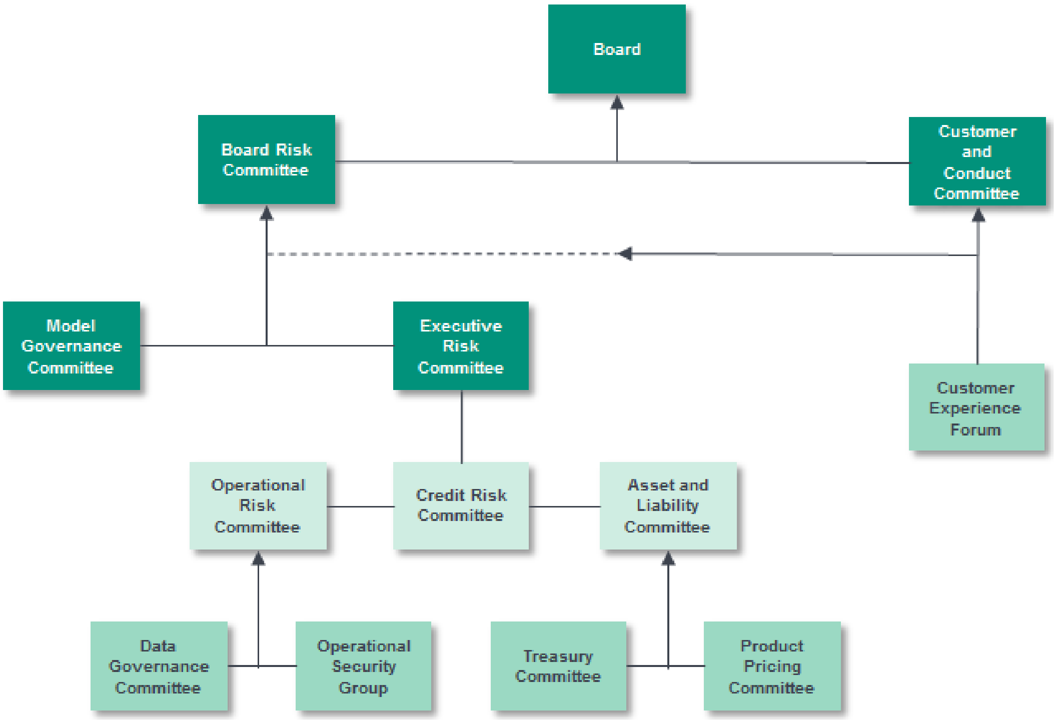
- **First line of defence –** primary responsibility for the identification, control, monitoring and mitigation of risk in their day-to-day activities lies with each individual across the business. These key risks are overseen by appropriate controls within an overall control environment.
- **Second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

- **Third line of defence –** the Internal Audit function is responsible for providing independent assurance of the effectiveness of the risk management structure and adherence to processes in the first and second lines.

6.4 Risk Governance

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

Within the risk structure set by the Board line managers are accountable for the identification, measurement and management of the risks within their areas of responsibility. Risk governance is provided by a structure consisting of six committees. Each committee has representation drawn from executive, divisional management and risk specialists. Further details on risk governance are included in the Risk Management Report on pages 46-57 of the 2017 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 Board Risk Committees.

The Customer and Conduct Committee (CCC), a separate Board committee, is responsible for providing oversight of the Society'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 Board Risk Committee.

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

6.4.2 Board Risk Committee

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

Executive Risk Committee

The Executive Risk Committee (ERC) is chaired by the Chief Risk Officer. Its primary responsibility is for the identification, control and mitigation of risk exposures and the oversight of all prudential and conduct risks across the Society.

Credit Risk Committee

The Credit Risk Committee (CRC), chaired by the Head of Credit Risk, is responsible for monitoring and reviewing exposure to credit risks in the Society's retail and commercial loan portfolios in line with the Board approved Risk Appetite statement.

Operational Risk Committee

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

Model Governance Committee

The Model Governance Committee (MGC), chaired by the Chief Financial Officer, is responsible for approval and oversight of models used by the Society to assess and quantify exposure to credit risk.

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

Asset and Liability Committee

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

6.5 Stress Testing

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 Society's financial position and risk profile provide sufficient resilience to withstand the impact of severe economic stress on the market (systemic stress) or firm specific stress events. Stress testing also informs the identification and calibration of early-warning triggers, management actions and contingency and recovery plans to mitigate or avoid potential stresses and vulnerabilities and as such is integral to the Society's risk management framework.

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

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

Further details on stress testing are included in the Risk Management report on pages 46-57 of the 2017 Annual Report and Accounts.

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 Society as they become due. The Society faces this risk primarily from loans to residential customers, loans to commercial customers and from the assets held by 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 Society'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 Society. Each of the business areas, residential first, 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 Society's overall approach to measure, mitigate and manage credit risk in a manner consistent with the risk appetite approved by the BRC 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 46-57 of the 2017 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
	Dec-2017	Dec-2017	Dec-2017	Dec-2017
Retail financial services	7,277.7	7,277.7	870.9	69.7
Secured personal lending	319.2	319.2	131.7	10.5
Commercial lending	813.5	813.5	635.2	50.8
	8,410.4	**8,410.4**	**1,637.8**	**131.0**
Treasury				
Central governments or central banks	1,110.0	1,110.0	-	-
Financial institutions	277.7	241.7	43.4	3.5
	1,387.7	**1,351.7**	**43.4**	**3.5**
Other assets	61.7	61.7	61.1	4.9
Total	**9,859.8**	**9,823.8**	**1,742.3**	**139.4**

*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 2017 is as follows:

EAD Pre-CRM	UK £m	Total £m
Retail financial services	7,277.7	7,277.7
Secured personal lending	319.2	319.2
Commercial lending	813.5	813.5
	8,410.4	**8,410.4**
Treasury		
Central governments or central banks	1,110.0	1,110.0
Financial institutions	277.7	277.7
	1,387.7	**1,387.7**
Other Assets	61.7	61.7
Total	**9,859.8**	**9,859.8**

The following table shows the residual maturity of the exposures at 31 December 2017. The maturity of exposures is shown on a contractual basis. This does not take into account any capital repayments receivable over the life of the exposure.

EAD Pre-CRM	Up to 12 months £m	1-5 years £m	More than 5 years £m	Total £m
Retail financial services	96.0	270.2	6,911.5	7,277.7
Secured personal lending	43.1	274.5	1.6	319.2
Commercial lending	164.5	404.0	245.0	813.5
	303.6	**948.7**	**7,158.1**	**8,410.4**
Treasury				
Central governments or central banks	1,110.0	-	-	1,110.0
Financial institutions	183.9	84.5	9.3	277.7
	1,293.9	**84.5**	**9.3**	**1,387.7**
Other assets	-	-	61.7	61.7
Total	**1,597.5**	**1,033.2**	**7,229.1**	**9,859.8**

7.1.2 Retail Financial Services Credit Risk

Credit risk is inherent in the Society's retail mortgage book. Credit risk is assessed both for the Society's existing mortgage assets and also for mortgage lending to which the Society 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 Society's residential mortgage portfolio is managed using a rating system which has been developed in line with the IRB approach to credit risk as described below.

The following table shows the Society's exposure to first charge retail mortgages under IRB at 31 December 2017:

PD Bands	Exposure at Default Estimate Dec-2017 £m	Exposure Weighted Average Loss Given Default Dec-2017	Average Risk Weight Dec-2017	Average Expected Loss Dec-2017
0%<=PD<0.2%	5,792.3	23.3%	6.4%	0.0%
0.2%<=PD<1%	1,289.7	30.0%	23.3%	0.1%
1%<=PD<9.3%	93.3	28.2%	70.5%	0.9%
9.3%<=PD<26.47%	46.4	22.0%	126.5%	3.8%
26.47%<=PD<44.36%	14.6	23.4%	135.7%	10.0%
44.36%<=PD<100%	21.8	22.6%	60.7%	17.4%
In default book	19.6	25.0%	203.4%	8.7%
Total	**7,277.7**	**24.6%**	**12.0%**	**0.2%**

IRB Approach Overview

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

- (PD) – the probability of an obligor defaulting in the next 12 months;
- (EAD) – an estimate of the outstanding balance if the customer does 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 calculated using the models listed above.

The PD model predicts the likelihood of a mortgage defaulting within the next 12 months. Default is defined as being six or more months in arrears, or earlier if the borrower displays one or more indicators that they are unlikely to make repayments. The probability of default is calculated using a combination of the credit score obtained at the point of application, the behavioural score and the arrears status of the mortgage. This approach allows for grade migration to occur as account performance is influenced by the economic cycle. The PD for retail mortgages uses a hybrid rating system that combines Point in Time 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 Pillar 1 capital requirement.

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

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

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

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

As at December 2016, the default prediction for the following year, which is derived from the Retail PD model, was 27% higher than the actual default rate experienced during 2017. This indicates that at an aggregate level the PD model is appropriately conservative. In 2017, 24 repossessed properties were sold (2016: 28). Three quarters of these were residential properties. The LGD model also remains conservative, with the average actual loss being lower than model predictions across the 24 observations.

With such a low volume of sales, an assessment of the performance of the LGD model is made acknowledging that there may be individual exceptional cases where the level of loss could not be reasonably predicted using a statistical modelling approach. With this in mind, actual loss experience has been favourable compared with the predictions of the LGD model.

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

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

IRB model governance

The MGC is the designated committee through which requests to implement any changes to the IRB rating system are initially submitted. 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.

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

Retail Credit Risk Management

A series of specific limits and thresholds have been established and reflect the Society'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 retail lending risk appetite.

The Credit Risk Committee reviews comprehensive risk based information on a quarterly basis and has appropriate controls in place to ensure that new lending complies with the Society's stated risk appetite. Limits and triggers are reviewed regularly by ERC and BRC 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 Society's subsidiary, Nemo Personal Finance Limited (Nemo), manages loans to individuals secured by way of a second charge over residential property. All customers therefore have an existing first mortgage, and a typical borrower requested finance to fund home improvements or to consolidate their debts. Depending on the borrower's status, loans were made available from £7,500 to £500,000 and were typically repayable over terms between three and twenty-five years.

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

Nemo Credit Risk Management

The strategy for secured personal lending is to continue to manage the business prudently, but not take any new business onto the loan book. Management information is presented regularly to the 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 BTV. At the point of application no LTV was greater than 100% although historically it has been possible for the capitalised Payment Protection Insurance (PPI) premium to raise the LTV above 100%. Defaulted exposures attract a risk weighting of between 100% and 150% depending on the BTV and the level of provisions held. Adjustments to the exposure for Effective Interest Rate are treated as unsecured.

7.1.4 Commercial Lending Credit Risk

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

The Society's commercial loan portfolio comprises the following:

	Drawn commitments £m	Un-drawn commitments* £m	Total £m
Loans to Registered Social Landlords secured on residential property	153.8	3.6	157.4
Other loans secured on residential property	342.0	25.9	367.9
Loans secured on commercial property	286.2	5.2	291.4
Effective Interest Rate adjustment	(3.2)	-	(3.2)
	778.8	**34.7**	**813.5**

*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 Society's commercial lending risk appetite. These are subject to monthly review by CRC and quarterly review by BRC. 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 Society remains cautious with regard to commercial lending which is undertaken on a prudent basis.

The Commercial Lending Division operates a relationship management approach. Each customer has a specific lending manager who is responsible for submitting credit applications for that customer (whether existing or new customer) and for managing the customer/lender relationship. Each lending manager is a highly experienced property lender with a strong track record gained in a traditional banking environment and/or within the division itself. Relationship managers are assigned based on experiences/seniority and on size/complexity. Exceptions to this are connections in weak or defaulted slots where exposures are managed by an Asset Management 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 Credit Risk Policy Statement. A risk grading framework has been developed, and the entire portfolio is risk graded. Additionally, with the exception of loans to Registered Social Housing Landlords, each exposure is assigned a Slot which will determine its risk weighting and in turn support underwriting decisions / sanctioning authorities alongside pricing requirements and wider portfolio management design principles. Every slot and risk grade is reviewed at least annually in line with the principles of good credit husbandry and IRB requirements.

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

	Remaining Maturity <2.5 years		Remaining Maturity >=2.5 years	
Slot	EAD £m	RWA %	EAD £m	RWA %
1-Strong	4.4	50.0%	13.6	70.0%
2-Good	166.9	70.0%	341.8	90.0%
3-Satisfactory	63.4	115.0%	41.4	115.0%
4-Weak	9.3	250.0%	2.2	250.0%
Non-Defaulted Total	**244.0**	**88.2%**	**399.0**	**92.8%**
5-Default	17.1	0%	0.1	0%
Totals	**261.1**	**82.4%**	**399.1**	**92.8%**

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

Performance of the slotting process is monitored quarterly at the MGC.

7.1.5 Treasury Credit Risk

The Society has exposures to banks, building societies and sovereign in its non-trading treasury portfolio. The Society 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 Society'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 Society'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 Society'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 Society'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 Society's exposure to institutions includes an element attributable to derivatives. The Society uses derivatives to reduce its exposure to market risk, for example interest rate and foreign exchange risk. The Society has been transacting all new eligible swaps via the London Clearing House (LCH) since 2014. A significant proportion of the Society's derivative book is with the LCH at December 2017 (84%). The Society currently have no plans to clear historical swaps as this is not considered to be cost effective at present.

Basel III requires the Society to calculate a CVA charge to capital for derivatives that have not been centrally cleared. The Society 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 small, is expected to decrease as the Society's new swaps are transacted via LCH and older swaps mature off the book.

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

Central governments or central banks

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	EAD Pre-CRM £m	EAD Post-CRM £m
1	0%	Aaa to Aa3	AAA to AA-	1,110.0	1,110.0

Financial Institutions

Credit quality step	Risk weighting	Moody's ratings	Fitch's ratings	EAD Pre-CRM £m	EAD Post-CRM £m
1	4%/20%	Aaa to Aa3	AAA to AA-	189.7	163.6
2	20%/50%	A1 to A3	A+ to A-	69.7	58.3
3	20%/50%	Baa1 to Baa3	BBB+ to BBB-	18.3	19.8
n/a	20%/50%	Unrated	Unrated	-	-
				277.7	**241.7**

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

Collateral is held or issued based on the net market valuation of the Society's derivatives with each counterparty. The collateral document is the ISDA or GMRA Credit Support Annex (CSA). The collateral document gives the Society 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.
The Society currently has no exposures where a downgraded by the rating agencies would result in additional 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. All of the Society's derivatives were eligible for netting as part of the CSA in 2017.

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

	Dec-2017 £m	Dec-2016 £m
Interest rate contracts - Prior to netting	27.0	25.4
Other contracts - Prior to netting	2.6	5.0
Gross positive fair value of contracts	**29.6**	**30.4**
Netting benefits	(29.5)	(45.8)
Netted current credit exposure	**0.1**	**(15.4)**
Collateral used	1.2	14.7
Negative replacement costs due to netting	6.5	3.2
Potential future credit exposure	19.0	10.2
Net derivative credit exposure†	**26.8**	**12.7**

†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 Society'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 Society 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 Society'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 2017 Annual Report and Accounts on pages 87-96.

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 2017.

	Retail financial services £m	Secured personal lending £m	Commercial lending £m	Total £m
Up to date	7,179.8	295.2	813.5	8,288.5
Past due:				
Up to 3 months	67.6	15.1	-	82.7
3 to 6 months	15.8	3.9	-	19.7
6 to 12 months	7.6	2.3	-	9.9
Over 12 months	5.6	2.7	-	8.3
Possessions	1.3	0.0	-	1.3
	97.9	**24.0**	**-**	**121.9**
Total exposures	**7,277.7**	**319.2**	**813.5**	**8,410.4**
Impairment Provisions	5.5	9.8	15.0	30.3
Charge/(Release) for the year	**0.3**	**(5.3)**	**(5.0)**	**(10.0)**

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 2017.

	Individual provision £m	Collective provision £m	Total £m
Balance at 1 January 2017	14.8	30.6	45.4
Charge for the year	0.9	(10.9)	(10.0)
Write-offs	(5.1)	-	(5.1)
Balance at 31 December 2017	**10.6**	**19.7**	**30.3**

Available for sale assets

As at 31 December 2017, none (2016: 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 Society 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

The Society no longer has 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 Society'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 Society operates across the majority of the UK, but with a moderate concentration in Wales. As at 31 December 2017, approximately 32.4% of retail and secured personal lending loan exposures by account and 29.8% by value were concentrated in Wales.

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

For commercial lending, exposure to each of the principal lending categories is monitored and limits are set restricting the aggregate exposure to any single counterparty or group of closely connected counterparties. Concentration of risk within the portfolio is monitored using indicators such as maturity profile, industry sector and geography. In terms of counterparty concentration, the largest single exposure to a commercial counterparty is 3.8% of gross balances in the commercial book.

7.1.8 Credit Risk Mitigation

The Society 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 Society's main source of collateral and means of mitigating credit risk inherent in its residential mortgage portfolio. All mortgage lending activities are supported by an appropriate form of valuation using an independent firm of valuers.

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

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

Commercial mortgages

Within the commercial portfolio the main source of collateral and means of mitigating credit risk is commercial and or residential property. The latter reflects either the residential investment element of the portfolio or loans to social housing landlords. Collateral for the majority of the portfolio 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. Where the Society has itself entered into a fixed rate with a commercial borrower than any adverse mark to market positions are referenced in loan to value positions which are monitored on a regular basis.

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 Society, 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 equity of the institution being considered for an exposure limit 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 Society limit.

7.2 Liquidity Risk

Liquidity risk is the risk that the Society is not able to meet its financial obligations as they fall due, or can do so only at excessive cost. The objective of the Society's liquidity risk appetite 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 Society and to ensure all financial obligations are met.

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

ALCo exercises control over the Society'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 Society conducts an Internal Liquidity Adequacy Assessment Process (ILAAP) at least annually. This is used to assess the Society's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Society.

The most recent liquidity assessment was approved by the Board in June 2017. The Society's ILAAP includes stress tests that consider a range of severe scenarios and their impact on the Society, particularly with respect to retail saving outflows. The ILAAP concludes that the Society's liquidity reserves are adequate to sustain the Society 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 Society's assets and liabilities changes as a result of changes in market prices, the principal elements being interest rate risk, including the use of derivatives, and foreign currency risk.

The Society's Treasury department is responsible for managing the Society's exposure to all aspects of market risk within the operational limits set out in the Society's Treasury Policies. Oversight is provided by Treasury Committee, ALCo, ERC and BRC 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 Chief Financial Officer covering significant issues dealt with by ALCo.

Interest Rate Risk

The Society 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 Society 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 Society 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 Society 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 Society are interest rate exchange contracts, commonly known as interest rate swaps.
The table below describes the principal activities undertaken by the Society, 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 Society 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 Society has funding obligations for a defined benefit scheme which is closed to new entrants. It was closed to future accrual on 31 July 2010. Pension obligation risk is the risk that the value of the Fund's assets, together with ongoing employer and member contributions, will be insufficient to cover the projected obligations of the Fund over time. The return on assets, which includes cash 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 2017 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 Society's non-sterling funding.

The Society 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 Society. When present the Society 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 46-57 of the 2017 Annual Report and Accounts.

7.4 Conduct Risk

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

The sustainability of the Society'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 Society 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 46-57 of the 2017 Annual Report and Accounts.

7.5 Operational Risk

The Society 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 Society corporate risk registers and supports appropriate oversight of the key risk exposures facing the Society.

The Society'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 technology and product development and the external operating environment.

Risk appetite for all principal risk categories, including Operational Risk, is captured and for each secondary operational risk category. Each risk on the register is assessed using a 'Probability/Impact' matrix which is used to quantify, in financial terms, potential risk to the Society, 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 the Society's Risk function with the highest scoring risks reported to the Board quarterly. For individual risks which are deemed unacceptable, remedial action is taken, where such action falls within the Society'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.

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

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

Operational risk events, including those which generate losses, are recorded as they arise, and reported to the Risk function each month. All operational losses and 'near misses' are reported to ORC on a quarterly basis. BRC 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 46–57 of the 2016 Annual Report and Accounts.

8. Securitisation

8.1 Retained Securitisation Positions

The Society currently has three Residential Mortgage Backed Security (RMBS) issuances in place as a means of raising wholesale funding. The RMBS issuances involve the formation of special purpose entities (SPE's), currently Friary No. 2 plc, Friary No. 3 plc and Friary No. 4 plc which have purchased beneficial interests in separate portfolios of residential mortgages that are funded by the issue of floating rate mortgage backed securities (the Notes).

The Notes have been issued by Friary No. 2 plc, Friary No. 3 plc and Friary No. 4 plc to external counterparties and to the Society, 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 Society. Principality Building Society is both originator and servicer for each of the issuances. Other roles fulfilled by the Society are fully described in the Friary No. 2 plc, Friary No. 3 plc and Friary No. 4 plc base prospectuses, copies of which can be found at www.euroabs.com.

The equity of Friary No. 2 plc, Friary No. 3 plc and Friary No. 4 plc are not owned by the Society. 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 Society 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 Society receives the excess spread on the transactions as deferred consideration, after Friary No. 2 plc, Friary No. 3 plc and Friary No. 4 plc have met their liabilities.

As at 31 December 2017, £251.8m (2016: £304.9m) 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 £266.2m (2016: £318.2m), with £45.5m (2016: £45.5m) retained by the Society. None of the self-issued securities retained by the Society in relation to Friary No. 2 plc are capable of repo financing. As at 31 December 2017, 0.76% (2016: 0.67%) of the mortgages transferred to Friary No. 2 plc were greater than 2 months in arrears.

As at 31 December 2017, £323.1m (2016: £410.2m) of mortgages issued by the Society had been transferred to Friary No. 3 plc which remains on the statement of financial position of the Society as it retains the risks and rewards. These assets are treated as encumbered. The amortised value of the bond was £337.3m (2016: £438.9m), with £42.7m (2016: £42.7m) retained by the Society. The £34.1m A Notes of self-issued securities retained by the Society in relation to Friary No. 3 plc are capable of repo financing. As at 31 December 2017, 0.86% (2016: 0.55%) of the mortgages transferred to Friary No. 3 plc were greater than 2 months in arrears.

Friary No. 4 plc was issued in June 2017. As at 31 December 2017, £472.2m of mortgages issued by the Society had been transferred to Friary No. 4 plc which remains on the statement of financial position of the Society as it retains the risks and rewards. These assets are treated as encumbered. The amortised value of the bond at 31 December 2017 was £491.4m, with £41.3m B Notes retained by the Society. None of the self-issued securities retained by the Society in relation to Friary No. 4 plc are capable of repo financing. As at 31 December 2017, 0.31% of the mortgages transferred to Friary No. 4 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 securitisations which continue 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 2017 are as follows:

Securitisation Company	Type	Date of Securitisation	Dec-2017 Notes in Issue £m	Dec-2017 Balance £m	Dec-2016 Notes in Issue £m	Dec-2016 Balance £m
Friary No.2 plc	Residential mortgage	9 June 2014	266.2	251.8	318.2	304.9
Friary No.3 plc	Residential mortgage	4 February 2016	337.3	323.1	438.9	410.2
Friary No.4 plc	Residential mortgage	1 June 2017	491.4	472.2	-	-

Note Class	Dec-2017 Note Balance £m	Dec-2016 Note Balance £m
Friary No.2 plc		
A	220.7	272.7
B	45.5	45.5
Friary No.3 plc		
A	294.6	396.2
B	42.7	42.7
Friary No.4 plc		
A	450.1	-
B	41.3	-

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

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

In October 2016, the Society became a member of the Term Funding Scheme (TFS). As at 31 December 2017 the Society had outstanding liabilities under the scheme of £500.0m (2016: £250.0m). The scheme allows the Society the ability to pledge mortgage assets with the Bank of England in return for cash.

In October 2012, the Society became a member of the Funding for Lending Scheme (FLS). As at 31 December 2017 the Society had outstanding liabilities under the scheme of £nil (2016: £207.0m). The scheme allows the Society 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 20.3% (2016: 19.3%) of total assets, further details are provided in the 2017 Annual Report and Accounts. Further information on accounting policies for securitisations are included in note 1 to the 2017 Annual Report and Accounts.

8.2 Purchased Securitisation Positions

Since May 2012 the Society has selectively purchased senior tranches of positions in RMBS. The Society's total exposure to purchased securitisation positions at 31 December 2017 was £39.0m (2016: £40.9m) based on market values, with the exposures consisting entirely of residential mortgage-backed securities. Such purchased securitisation positions provides the Society with a diversified, capital-efficient source of investment income. Investments are undertaken within a clearly defined credit risk policy. The credit risk of the exposures underlying the purchased securitisation positions are monitored on a semi-annual basis for indications of impairment.

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

The purchased securitisation positions are all in the most senior tranches of the issued note classes of each securitisation and part of the Society'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-2017 Exposure Value £'m	Dec-2017 Exposure Weighted Average RW %	Dec-2016 Exposure Value £'m	Dec-2016 Exposure Weighted Average RW %
1	AAA	Aaa	AAA	39.0	20.0	40.9	20.0

The purchased securitisation positions are predominantly prime residential mortgage backed securities, with one buy-to-let mortgage backed position of £5.7m. These have all been originated and issued in the UK.

9. Appendix A – Grandfathering Profile & Capital Allowances

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

10. Appendix B - Remuneration

The following table displays the 2017 remuneration for the Society's managers and members of staff deemed as Material Risk Takers, as defined by the Remuneration Code. This includes executive and non-executive directors.

The Report of the Remuneration Committee contained within the 2017 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, two severance payments totalling £209,000 were made. These amounts are included in the figures presented in the remuneration table set out below.

The total amount of deferred remuneration paid out in the year was £44,000.

Aggregate MRT Remuneration

Of the 31 beneficiaries of remuneration being paid to MRTs, 21 were in receipt of a variable remuneration during the financial year.

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

	Number of beneficiaries	Fixed remuneration £k	Variable remuneration £k	Total remuneration £k	*Outstanding deferred remuneration £k*
Society	31	4,091	982	5,074	0

11. Appendix C – Asset Encumbrance

The following disclosures are presented in the format prescribed by the EBA

Template A - Assets

Dec-2017	Carrying amount of encumbered assets	Fair value of encumbered assets	Carrying amount of unencumbered assets	Fair value of unencumbered assets
Assets of the reporting institution	**1,877.2**		**7,385.4**	
Equity instruments	-	-	-	-
Debt securities	-	-	124.9	124.9
Other assets	1,877.2		7,260.5	

Dec-2016	Carrying amount of encumbered assets	Fair value of encumbered assets	Carrying amount of unencumbered assets	Fair value of unencumbered assets
Assets of the reporting institution	**1,600.0**		**6,681.2**	
Equity instruments	-	-	-	-
Debt securities	-	-	389.6	389.6
Other assets	1,600.0		6,291.6	

*Other assets include derivative financial assets; property plant and equipment; intangible assets; prepayments and deferred tax assets. These assets would not be available for encumbrance in the normal course of business.

Template B – collateral received

The EBA Guideline allows competent authorities to waive the requirement to disclose Template B – Collateral received, and in Supervisory Statement SS11/14 (CRD IV; compliance with the European Banking Authority's Guidelines on the disclosure of encumbered and unencumbered assets) the PRA waived the Template B requirements subject to a firm meeting certain criteria. The Society meets the criteria and therefore Template B is not disclosed.

Template C – Encumbered assets/collateral received and associated liabilities

Dec-2017	Matching liabilities, contingent liabilities or securities lent	Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered
Carrying amount of selected financial liabilities	1,624.2	1,877.2

Dec-2016	Matching liabilities, contingent liabilities or securities lent	Assets, collateral received and own debt securities issued other than covered bonds and ABSs encumbered
Carrying amount of selected financial liabilities	1,359.9	1,600.0

Template D – Information on importance of encumbrance

The most material sources of encumbrance for the Society are secured funding via the Society's securitisation programmes which are supported by pledging mortgage assets. Further detail on these activities is set out in Section 8 and note 17 to the 2017 Annual Report and Accounts.

A further source of encumbrance arises in relation to the collateralisation of the Society's derivative contracts.

12. Appendix D – EBA Leverage Ratio disclosure templates

The following disclosures are presented in the format prescribed by the EBA.

Template A – Table LRSum – Summary reconciliation of accounting assets and leverage ratio exposures

	Dec-2017	Dec-2016
Total Assets as per published financial statements	9,262.6	8,281.2
Adjustment for derivative financial instruments	20.3	10.2
Adjustments for securities financing transactions (SFTs)	-	-
Adjustment for off balance sheet items	341.6	283.9
Other adjustments	(9.3)	(9.7)
Leverage ratio total exposure measure	**9,615.2**	**8,565.6**

Template B – LRCom – Leverage ratio common disclosure

	Dec-2017 End State	Dec-2017 Transitional	Dec-2016 End State	Dec-2016 Transitional
On balance sheet items (excluding derivatives, SFTs and fiduciary assets, but including collateral)	9,231.6	9,231.6	8,246.7	8,246.7
Asset amounts deducted in determining Tier 1 capital	(9.3)	(9.3)	(9.7)	(9.7)
Total on balance sheet exposures (excluding derivatives, SFTs and fiduciary assets)	**9,222.3**	**9,222.3**	**8,237.0**	**8,237.0**
Replacement cost associated with all derivative transactions	31.0	31.0	34.5	34.5
Add on amounts for PFE associated with all derivative transactions	20.3	20.3	10.2	10.2
Total derivative exposure	**51.3**	**51.3**	**44.8**	**44.8**
Off balance sheet exposures at gross notional amount	376.3	376.3	314.2	314.2
Adjustments for conversion to credit equivalent amounts	(34.7)	(34.7)	(30.3)	(30.3)
Total of other off balance sheet exposures	**341.6**	**341.6**	**283.9**	**283.9**
Tier 1 Capital	511.1	541.1	468.7	504.7
Leverage ratio total exposure amount	**9,615.2**	**9,615.2**	**8,565.6**	**8,565.6**
Leverage ratio	**5.32%**	**5.63%**	**5.47%**	**5.89%**
Choice on transitional arrangements for the definition of the capital measure	**End state**	**Transitional**	**End state**	**Transitional**

Template C – Table LRSpl – Split of on balance sheet exposures (excluding derviatives, SFTs and exempted exposures)

	Dec-2017	Dec-2016
Total on balance sheet exposures (excluding derivatives, SFTs and fiduciary assets)	**9,231.6**	**8,246.7**
Banking book exposures, of which:	**9,231.6**	**8,246.7**
Covered Bonds	-	-
Exposures treated as sovereign	1,110.0	922.1
Exposures to regional governments, MDB, International organisations and PSE not treated as sovereigns	-	10.1
Institutions	168.8	141.5
Secured by mortgages of immovable properties	7,784.8	6,940.8
Retail exposures	29.7	37.6
Corporate	-	-
Exposures in default	35.3	52.8
Other exposures (e.g. equity, securitisations and other non-credit obligation assets	103.0	141.8

Template D – Table LQRA – Qualitative information on risk of excessive leverage and factors impacting the leverage ratio

The Society leverage ratio is a key indicator monitored by Board regularly. The leverage ratio is projected over the Society's planning horizon and is included in stress tests to ensure that the risk of excessive leverage is managed.

The Society's leverage ratio has reduced year on year as the growth of the Society's Tier 1 capital under the end state position has not been proportional to the year on year balance sheet growth due to the strong growth of the Society's mortgage book. The end state definition has reduced less than the transitional ratio year on year showing the additional impact due to grandfathering of the Society's PIBS.

13. Appendix E – Countercyclical Capital Buffer

The tables below contain the Geographic distribution of credit risk exposures relevant for the calculation of the countercyclical capital buffer. For the purposes of this calculation this includes retail and commercial mortgage loans, treasury assets, securitisations and other assets.

Breakdown by Country	General credit exposures		Securitisation exposure		Own funds requirements					
	Exposure value for SA	Exposure value for IRB	Exposure value for SA	Exposure value for IRB	Of which: General credit exposures	Of which: Trading book exposures	Of which: Securitisation exposures	Total	Own funds requirement weights	Countercyclical capital buffer rate
UK	1,882.9	7,937.9	39.0	0	138.8	-	0.6	139.4	100%	0%

The table below shows the Society's specific countercyclical capital buffer.

Total risk exposure amount	**1,955.4**
institution specific countercyclical buffer rate	**0%**
institution specific countercyclical buffer requirement	**0**

14. Appendix F – Capital instruments key features

The table below shows the capital instrument currently held by the Society with the key details of the instrument as at 31 December 2017.

1	Issuer	Principality Building Society
2	Unique identifier	GB00B010CN56
3	Governing law(s) of the instrument	English
4	Transitional CRR rules	Additional Tier 1 up to headroom/Tier 2 up to headroom
5	Post-transitional CRR rules	Not eligible
6	Eligible at solo/(sub-)consolidated/ solo&(sub-)consolidated	Solo & Consolidated
7	Instrument type (types to be specified by each jurisdiction)	PIBS
8	Amount recognised in regulatory capital	£60,000,000 (£30,000,000 Additional Tier 1 & £30,000,000 Tier 2)
9	Nominal amount of instrument	£60,000,000
9a	Issue price	99.232
9b	Redemption price	100.000
10	Accounting classification	Liability - amortised cost
11	Original date of issuance	01/06/2004
12	Perpetual or dated	Perpetual
13	Original maturity date	01/06/2020
14	Issuer call	Yes
15	Optional call date, contingent call dates and redemption amount	01/06/2020
16	Subsequent call dates, if applicable	Every five years
17	Fixed or floating dividend/coupon	Fixed
18	Coupon rate and any related index	7.00% up to 01/06/2020
19	Existence of a dividend stopper	n/a
20a	Fully discretionary, partially discretionary or mandatory (in terms of timing)	Partially discretionary
20b	Fully discretionary, partially discretionary or mandatory (in terms of amount)	Partially discretionary
21	Existence of step up or other incentive to redeem	No
22	Noncumulative or cumulative	Noncumulative
23	Convertible or non-convertible	Non-convertible
24	If convertible, conversion trigger(s)	n/a
25	If convertible, fully or partially	n/a
26	If convertible, conversion rate	n/a
27	If convertible, mandatory or optional conversion	n/a
28	If convertible, specify instrument type convertible into	n/a
29	If convertible, specify issuer of instrument it converts into	n/a
30	Write-down features	n/a
31	If write-down, write-down trigger(s)	n/a
32	If write-down, full or partial	n/a
33	If write-down, permanent or temporary	n/a
34	If temporary write-down, description of write-up mechanism	n/a
35	Instrument type immediately senior to instrument	n/a
36	Non-compliant transitioned features	Yes
37	If yes, specify non-compliant features	Call date

15. Glossary of Terms

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

Credit risk mitigation	Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.
CRR IV	Capital Requirements Regulation IV. This implements Basel III directly to firms across the EU.
CVA	Credit Valuation Adjustment. The adjustment reflects the current market value of the credit risk of the counterparty to the institution.
EAD	Exposure at Default. An estimate of the outstanding balance if the customer does default.
ECAI	External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.
FCA	Financial Conduct Authority. The financial services industry regulator in the UK for Conduct issues
Guarantee	An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.
ICAAP	Internal Capital Adequacy Assessment Process. The Society'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.
ILAAP	Internal Liquidity Adequacy Assessment Process. The Society's own assessment of the levels of liquidity that it needs to meet its current and financial obligations. These are assessed under normal and stressed condition.
Interest rate risk	Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates.
IRB	Internal Ratings Based approach. A Basel III approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk-sensitive than the Standardised Approach and may only be used with PRA permission.
LIBOR	London Inter Bank Offered Rate.
LGD	Loss Given Default. An estimate of the outstanding balance not recovered and the costs associated with that recovery process.
LTV	Loan To Value. A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Society calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI).

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

Securitisation	A process by which a Society's 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 Society has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.
SPE	Special Purpose Entities. Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Society uses an SPE set up under securitisation issue. Where the Society has control of these entities or retains the risks and rewards relating to them they are consolidated within the Society's results. This term is used interchangeably with SPV (special purpose vehicle).
Stress testing	Various techniques that are used by the Society to gauge the potential vulnerability to exceptional but plausible events.
SREP	Supervisory Review and Evaluation Process. (CRD IV Section III, the PRA's process for reviewing the adequacy of a firm's ICAAP)
Subordinated debt	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing Members but before the claims of holders of permanent interest-bearing shares.
TCR	Total Capital Requirement. The total amount of capital an institution needs to hold to meet Pillar 1 and Pillar 2 capital requirements. Replaced the previous individual capital guidance (ICG) terminology as of 1 January 2018.
The Standardised Approach (credit risks)	The basic method used to calculate credit risk capital requirements under Basel III. In this approach the risk weights used in the capital calculation are determined by PRA supervisory parameters. The standardised approach is less risk-sensitive than IRB.
The Standardised Approach (operational risks)	The standardised approach to operational risk, calculated using the average of three year historical net income multiplied by a factor of 12-18%, depending on the underlying business being considered.
Total Remuneration	The sum of fixed pay, variable pay, director fees, car allowance, pension and benefits in kind.