ANNUAL REPORT
AND ACCOUNTS

2018







Building your future

Principality
Building Society
Cymdeithas Adeiladu

Where home matters
www.principality.co.uk

Key highlights of 2018

We were busy in 2018 building the future for our Members

Supported over 6,400 first-time buyers onto the housing ladder

Members' savings balances of over £6.9 billion
(2017: £6.5bn)

Raised £220,000 for our charity partnerships

Net retail mortgage growth of £718.7m
(2017: £917.2m)

£43.8 million
Underlying profit before tax
(2017: £53.4m)

Customer service net promoter score of 78.6%
(2017: 74.8%)

£124.1m
New Commercial business

Strong capital ratios with a Common Equity Tier 1 ratio of 27.06%
(2017: 26.14%)

Profit before tax
£40.7 million
(2017: £57.6m)

The above measures, apart from Profit Before Tax, are alternative performance measures (APMs). Further information on these APMs can be found in the Strategic report, with definitions included within the glossary.

Welcome

08

Chief Executive's Review of the Year

36

Meet the Board of Directors

91

Financial statements

Performance and Strategy

Chairman's Review of the Year

I am pleased to report that Principality has posted another strong set of results in 2018, providing a secure haven for Members' savings and helping them get the home they want. Our assets have increased to £9.7bn and we have recorded another solid year of profit which has further strengthened our capital to invest in the long-term future of the Society.

Pictured: *Laurence Philip Adams, Chairman*

Strong performance

Our business model has enabled us to offer our Members some of the most competitive savings rates on the High Street and as a mutual organisation we do not have to satisfy shareholders by paying them dividends.

Despite a very competitive housing market, the Board and I are proud that more than a quarter of our mortgage completions in the past 12 months helped first-time buyers onto the property ladder. Helping people get a home and stay in one for longer is what we stand for as a mutual building society.

We are in the process of improving our technology to give our Members the choice to interact with us by their preferred method. This means we will have more of our products available online so customers can access their accounts 24/7. This is an exciting chapter in our rich history and one which will help the business to strengthen what it can offer Members and customers.

Brexit negotiations are impacting on the confidence of the housing market, along with the possibility of rising interest rates also affecting decision making. Never has it seemed so hard for businesses and individuals to plan ahead given the uncertainties and the volatility of the economy at the moment.

As you would expect, we have had to consider multiple scenarios to stress test our business. We are resilient and have a strong capital and liquidity position which puts us in a position to deal with any shocks that might emerge and thus keep our Member's money safe.
We continue to closely monitor market trends so that we can run our business in the best interests of our Members.

These solid foundations provide support for our investment plans to grow our business in a safe and sustainable way for our Members and to make sure we are in a strong position for future generations.

Supporting our Members, colleagues and communities

We give great consideration to what makes us unique as an organisation and align this with our ambition – to be proactive, personable, easy to do business with and to provide practical solutions to help our Members prosper in their homes.

I am proud to say that once again our colleagues have done some fabulous things for our three charity partners, schools and community projects and you can read all about their outstanding efforts in the Member, Colleague and Community section. Our work in the area of Financial Education has been especially outstanding and I am very pleased that so many young people have been able to benefit from our expertise.

The entire Board is immensely proud of the work our colleagues have put in over the year to help vulnerable groups of people across Wales.

Our colleagues have once again received recognition for another phenomenal year of success, receiving some very high profile national awards for providing great customer service to our mortgage and savings Members and customers, as well as for their work in the communities in which we operate.

Principality has been busy upgrading and modernising our head office in Cardiff and a number of our branches. This is important not only to improve the working conditions of our colleagues but also to enhance the service we provide to our Members.

Diversity

One of our core values is "doing the right thing" and Principality's commitment to ensuring a more diverse and inclusive workforce is a genuine focus to achieve a culture that is inclusive to all. We want our workforce to reflect the diverse nature of the communities we serve so passionately.

We strongly believe in growing and developing our staff at all levels. Our recruitment practices are fair and inclusive, and we have a strong focus on career and talent development to ensure that the best people are placed in the right roles. Women make up almost two thirds of our workforce and are spread across junior and senior roles.

In 2016, we were an original signatory to the Women in Finance Charter and are committed to reaching our target of 33% of women in senior positions by 2021. At 28%, we are close to that total three years ahead of that deadline, which emphasises the great work we have done already. This commitment is also reflected by the Board's composition which is 30% female.

Board changes

Principality needs a strong Board to make sure your Society is being run in your best interests. We have been fortunate to attract high calibre directors who have contributed to the success of the Society as well as to recruit capable new directors. This year, we said goodbye to Natalie Elphicke after six years on the Board. Natalie served the Society with distinction as the Chair of the Board Risk Committee. We wish her well in her future endeavours.

The Board appointed experienced financial leader Claire Hafner to be a non-executive director in April. Claire is a qualified accountant with substantial experience in a wide range of sectors including finance, multimedia and telecoms. Her knowledge will be a real asset as we transform our core business of mortgages and savings. Claire also fully embraces the ethos of the mutual sector and is an exciting addition to the Board of Principality.

Governance

Our priority is to keep our Member's money safe and we remain supportive of regulators as they raise standards across the industry. General Data Protection Regulation came into force in May. This will strengthen the data protection framework across the EU and provide consumers with greater control over their personal data. Protecting the personal data of our Members is a high priority for Principality, as is protecting our Members' savings by investing in IT and security and I am pleased the procedures we have implemented were done successfully.

Thank you

We anticipate that competition in the mortgage market will continue to place downward pressure on margins and we need to see how the economy performs in light of the Brexit negotiations. However, our solid, resilient performance over many years means that we expect to continue to grow in a measured way and to invest in the long-term future of the Society for the benefit of all our Members.

Our Society would not be successful without our dedicated colleagues, the support of our agencies, intermediaries and commercial partners who have a tremendous rapport with their communities. We would not be successful without the support of you, our loyal Members. So on behalf of myself and the rest of the Board, I would like to thank all our staff and you, our Members, for choosing Principality Building Society.

C. P. Adams

Laurence Philip Adams
Chairman
5 February 2019

Pictured: *Julie-Ann Haines, Chief Customer Officer at our 2018 Charity Partnership Celebration*

Pictured: *Staff volunteering during the 2018 Eisteddfod at Cardiff Bay*

Chief Executive's Review of the Year

Principality Building Society has delivered a robust performance in 2018 despite an increasingly challenging environment. We have continued to grow in our core markets of savings and mortgages whilst providing award-winning customer service to our Members. Our capital and liquidity remain strong and provide a firm platform for growth and investment in our business for the long-term. I am immensely proud of our performance and the delivery of my colleagues, our service to Members continues to be stand out and our Members tell us it sets us apart from the competition.

Performance

We have made pleasing progress in delivering on our growth strategy, despite a very competitive mortgage market and increasing economic and political uncertainty. Net retail mortgage lending has increased by £718.7m in the year (2017: £917.2m), and our total assets increased to £9.7bn (2017: £9.3bn). This is a great achievement and building profitable scale is important to enable us to deliver on our ambition to transform our business for current and future generations of Members, whilst continuing to deliver stand out personal service and ensuring a secure home for our Members' savings.

Pictured: *Steve Hughes, Chief Executive*

In order to support the growth in our lending, we attracted an additional £426.0m in savings, and have maintained our position as one of the best savings providers on the High Street. Savings rates remain low across the sector. We don't operate in isolation of the market and the rates we can offer to Members are impacted by the interest we earn on mortgages.

Competition has forced mortgage rates to near historic lows with net interest margins being squeezed across the industry. With that in mind, in 2018 we have still delivered an average rate to savers of 1.08%, compared with a market average over the same period of 0.70%[1]. Balancing the needs of savers whilst sustaining a profitable business and remaining competitive in the mortgage market is a constant focus for the Board and we will always seek to deliver in the long-term interest of our Members.

[1]Source: CACI's CSDB, weighted UK average interest rates for fixed and variable rate stock, January-October 2018 (latest data available).

Pictured: Welcoming our new 2019 charity partners to Principality House

Pictured: Commercial Development at Eco Site, Cardiff

Our profitability continues to be good and this is reflected in our reserves position of over £550m and strong capital ratios. We need to remain focussed on running the building society for the long-term and, as anticipated and previously communicated, this has resulted in underlying profits falling year on year from £53.4m to £43.8m in line with our expectation. This reflects the true trading performance of the business and has been driven primarily by:

- investing in the business to meet the changing needs of our Members and to ensure we are relevant for the future;
- higher interest payable as a consequence of securing long-term wholesale funding and continuing to pay better than average savings rates to our Members;
- the run-off of Nemo, our second charge loans business, as we redeploy capital into residential mortgage lending; and
- a release in impairment provisions in the prior year not being repeated as we have maintained a strong and prudent balance sheet position.

Statutory pre-tax profit was £40.7m (2017: £57.6m) and has been impacted by the above factors together with fair value movements in derivatives as set out in the Strategic Report.

As a mutual building society, our aim is not to maximise profit but to balance near term performance with the right decisions for the long-term future of our business. In an increasingly competitive market we need to ensure we are an efficient organisation and control costs effectively.

We have once again differentiated ourselves in the market by providing outstanding customer service, receiving external recognition of our fantastic service for both mortgages and savings. I am proud that consumer champion Which? named us as a top scoring mortgage lender for customer satisfaction. Also getting the recognition as Moneyfacts best ISA provider is great testament to the work we do, not just with our Members but also the service we provide for our intermediary partners.

Our Commercial team has once again performed well, delivering a profit of £13.1m (2017: £17.9m) and Nemo, our second charge loans business, has contributed a profit of £13.4m (2017: £17.1m). I am delighted that our Commercial business has generated £124.1m (2017: £143.8m) of new loans in the year and the Nemo book continues to perform well, the dividend contribution to Members is important.

I am especially delighted that the work we have done on the Principality Commercial side is benefitting communities where affordable housing is needed. We have played an instrumental role in the Mill at Canton project in Cardiff which I feel is an exemplar of how government, lenders, housing developers and housing associations can partner to have meaningful impact in our communities. It has meant more than 100 families will be in affordable rental homes on this wonderful new site by mid 2019 as well as creating a flourishing private market. Seeing such tangible investment in our communities and delivery of homes where they are needed makes me very proud.

Changes for the future

Despite our stand out customer service, we know we have to keep pace with evolving technology and our Members, both existing and future, will demand more of us. Behind the scenes we have been investing in our infrastructure to improve the flexibility of our services. It is a challenging but exciting period in Principality's history as we look to transform the business for our existing and next generation of savers and borrowers.

After significant investment we have rolled out our Principality Connected video conference service, which means the equivalent of face-to-face interviews can take place anywhere throughout our retail branch network. The feedback from customers has been very positive.

The technology we are set to introduce in the next few years will be used to complement our personal service which our Members and customers tell us makes us stand out. We will be able to offer people a service that suits their lifestyles, complementing the personal face-to-face branch service we offer Members, by giving them a choice of how they want to access their accounts, by phone, online, or via mobile devices.

We are in the process of modernising our branches having listened to feedback from our Members. Our commitment to the High Street remains strong and we have seen footfall and demand rise in some areas, as other financial institutions have withdrawn their presence. This goes against the trend we are seeing across the rest of the UK and while our Members continue to use, value and recommend our branches, it will form the bedrock of our service offering.

Our people

We will continue to invest in our people, who embody everything positive we stand for as a mutual business. We have continued to provide career progression internally whilst our growing reputation has made us more attractive in the external job market, as we continue to retain and hire the best people to take our business forward. Our colleagues live and work in the communities they serve and have developed a strong connection with them. We strive to be an inclusive business with colleagues who are passionate about doing the right thing for Members.

Pictured: Principality colleagues at the 2018 AGM

The inclusive culture we have created led to us being named as one of the top largest employers in the UK by Great Place to Work® and our colleague engagement continues to be excellent. It is testimony to the level of trust amongst our colleagues and the effort they put in to make sure Members get the best possible customer experience. In fact, our net promoter score has improved on last year increasing from 74.8% to 78.6% of Members saying they would recommend us to their family or friends based on their level of satisfaction with Principality.

Communities

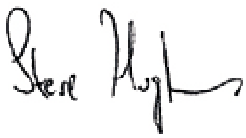
As well as looking after the best interests of our Members, Principality will continue to do the right thing by the communities we serve. I am immensely proud of the efforts we have made to provide financial education to school children across Wales, with more than 5,000 benefitting from our Business in the Community (BITC) Business Class Partnership, and our participation in Let's Talk Money Week, run by the Money Advice Service. It is vital that we equip future generations with the knowledge and confidence to be able to make informed financial decisions. Our work in this important area has been recognised with an award by BITC for education. We have ambitious plans to roll out a financial education qualification across Wales. This is currently being piloted with seven schools and 1,400 pupils in Carmarthenshire and will make a real difference to young people's lives.

This year marks the end of our three-year partnership with our charities School of Hard Knocks, Cancer Research Wales and homelessness charity Llamau. Our work with these magnificent charities encapsulates for me what it means to be a mutual organisation, supporting communities and helping Members to prosper in all aspects of their lives. Colleagues have done a wonderful job in helping to raise £504,000 for the charities since 2016. We wish all of our charity partners the best of luck and hope their work helping people in our communities goes from strength to strength.

I am looking forward to working with our new charity partners Alzheimer's Society Cymru and Teenage Cancer Trust Cymru during the next three years. Two poignant and worthwhile causes I know our colleagues will get fully behind.

Outlook

Looking ahead there will continue to be significant political and economic uncertainty, whilst we expect price competition in the mortgage market to remain fierce and for our margins to be squeezed further. Our profitability will continue to be robust but will be progressively lower in the next few years as we reshape and invest in our business for the long-term. We will continue our single minded focus on transforming our core mortgage and savings business. Our Society has resilience through its strong capital and liquidity base to deal with any headwinds that might emerge and ensure we protect our Member's interests. Our performance in recent years in terms of growth and profitability has built a solid foundation to allow us to invest for the future. We will seek to grow our business in a safe and sustainable way for our Members and to make sure we are in a strong position for future generations.



Stephen Hughes
Chief Executive
5 February 2019

Strategic Report

for the year ended 31 December 2018

Our purpose and vision

158 years ago Principality Building Society was founded in Church Street, Cardiff. Then known as Principality Permanent Investment Building Society, its aim was to encourage people to save in order to achieve the safety and security of owning their own home. That guiding principle is as relevant today as it has always been.

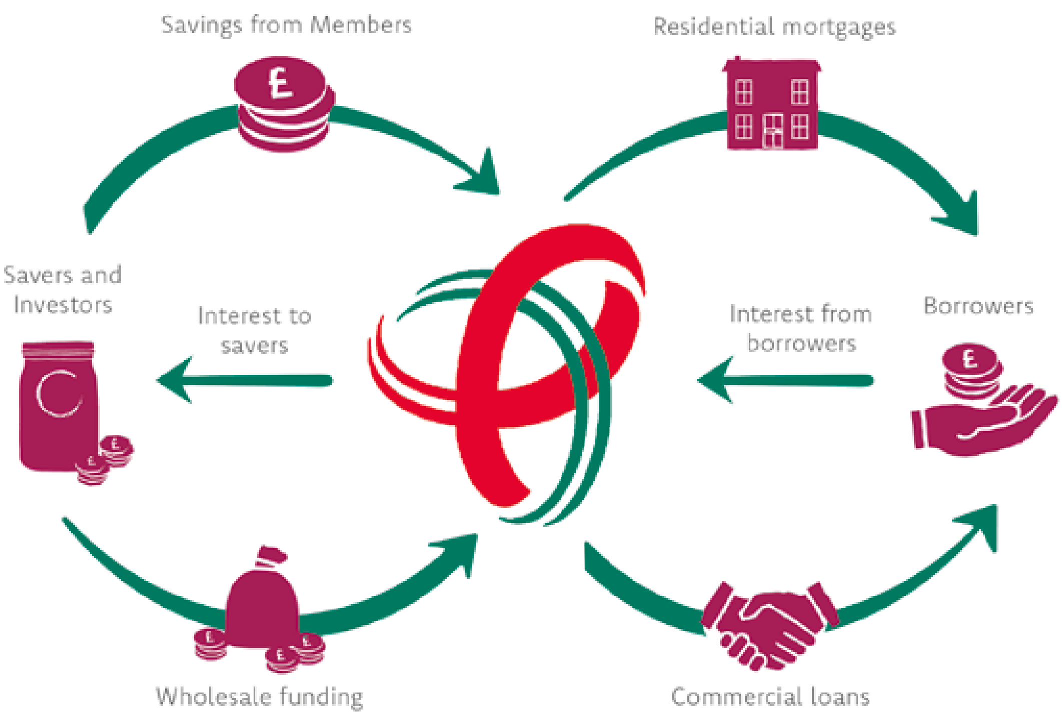
Our purpose as an organisation is to help our Members to prosper in their homes. Our Members tell us that home is the heart of life, where their plans, decisions and memories are made, and it is where we will change our Members lives for the better. Our purpose underpins everything that we do but it is not just about the products we offer – it is about the value we add to people's lives at every stage. Our purpose also informs our strategic thinking and has helped us to develop our vision to deliver products and propositions that meet the needs of current and future Members and to allow Members to do business with us through any channel they choose – seamlessly. Achieving our vision will ensure we remain relevant, successful and differentiated into the future.

Our business model

As a mutual building society we are owned by and run for the benefit of our 500,000 Members – our savers and borrowers. Our business model means that over 80% of our funds are raised from Members' savings and deposit accounts, enabling us to provide loans secured against residential and commercial properties. The difference between the income earned on these loans and the interest paid to savers and wholesale funding providers generates net interest income for the Society.

Net interest income is used for a number of purposes including investing in our communities through our branch and agency network, community projects, enhancing our offering to ensure we are helping Members to prosper in their homes, covering operational expenses, reinvesting in the business to ensure we achieve our vision and holding capital to safeguard the Society for future generations.

Our model primarily operates across two lines of business: retail financial services and commercial lending, and our distribution channels allow us to reach customers via branch, broker, phone and web. Our secured personal lending business, Nemo, stopped offering new customer loans in 2016 but continues to focus on delivering both excellent customer service and a meaningful contribution to the group results. Additional contribution also comes from sales of protection products, home insurance and funeral plans to ensure our Members are protected in the long-term.



Our strategy

Our strategy has been developed to help us achieve our vision. It clearly sets out our focus on our core mortgage and savings business, with the aim of driving sustainable growth through customer focussed propositions, differentiated service, development of internal expertise and efficient processes and delivery. This focus will drive our key activities, and our progress towards achieving our vision is continually measured through a clear set of Key Performance Indicators (KPIs) which are aligned to our strategic pillars.

Strategic Pillars	Key Activity	Performance Indicators
PURPOSE LED P ORGANISATION "We'll be a **Purpose Led Organisation** helping customers prosper in their homes at every stage in life"	We'll transform our Savings and Mortgage products to help people to prosper in their homes. We'll be famous in Wales and beyond so we can become a Challenger Building Society. We'll actively manage our costs to ensure we provide maximum value to our Members and create a robust, scalable Society. We'll work with our communities to provide support and create opportunities for them to prosper.	Net Retail Mortgage Growth Brand Consideration Cost Income Ratio
BRILLIANT B PEOPLE "We'll inspire **Brilliant People** across the Society with a customer focussed culture"	We'll be an employer of choice, continuing to attract and retain talented and passionate people. We'll inspire a strong inclusive customer focussed culture, investing in our colleagues and building their capability as we transform our Society. We'll empower our colleagues to live our values, helping them to prosper at every stage of their working life.	Employee Engagement Score
STAND-OUT S EXPERIENCE "We'll provide our Members with a **Stand-Out Experience** focussed on customer service and the safety and security of their Society"	We'll put customer experience at the heart of what we do, using insight to drive the right actions and decisions. We'll invest in providing choice and personal service to our customers, while creating a digital channel that complements our existing channels. We'll do the basics right, providing safety, security and reliability to our Members in a fast changing market.	Net Promoter Score Underlying Profit Before Tax Profit Before Tax Net Interest Margin Common Equity Tier 1 Ratio

Our progress

Over the last four years we have focussed on delivering our strategy and have invested in a number of areas to improve the organisation. Below is a summary of our progress against our strategic aims:

Purpose Led Organisation

Investment in the transformation of our core mortgage and savings products, including more products to meet our Members needs and developing a pipeline of savings propositions designed around customer needs.

Commercial lending focus on supporting communities to prosper through funding of projects for development of both open market and affordable housing, for example, the Mill at Canton is helping deliver 800 homes on a former brownfield site in Cardiff.

Continued growth of brand awareness through leveraging the sponsorship of Principality Stadium and the exposure generated by rugby internationals and high profile concerts.

Ongoing focus on our charity partnerships across three key pillars of financial education, getting and staying in a home and health and wellbeing.

Awarded Wales Responsible Business Education Award.

Brilliant People

Continued investment in people and talent development, with a clear focus on recruiting colleagues who are a strong cultural fit with values that align to our own.

Enhanced focus on equality and diversity through initiatives such as the Chwarae Teg Women's Career Development Programme.

Investment in our working environment, including redevelopment of Principality House and refurbishment of the branch network.

Recognised as a Great Place to Work®.

Stand-Out Experience

Improved efficiency of processes, including programmes to review both our mortgage and savings journeys and identify areas for improvement.

Ongoing monitoring of customer feedback and insight to inform decision making and improve the customer experience.

Investment in technology such as Principality Connected video conferencing and our online journeys to improve access to our colleagues and services.

Named Which? Best Mortgage Provider for Customer Satisfaction.

Principality was awarded ISA provider of the year at the Moneyfacts Consumer Awards.

Shortlisted for Commercial Lending funder for the year.

PERFORMANCE AND STRATEGY

Our transformation

The world we live in continues to change at a fast pace, with technology changing the way many people conduct their financial business. We recognise that we need to adapt to continue to be relevant and investment in technology is vital to ensuring our ongoing success. We began laying the foundations for our transformation in 2017 and we have continued our journey throughout 2018. Our transformation programme will take a number of years but Member experience will remain at the heart of our decision-making. As we transform our digital experience we remain dedicated to delivering the same stand-out experience that Members currently receive, ensuring our Members have a consistent experience and feel that we are taking steps to improve their interactions with us across all of our channels.

Key Performance Indicators

Our performance against our strategy is measured through the KPIs that are aligned to our strategic pillars. This alignment provides us with clear sight of the progress we are making toward achieving our vision and ensuring our Members prosper in their homes at every stage of life.

	2018	2017
Purpose Led Organisation		
Net Retail Mortgage Growth	£718.7m	£917.2m
Brand Consideration[1]	21.7%	19.4%
Cost Income Ratio	66.4%	65.0%
Brilliant People		
Employee Engagement Score	76.0%	78.0%
Stand-Out Experience		
Net Promoter Score[2]	78.6%	74.8%
Underlying Profit Before Tax[3]	£43.8m	£53.4m
Profit Before Tax	£40.7m	£57.6m
Net Interest Margin	1.26%	1.44%
Common Equity Tier 1 Ratio	27.06%	26.14%

1. The brand consideration metric is now provided by an alternative third-party. Comparative figures have been restated.
2. Source: Based on internal survey data for the 12 months ended 31 December 2018.
3. Reconciliation can be found on page 19.

The above key performance indicators, apart from Profit Before Tax, are alternative performance measures (APMs) which are internally used to inform key management decisions. Further information on these APMs can be found below, or definitions included within the glossary.

Member experience

Our strong financial performance has enabled us to invest in activity aligned to our purpose, while ensuring that we maintain the high levels of service our Members expect from us. We pride ourselves on our service and we measure how well we are doing in this area through our Customer Service Net Promoter Score. The score measures the likelihood of a Member to act as a promoter of the Society, based on internally designed instant feedback surveys. 2018 has seen our score increase from 74.8% to 78.6% and this rise is testament to our ongoing focus and commitment to providing a stand-out experience. Brand consideration, a measure of how potential customers view Principality when choosing a financial services provider, has also increased in the year.

Managing and reducing environmental impacts

As a responsible corporate citizen, we seek to do the right things to limit the impact we have on our environment. We are committed to continuing to work on becoming more efficient in heating and lighting our buildings, increasing the effectiveness of recycling programmes and improving employee awareness of environmentally responsible behaviour such as reducing paper use.

Through the course of 2018, we refurbished our head office building, Principality House, which provided an opportunity to make a number of improvements to the working environment. We were able to reduce our carbon footprint by replacing our lights with more efficient lighting technology and lighting controls and by upgrading our heating, ventilation and air conditioning systems with a more efficient set-up which uses less energy.

Waste management

Managing waste effectively is an important area of focus for the Society. Throughout our estate we have a structured approach to waste disposal with a key focus on effective management of and driving efficiencies around recycling.

Technology

Our IT department regularly review our technology and IT usage to identify where we can improve. Desktop PC's and laptops have recently been replaced with more energy efficient equipment. Old equipment is recycled and where possible, is refurbished and donated to local schools. Over the last year, video conferencing solutions have been introduced to all branches and a number of meeting rooms in head office. These are being used for both internal meetings and customer appointments, reducing the need for colleague and customer travel.

External support

We consult with a number of external companies and schemes to identify cost-effective energy saving measures. We've also engaged with organisations such as the www.carbontrust.com/client-services/wales/ and www.wrapcymru.org.uk/about-wrap-cymru for advice and guidance on areas for improvement. We have membership of www.cynnalcymru.com and sponsor an initiative called www.sizeofwales.org.uk that is helping tackle climate change.

Environmental priorities

- In 2015, as a qualifying business, we were proud to be one of the first organisations to be certified in the mandatory ESOS (Energy Saving Opportunity Scheme) and we plan to take a similar approach to the second phase which we will be working towards in 2019.

- Within our residential mortgage activity we are following the decarbonisation agenda closely and looking at how our product range might develop to complement this.

- Our commercial team have for several years had a focus on environmental efficiency – seeking Energy Performance Certificates through the origination process, for example the development of Llewellyn House at Harbourside Business Park, Port Talbot was rated BREEAM excellent.

- We will be working hard to build colleague awareness through education of the measures that they can take to support and contribute to our sustainability agenda.

Tracking our progress

We continue to track our performance to ensure that we are reducing our environmental impact year on year. Notable areas include business miles travelled, printing reductions, levels of waste sent for recycling and energy usage where, for example, we have reduced our electrical usage (kWh) by 33% over the last four years within Principality House and 35% across our branch network.

Financial review

Income statement overview:

Continuing Operations	2014* £m	2015 £m	2016 £m	2017 £m	2018 £m
Net interest income	133.8	134.1	124.9	125.9	119.6
Other income	8.1	6.8	9.7	7.5	5.6
Fair value (losses)/gains	(1.5)	0.9	1.6	4.3	(2.4)
Operating expenses	(64.7)	(83.7)	(82.1)	(89.6)	(81.5)
Impairment provisions (charge)/release	(13.5)	(4.8)	2.7	10.0	(0.6)
Other provisions	(8.7)	(4.3)	(6.5)	(0.5)	–
Profit before tax	**53.5**	**49.0**	**50.3**	**57.6**	**40.7**

Statutory pre-tax profit for the year was £40.7m (2017: £57.6m). This reduction was anticipated and was driven by a lower level of net interest income, a significant release in impairment provisions in 2017 not being repeated in 2018, and a change in fair value movements from a £4.3m gain to a £2.4m loss. These reductions to profit were in part offset by an £8.1m fall in operating expenses, which was achieved despite an increase in transformation programme costs as we continue to invest in the business.

Underlying pre-tax profit, which primarily excludes fair value movements and reflects the true trading performance of the business was £43.8m (2017: £53.4m).

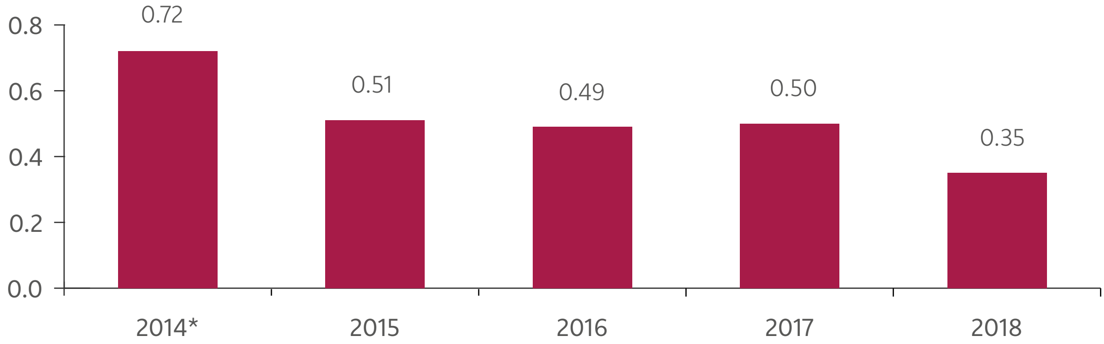
* Profit before tax in 2014 included a £10.1m gain in relation to the defined benefit pension scheme.

The table below details the adjustments made to statutory profit to arrive at underlying profit:

	2018 £m	2017 (restated) £m
Statutory profit before tax	40.7	57.6
Adjusted for:		
Fair value losses/(gains)	2.4	(4.3)
FSCS levies	–	0.1
Additional pension charge for GMP equalisation	0.7	–
Underlying profit	**43.8**	**53.4**

The purpose of the underlying profit measure is to reflect management's view of the group's underlying performance, presented to aid comparability across reporting periods by adjusting for items which affect statutory measures but are deemed to be either non-recurring or uncontrollable in nature. This aligns to measures used by management to monitor the performance of the business and inform decisions regarding variable remuneration. The calculation of underlying profit has been reviewed to ensure it aligns to this purpose, resulting in certain changes from the analysis presented in previous reporting periods, principally by excluding fair value movements on derivatives and hedge accounting but including provisions for customer claims, in line with common industry practice. The comparative period has been restated accordingly.

Return on assets, calculated as statutory profit after tax divided by average total assets has decreased in line with expectations as we continue to redeploy capital from secured personal lending to residential mortgage lending.



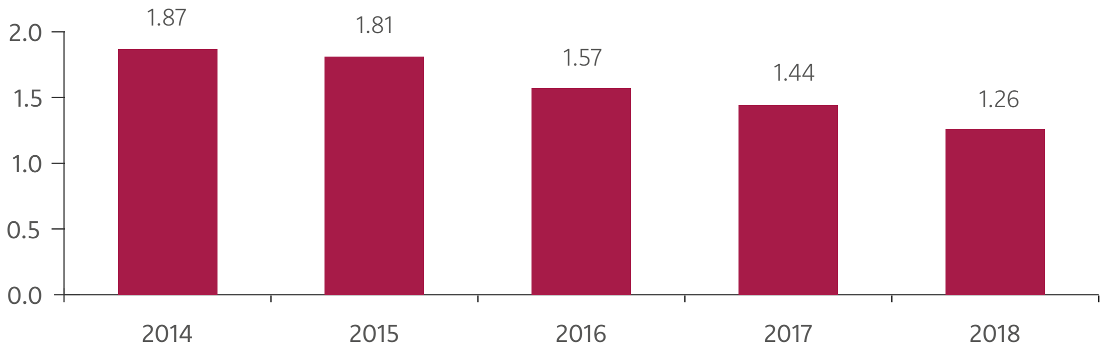
* Return on assets in 2014 included the impact of a £10.1m gain in relation to the defined benefit pension scheme.

Net Interest Margin

Our net interest margin for the year was 1.26% (2017: 1.44%). This reduction from previous years has been impacted in part by a continued decrease in the secured personal lending portfolio. At the same time, and together with other financial services organisations, we have experienced further pressures on margin due to the ongoing competitiveness of the residential and commercial mortgage markets, driving the replacement of older, higher margin loans with newer, lower margin lending.

Our lending continues to be primarily funded by Member's retail savings, with 82.2% (2017: 83.5%) of loans and advances to customers funded in this way. Interest rates paid on savings are impacted by the level of interest earned on mortgages. Although we saw a reduction in interest received due to an increasingly competitive mortgage market, we have sought to continue to offer better than average savings rates to our Members, which together have resulted in a decrease in the net interest margin earned.

In addition to the funding provided by retail savings, we aim to maintain a diverse range of funding sources, which includes wholesale funding raised through the issuance of Residential Mortgage Backed Securities (RMBS) and senior unsecured notes. These provide us with secure funding over a longer-term, providing increased stability in uncertain market conditions; however they come at a cost which has further impacted net interest margin.



Other income

Other income at £5.6m (2017: £7.5m) has decreased from the prior year, driven primarily by lower levels of profit share income in respect of the group's general insurance partnerships.

Fair value movements

Fair value movements represent the change in value of certain assets and liabilities to reflect underlying market rates. These movements are primarily timing differences, which in any given year can be an overall loss or a gain; however, will reverse as the asset or liability approaches maturity and therefore trend to zero over time. During the year we recognised a loss of £2.4m in the income statement (2017: £4.3m gain) in relation to these movements in fair value.

Operating expenses

We recognise that operating efficiently is a significant factor in achieving optimal Member value, and as such operating expenses remain a key area of focus. Operating expenses decreased in the year to £81.5m (2017: £89.6m), despite an increase in spending on the group's strategic transformation programme and an additional, one-off £0.7m defined benefit pension scheme charge for guaranteed minimum pension (GMP) equalisation which has become a legal requirement following the recent High Court ruling in respect of Lloyds Banking Group.

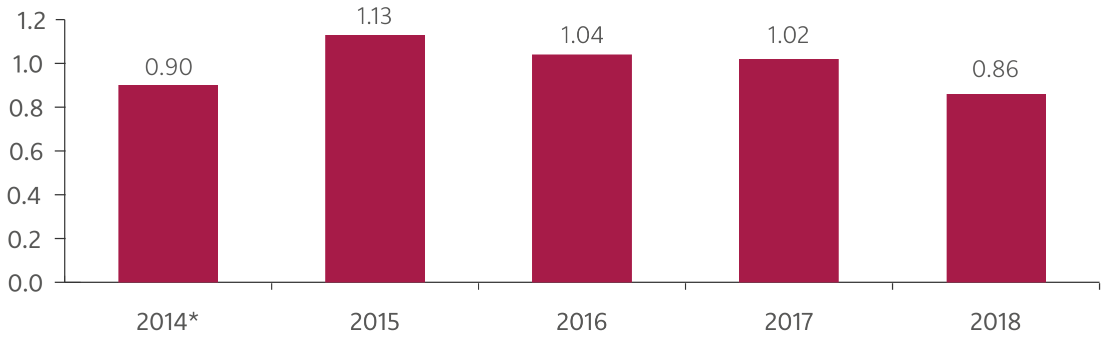
The overall reduction in operating expenses has been driven by a continued focus on managing the core cost base of the business, including the lower costs of servicing the secured personal lending portfolio as we took action in 2018 to combine the operations with those of the Society. Operating expenses in 2017 also included an impairment charge of £5.8m against the Society's head office building, Principality House. No such impairment was identified in 2018.

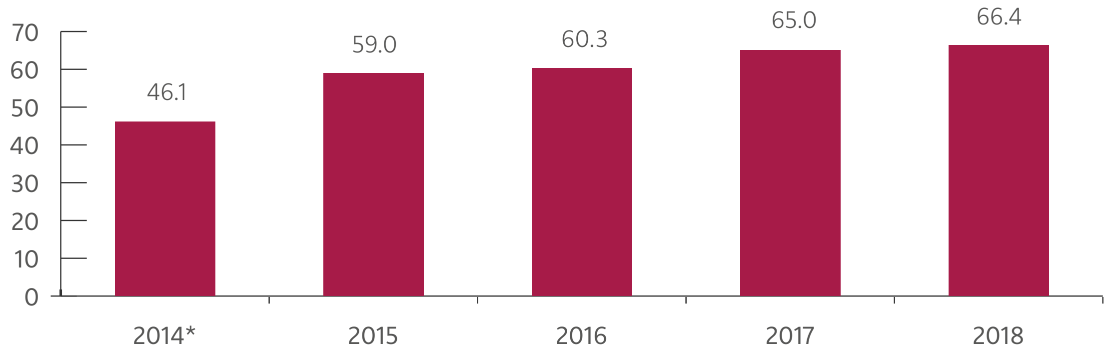
The year on year operating expenses comparison is set out in the table below:

	2018 £m	2017 £m
Retail financial services	75.4	80.5
Commercial lending	3.7	3.6
Secured personal lending	2.4	5.5
Total operating expenses	**81.5**	**89.6**
Management expense ratio	0.86%	1.02%
Cost income ratio	66.4%	65.0%

The reduction in costs is reflected in the management expense ratio, which compares costs as a proportion of the assets of the business. The cost income ratio has increased marginally over the same period; however, this compares costs as a proportion of total income, and overall total income, in particular net interest income, has reduced by a greater proportion than costs over the same period, for the reasons set out above. These key cost ratios will remain an area of focus in 2019 and beyond.

Operating expenses (continued)





* Ratios in 2014 included the impact of a £10.1m gain in relation to the defined benefit pension scheme.

Impairment provisions for losses on loans and advances

	2018 £m	2017 £m
Retail mortgage lending	2.4	0.3
Commercial lending	(0.5)	(5.0)
Secured personal lending	(1.3)	(5.3)
Total	**0.6**	**(10.0)**

Impairment charges totalled £0.6m in 2018 compared with a £10.0m release in 2017. These are not directly comparable however as the group, in line with its peers, has had to apply the new accounting standard for financial instruments, IFRS 9, from 1 January 2018. IFRS 9 changes the recognition of impairment provisions from an incurred loss basis i.e. losses based on events that occurred prior to the balance sheet date, to an expected loss basis, which takes into account losses that may result from future events.

The impairment charge in 2018 comprises releases of provisions for closed loans of £6.5m, offset by charges of £7.1m. Although the group continues to have a low overall level of arrears, reflecting our prudent affordability, credit quality and underwriting standards, as at 31 December 2018 we consider there to be a reasonable probability that the ongoing political and economic uncertainty will negatively impact house price growth, levels of employment and ultimately arrears levels over the next few years. These considerations have been taken into account in determining the level of provisions to be held and mean that the business is well positioned to deal with the future economic uncertainty that exists.

The impairment release in 2017 related to the commercial and secured personal lending portfolios. Commercial lending impairment releases reflected improvements in both the commercial lending market and the overall quality of the book, including the work undertaken in recent years to bring resolution to the remaining legacy low credit quality or distressed loans. Provision releases in the secured personal lending portfolio were largely a result of the continued reduction in the book and releases have also been seen in 2018, albeit not to the levels previously experienced.

The total impairment provisions held on the statement of financial position were as follows:

	2018 £m	2017 £m
Retail mortgage lending	9.2	5.5
Commercial lending	12.4	15.0
Secured personal lending	8.9	9.8
Total	**30.5**	**30.3**

PERFORMANCE AND STRATEGY

Provisions for other liabilities and charges

At 31 December 2018, the group held a provision of £3.3m (2017: £3.8m) in relation to customer redress, including Payment Protection Insurance ("PPI").

The provision considers sales of PPI via direct channels as well as via brokers, some of whom are no longer trading, as well as recent customer behaviour and reopening previously closed complaints. The provision will continue to be monitored and customer trends and behaviour analysed in order to ensure the provision remains appropriate as circumstances become clearer.

Further information on the level of provisions and the uncertainties therein can be found in notes 2, 19 and 30.

Taxation

The statutory rate of corporation tax was 19.0% for 2018. The actual effective tax rate from continuing operations for the group was 19.2% (2017: 24.5%) compared with the statutory rate of 19.0% (2017: 19.3%). The rate differential in 2018 is due to income statement expenditure which is disallowable for corporation tax purposes. In 2017, the rate differential was also impacted by disallowable expenditure; however, was mainly driven by the impact of the Bank Corporation Tax surcharge which results in an additional tax charge of 8.0% on Society profits over £25.0m.

A reconciliation of the effective rate to the statutory rate is provided in note 12.

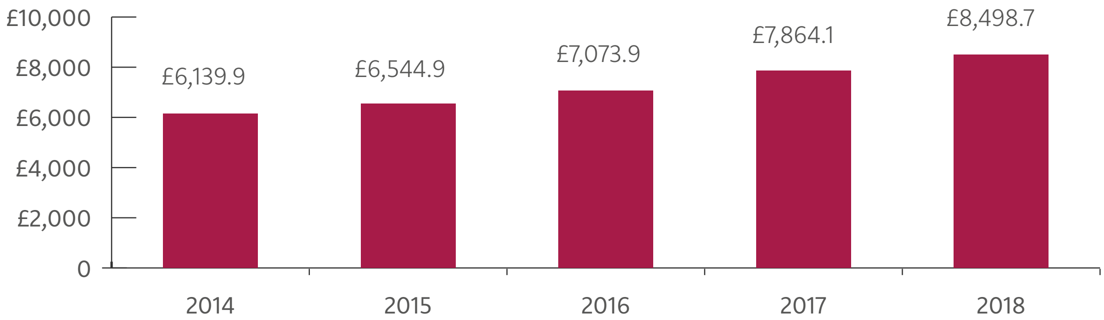
Statement of Financial Position

Total assets increased by £424.8m to £9,687.4m.

	2014 £m	2015 £m	2016 £m	2017 £m	2018 £m
Liquid assets	1,037.4	962.0	1,116.8	1,320.0	1,112.5
Loans and advances to customers	6,139.9	6,544.9	7,073.9	7,864.1	8,498.7
Other assets	87.7	77.5	90.5	78.5	76.2
Total assets	**7,265.0**	**7,584.4**	**8,281.2**	**9,262.6**	**9,687.4**
Retail savings	5,613.0	5,621.8	6,165.2	6,563.8	6,989.8
Wholesale funding	1,001.7	1,287.5	1,468.8	2,035.9	2,019.4
Other liabilities	239.0	226.1	168.8	142.5	127.5
Total liabilities	**6,853.7**	**7,135.4**	**7,802.8**	**8,742.2**	**9,136.7**
Reserves	411.3	449.0	478.4	520.4	550.7
Total liabilities and equity	**7,265.0**	**7,584.4**	**8,281.2**	**9,262.6**	**9,687.4**

Loans and advances to customers

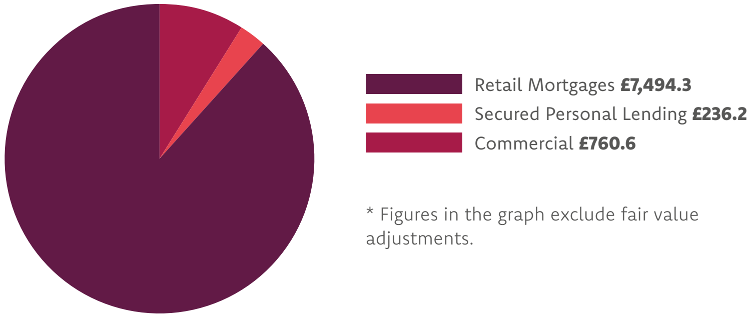
We have continued to focus on our core business of prime lending against residential and commercial property. This has delivered an increase in loans and advances to customers of £634.6m (2017: £790.2m) to £8,498.7m (2017: £7,864.1m). We have achieved this profitably and in line with our risk appetite. Net retail mortgage lending in the year was £718.7m (2017: £917.2m).



The retail mortgage portfolio has seen the majority of the increase to loans and advances to customers and remains the largest portfolio of the business at £7,494.3m (2017: £6,775.5m). This includes both lending to homeowners and a high quality buy-to-let portfolio of £1,929.4m (2017: £1,696.6m). The support for both residential mortgages and buy-to-let mortgages helps provide a broad range of products to both current and any future Members.

All buy-to-let lending is assessed against stringent interest cover and loan-to-value criteria.

We also hold a secured personal lending portfolio of £236.2m (2017: £311.8m), secured against residential property by a second charge. This business is in run off with balances reducing by £75.6m (2017: £92.3m reduction) in the year.



* Figures in the graph exclude fair value adjustments.

Our retail mortgage and secured personal lending portfolios reflect the prudent nature of our lending policies, with 68% (2017: 71%) of exposures having a loan to indexed valuation of less than 70%, and 82% (2017: 85%) less than 80%.

The exposures are well spread by geographical area within the UK, albeit with a larger share of lending in Wales, which by value makes up 30.7% of lending (2017: 29.8%) in the retail mortgage and secured personal lending portfolios.

Loans and advances to customers (continued)

The strong credit quality of loans issued is reflected in the low value and volume of the arrears against first and second charge residential lending. The percentage of retail mortgage lending cases fully secured by a first charge currently with arrears of more than three months is 0.49% (2017: 0.53%), which compares favourably with the industry average of 0.78%*. The number of properties taken into possession during the year was 36 (2017: 53).

The percentage of secured personal loans currently in arrears of two months or more by number is 4.76% (2017: 4.63%), which by value is 5.67% (2017: 5.66%).

The commercial lending portfolio is made up of commercial property exposures representing 35.7% (2017: 36.6%) of balances, and lending against residential property and to registered social landlords of 64.3% (2017: 63.4%). The Society provides loans secured on commercial property across England and Wales, with 47.1% (2017: 48.5%) of lending situated in Wales.

The commercial lending portfolio had two exposures greater than three months in arrears at the year-end (2017: nil). Focus is maintained on all loans experiencing difficulty to ensure positions are tightly managed and the potential for losses arising is realistically and conservatively assessed. Joint action plans are implemented with borrowers wherever possible to minimise the likelihood and extent of defaults. There are no arrears in respect of lending to registered social landlords.

* UK Finance arrears and possession data at 30 September 2018.

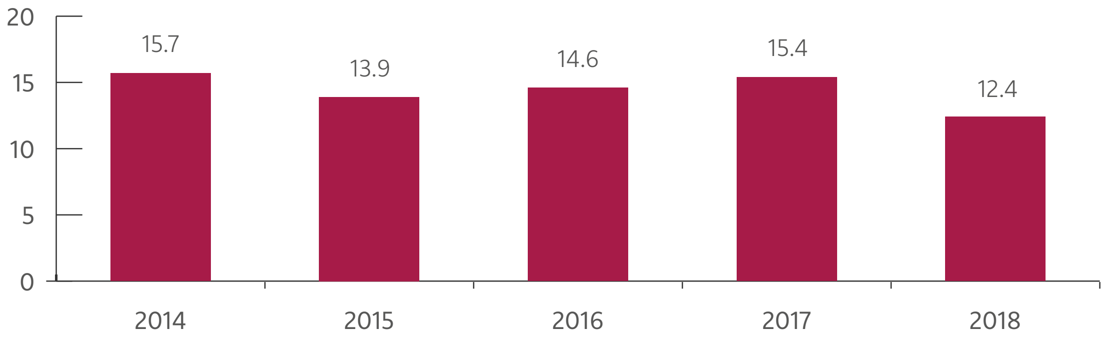
Defined benefit pension scheme

The Society operates a defined benefit pension scheme, which is closed to new entrants and to further accrual. During the year, the pension scheme deficit (the difference between the scheme assets and scheme liabilities) decreased to £3.9m (2017: £8.9m). The deficit includes an additional £0.7m charge in respect of GMP equalisation as detailed above.

The defined benefit scheme was subject to a triennial valuation on 30 September 2016, which was subsequently completed in December 2017. The scheme at the end of 2018 remains in deficit; however, the deficit has reduced significantly from the prior year, due largely to contributions made by the Society in the year of £4.6m (2017: £6.7m). The Society continues to work closely with the Trustees of the scheme to ensure the investment plan for the scheme assets is effective in both generating returns and mitigating risks, and thereby that the pension risk to the Society is appropriately managed.

Liquidity

We hold liquid assets to ensure we have sufficient access to funds to meet our financial obligations in both normal and stressed scenarios. We continue to maintain a robust liquidity position, with liquid assets at the year end of 12.4% (2017: 15.4%) as a proportion of shares, deposits and loans (SDL). Liquidity levels at the end of 2017 were increased by a £300m senior unsecured debt issuance. There were no such issuances in 2018 as we focussed on balancing the need for liquidity against the associated costs and margin impact.



Our liquidity is made up of cash and balances with the Bank of England and loans and advances to credit institutions.

The Liquid Asset Buffer as defined by the Prudential Regulatory Authority (PRA) includes highly liquid assets, typically central bank and sovereign exposures. At the year end, the proportion of the group's available liquidity which was buffer eligible was 86.3% (2017: 85.8%). Of the total liquid assets, none (2017: 1.2%) were less than A rated under Fitch credit ratings.

The PRA monitors liquidity using the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), measures introduced as part of the CRD IV regulatory changes. The group's Liquidity Coverage Ratio, a measure of our ability to withstand a short-term liquidity stress, was 155.8% at the year end (2017: 203.0%), well above the regulatory requirement. The NSFR is a longer-term stable funding metric, which measures the sustainability of the group's long-term funding. Based on current interpretations of the regulation, our NSFR is in excess of 100%, and we have sufficient stable funding to meet the new requirement.

We are a participant in the Bank of England's Term Funding Scheme, and also have access to contingent liquidity through the Bank of England's Sterling Monetary Framework.

Liquid assets are set out in the table below:

	2018 £m	2017 £m
Cash and balances with the Bank of England	931.8	1,026.3
Securities issued by the UK Government and Multilateral Development Banks	–	85.9
Total Buffer Eligible Assets	**931.8**	**1,112.2**
Loans and advances to credit institutions and other debt securities	180.7	207.8
Total	**1,112.5**	**1,320.0**

Funding

Members' savings are, and will remain, the most important part of the Society's funding base. However, given the highly competitive nature of the mortgage market and the lower relative cost of wholesale funding sources, it is important that we maintain an appropriate balance between retail and wholesale funding.

Funds are raised from a variety of sources in order to meet the strategic objective of maintaining a diversified funding mix. The largest component is retail savings, which at £6,989.8m (2017: £6,563.8m) represent 82.2% (2017: 83.5%) of all mortgage and loan balances. Retail savings balances have increased by £426.0m in the year (2017: £398.6m), reflecting the continued focus on offering attractive products to Members.

In 2017, we completed a fourth RMBS issuance, raising £475m of funding, together with an issuance of senior unsecured notes, raising £300m of funding. These issuances supported our strategic objective of maintaining a diverse and balanced funding base. No such issuances have been required in 2018; however, we continue to keep our funding requirements under close review. The total value of RMBS notes outstanding at the end of the year was £713.2m (2017: £932.1m).

During the year we have maintained our credit ratings on our long-term and short-term debt with both Moody's and Fitch. The group's current credit ratings are set out in the table below:

	Short -term	Long-term	Outlook
Moody's	P-2	Baa2	Stable
Fitch	F2	BBB+	Stable

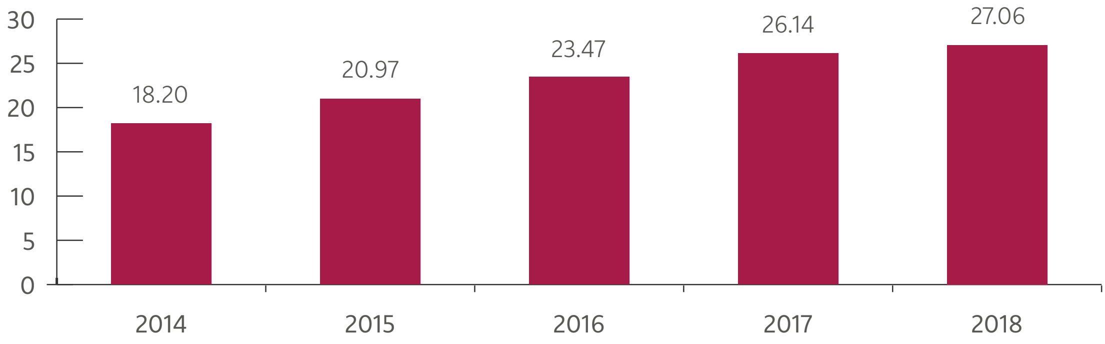
Asset encumbrance

We use our assets as collateral to support the raising of secured funding, primarily as part of the RMBS issuances or pledged under the terms of Bank of England funding schemes. At the end of the year, 22.9% (2017: 20.3%) of the group's assets were encumbered, representing £2,072.1m (2017: £1,719.2m) of residential mortgage assets and £145.0m (2017: £158.0m) of other assets.

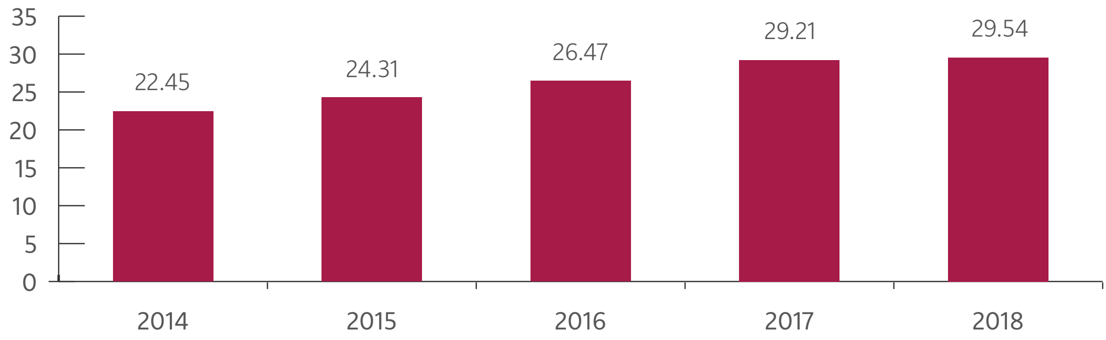
Capital

We hold capital to protect Members' deposits by providing a buffer against unexpected losses. The amount of capital required is assessed in relation to our overall risk appetite, the material risks to which the business is exposed and the management strategies employed to manage those risks. Capital comprises the group's general reserve and subscribed capital (Permanent Interest-Bearing Shares, or PIBS), adjusted in line with regulatory rules. Capital is held in both of the regulatory tiers. The group's general reserve qualifies as Common Equity Tier 1 capital, the very highest quality of capital. Under Basel III transitional rules, the PIBS qualify as Additional Tier 1 capital, but amortise on a straight line basis over eight years from 2014. The amortised portion of the balance is classified as Tier 2 capital.

Our primary measure in assessing capital adequacy is the Common Equity Tier 1 (CET1) ratio, which expresses the highest quality capital as a proportion of the sum of the risk weighted assets of the group. The risk weighting for each asset is calculated either through the use of internal models or through standardised calculations dependent on regulatory permissions for each portfolio of assets.
Our CET1 ratio has increased to 27.06% (2017: 26.14%) due to the impact of the increased capital generated by the profitability in the year, combined with a decrease in total risk weighted assets associated with the de-risking of the commercial portfolio and the run-off of the Nemo portfolio. This means that we are generating sufficient capital through our financial performance to facilitate the increase in lending to households and businesses.



Our Solvency ratio, the ratio of total capital to risk weighted assets, has increased to 29.54% (2017: 29.21%).



A further measure of capital strength is the Leverage ratio, a measure of Tier 1 capital held against total (non-risk-weighted) assets, including certain off-balance sheet commitments. At the end of the year our Leverage ratio was 5.60% (2017: 5.63%).

Anti-Corruption and Anti-Bribery matters

Anti-Corruption and Anti-Bribery matters are the subject of a separate report within the Directors Report on page 90.

Member, colleague and community

Member, Colleague and Community are the subject of a separate report on pages 30 to 34, which includes further detail in respect of the Employee Engagement score on page 34.

Principal risks and uncertainties

The principal risks and uncertainties faced by the group, together with the approach to managing these risks, are set out in the separate Risk Management Report on pages 52 to 70.

Tom Denman
Chief Financial Officer
5 February 2019

Member, colleague and community

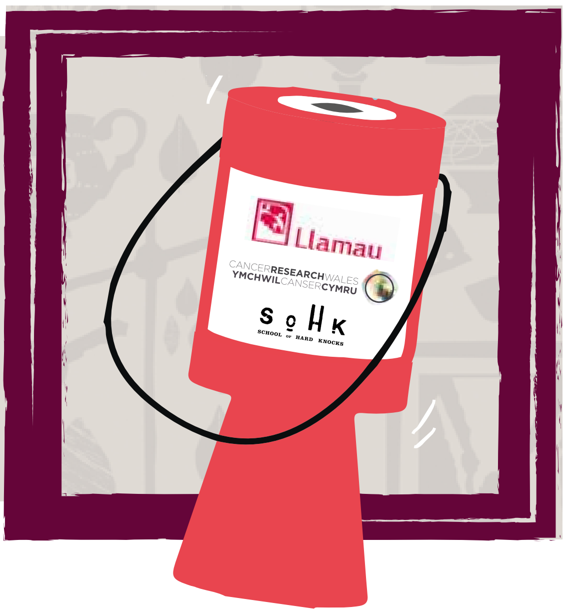
for the year ended 31 December 2018

Community work

As a Society we pride ourselves on the great work of our colleagues in the communities we serve. The focus of our community activity remains on the three key pillars of financial education, helping people get and stay in a home for longer and health and wellbeing. This activity also reflects our values, particularly 'doing the right' thing and 'delivering with passion'.

Our colleagues have raised money for the Society's three charity partners. These are Llamau, a leading homelessness charity in Wales; Cancer Research Wales, supporting research into prevention and early diagnosis of cancer; and School of Hard Knocks, which uses sport to help disadvantaged communities.

Our three-year partnership with these brilliant charities ended at the close of 2018, with £504,000 raised, which includes match-funding by the Society, split evenly between each charity.



Support for Llamau:

- 690 people supported through Learning for Life centres across Wales since 2016.
- 1,300 qualifications achieved since 2016.

The £168,000 we have raised for Cancer Research Wales contributed almost 10% towards major research grants for fighting cancer including:

- Bangor University: Helping to better understand the symptoms of prostate cancer and ensure effective diagnosis amongst men.
- Cardiff University: Investigating a novel therapeutic approach to prevent tumour plasticity in breast cancer, helping to stop cancer stem cells spreading.

Support for the School of Hard Knocks (SOHK):

- SOHK established their Welsh presence by forming a bigger team.
- 300 risk of referral pupils have stayed in school since 2016.
- 120 unemployed adults supported.

Other community donation highlights include:

- 89 Community projects supported in 2018, investing £76,000.
- Over 1,700 hours volunteered.

PERFORMANCE AND STRATEGY

Financial education

Since 2017, we have invested over £62,000 in sponsoring students from ten schools across Wales to complete financial education qualifications with the London Institute of Banking & Finance (LIBF). In addition, we have partnered with Business in the Community Cymru through their Business Class programme. Business Class is run by Business in the Community and Careers Wales on behalf of the Welsh Government, and brings together secondary schools and businesses across Wales. Highlights include:

10,000

students helped through Business Class since 2016.

More than

1,700

were helped as part of Talk Money Week 2018; with Principality staff taking part in literacy and numeracy workshops.

More than

250

pupils gained a GCSE equivalent in money skills in 2018 with a further 1,200 studying towards LIBF qualifications.

Bro Myrddin in Carmarthen has become the first

Young Money Centre of Excellence

in Wales, representing an entire school approach to financial education.

Sponsorship

Principality's wider sponsorships continued to add value to the health and wellbeing within our communities.

Highlights include:

Our partnership with the Welsh Rugby Union remains strong, with the Society's sponsorship of the Stadium benefitting Members through its Member Rewards scheme.

200

Only Boys Aloud help over 200 boys each year with community choirs across Wales.

Principality National Youth Leagues helping to raise profile of the game within local communities.

Sponsorship of Principality Premiership for a 14th consecutive season helping to grow grassroots rugby in Wales.

39

39 consecutive years of sponsorship of the Eisteddfod event which celebrates Welsh culture.

25

More than 25 years sponsoring the Royal Welsh Show.

Members

We pride ourselves on listening to our Members so colleagues can understand how to meet their needs and expectations. Members tell us that they value the friendliness and helpfulness of our colleagues.

We engage with Members in a number of ways:

- Principality's senior leadership team holds regular Talkback events all over Wales and the Borders.
- At the Annual General Meeting, Members have the opportunity to vote and put questions to the Board.
- Through a Customer Research Panel which consists of Members and customers.

We also have a Member Forum, made up of volunteer Members who act as a collective voice for all Principality Members. The Forum meets on a quarterly basis to share their views and to tell us what they think of our products and initiatives, and to help us make the right decisions for all our Members. The Forum has had significant and valuable input into the continuing strategy of the Society, and any interested Member may apply to join.

Our people strategy: helping our colleagues to prosper at every stage of their working life

The aim of our people strategy is to deliver ongoing improvements in colleague engagement and satisfaction. It is based on the following three elements:

- We will be an employer of choice, continuing to attract and retain talented and passionate people.

- We will inspire a strong customer focussed and inclusive culture, investing in our colleagues and building their capability as we transform our Society.

- We will empower our colleagues to live our values, helping them to prosper at every stage of their working life.

We are incredibly proud of our colleagues and the service they provide to our Members and we believe that if we are able to help our colleagues prosper, we will see them increasingly strive to support our Members and our business in the same positive way.

Recognised as a 'Great Place to Work®' in the large companies category 2017, we are committed to building on what our colleagues tell us they enjoy about working in our organisation and addressing their feedback around what we can improve.

We take pride in creating the right culture

At Principality, we seek to promote a high performing organisational culture through our colleagues living and demonstrating our values. The five values that underpin our culture are:

- Being courageous
- Doing the right thing
- Making it straightforward
- Delivering with passion
- Taking ownership

We are committed to providing an environment in which our values are recognised and celebrated, where colleagues take pride in how they interact with each other and our Members and where everyone, regardless of background or experience, feels they belong and can contribute. In order to continue to build a successful Society, we encourage our colleagues to value and respect each other and our values are a simple mechanism to drive the right culture for our organisation. Colleagues are encouraged to recognise each other 'in the moment' and value cards are available at all of our working locations for colleagues to gift to each other when they see demonstration of our values. Forming the basis for our individual business objectives, our values are prominent throughout the Society and are also recognised through quarterly and annual recognition celebrations.

We respect our colleagues as individuals: our diversity and inclusion approach

As a business, we are clear that having a diverse workforce that is representative of and reflects the communities we serve is crucial to our ongoing success. Seeing diversity represented throughout our business remains a priority and we have been encouraged by positive take-up amongst our colleagues for a number of diversity-focussed initiatives, including a female leadership development programme delivered by Chwarae Teg and our LGBT+ and Friends network. From Board level down, we are clear that diversity helps to improve the quality of decision making throughout our organisation and we are committed to increasing our diversity spread to further support our ambitions. We continue to be a signatory to HM Treasury's Women in Finance Charter and have set targets for our gender balance in our senior management and Board populations. Further details are available at www.principality.co.uk/gender-pay-gap-and-women-in-finance.

We encourage expertise: investing in our talent realise potential

As our business transforms, our people focus remains a constant. We are passionate about developing our colleagues and we have a strong learning culture with a clear focus on helping our colleagues to prosper at every stage of their working life. Our Leadership Pipeline provides a clear pathway for colleague learning and development throughout the organisation and initiatives such as our 'Learning at Work' week and networking group, 'Cuppa Club' which has attracted guest speakers including BBC newsreader, Lucy Owen, provide even more opportunities for informal learning and development. We recognise that no two colleagues will approach their development in the same way so in addition to our specialist talent management programmes, we also have a range of secondments and graduate schemes designed to support colleagues whatever their career aspirations.

Making it easier to do a great job: listening to our colleagues

At Principality, we work hard to listen and respond to our colleagues and we are proud to have a highly engaged workforce. Colleague surveys are an important enabler to hearing our colleague voice and we have introduced a number of initiatives to respond to feedback gathered, including the implementation of PBS Manager training, the creation of a skills exchange and the establishment of a mentoring scheme. More recently we've reinvigorated our colleague forum, ensuring we have a direct voice from our colleagues into our Board. The forum is a great vehicle to ensure our colleague voice is heard in all key matters within the Society.

In October 2018, 90% of our colleagues took part in our latest Great Place to Work® survey to share their views on working life at the Society. The survey is run by an independent third-party and the responses gathered are used to define scores in key outcomes including Engagement, Trust and Wellbeing. The 2018 survey showed that engagement remains strong at 76% (2017: 78%). The results of the survey are reviewed in detail and actions developed in response and delivered both at a team and Society-wide level. Colleagues are encouraged to share their views and feedback year-round and there are a number of open and anonymous feedback routes available.

Wellbeing

We have a long-established wellbeing approach that aims to promote both mental and physical health amongst our colleagues. With a wide ranging wellbeing-focussed offering, including interventions from free flu immunisations to investment in our mental health advocates and a full Employee Assistance offering, we work hard to support our colleagues through their best times and their more challenging times.

Rewarding our colleagues fairly

Our people approach means that we treat reward in a fair and consistent manner for all. We are committed to paying the Living Wage and all colleagues are able to participate in our variable pay award scheme which is linked to a combination of the Societies' success, meeting individual business objectives and our customer experience metrics. We recognise that delivering as a business takes a strong team and our variable pay award scheme has been developed to recognise our combined contribution.

Governance

Board of Directors

Laurence Philip Adams MA (age 62)
Chairman, Non-Executive Director

I was appointed a Non-Executive Director of the Society in August 2013 and was elected Chairman in April 2014. I am also a member of the Remuneration committee and Chairman of the Governance and Nominations Committee.

I have more than 25 years' experience in the banking industry. Previously, I have been involved as a Non-Executive Director helping to rescue the troubled Northern Rock PLC in 2007 where I headed the Risk Committee.

I am a qualified solicitor and previously served as Managing Director and Global Head of Legal and Compliance for the investment banking wholesale division of ABN Amro Bank and had a similar role for Citibank. I am a Non-Executive Director of Exane Limited and London Clearing House Limited, part of the London Stock Exchange.

Nigel Charles Annett CBE, MSC, MA [Hons], DSC Econ (age 60)
Non-Executive Director

I joined the Board of Principality as a Non-Executive Director in October 2013. I now serve as Chairman of the Board's Customer, Conduct and Transformation Committee. In addition, I also serve as a member of the Board Risk, Governance and Nominations and Remuneration Committees.

I used to work in investment banking, but after 10 years joined the Board of Welsh Water, initially as Planning Director. I was one of the founding Directors of Glas Cymru, the not-for-profit company that took over the ownership of Welsh Water in 2001, and I was Managing Director of Welsh Water until 2014.

In addition to serving on the Board of Principality, I am also a Board member of the Canal and River Trust and a Trustee of the Community Foundation in Wales.

Claire Hafner ACA, MA (age 59)
Non-Executive Director

I was appointed to the Society's Board as a Non-Executive Director in April 2018 and I serve as a member of the Audit, Governance and Nominations and Remuneration Committees.

I am a qualified accountant (ACA) and I have an MA in Languages and Economics. I trained and qualified at Ernst and Young in the audit department of the Financial Services department followed by a further three years in corporate tax. During my career, I have performed a broad range of roles across multiple sectors (including financial services and payments, professional services, multimedia and telecoms). I have previously served a term of six years as a Non-Executive Director of the West Bromwich Building Society.

Derek Anthony Howell BSc [Hons], FCA (age 64)
Senior Independent Director, Non-Executive Director

I was appointed a Director of the Society in April 2014 and have subsequently been appointed to the role of Senior Independent Director. I also serve as Chair of the Audit Committee and as a member of the Board Risk and Governance and Nominations Committees. In addition, I also serve as the Board appointed Whistleblowing Champion.

I hold a degree in Mathematics and qualified as a Chartered Accountant with Price Waterhouse – subsequently Pricewaterhouse Coopers (PwC). During my time with that firm I worked originally in the audit team and eventually specialised in corporate recovery and insolvency work, becoming a partner in 1988. I retired from the PwC partnership in April 2013 and have been engaged on a part-time basis since as a consultant, working on the Lehman insolvency.

I am also Treasurer of St John Cymru Wales and a Trustee of both the National Botanic Garden of Wales and Artes Mundi.

Sally Jones-Evans FCIB, MSC, MBA (age 52)
Non-Executive Director

I was appointed to the Society's Board in February 2015. Since joining the Board, I have become Chair of the Remuneration Committee. I also serve as a member of the Audit, Governance and Nominations and Customer, Conduct and Transformation Committees.

I spent 30 years in retail banking and general insurance.

I also sit on the Board of the Tearfund Charity and Hafryn Dyfrydwy Limited (a subsidiary of Severn Trent PLC) together with the Board of the Department for International Development.

David James Rigney ACMA, MBA, MA (age 55)
Non-Executive Director

I was appointed to the Society's Board in March 2015. Along with my Board responsibilities, I serve as Chair of the Board Risk Committee and as a member of the Audit, Governance and Nominations and Customer, Conduct and Transformation Committees.

I am a Chartered Management Accountant and during my career I have performed a broad range of roles across multiple sectors including a Board Director at Nationwide Building Society.

I am also a member of the LINK Board, Non-Executive Director and Senior Independent Director of Elexon Limited.

Tom Denman BSc (Econ) [Hons], ACA (age 44)
Chief Financial Officer (CFO)

I was appointed CFO on 1 June 2017 and joined the Board in August 2017. I have worked for the Society for nine years after joining in February 2009. Initially I held a senior finance role in the subsidiary businesses and later for the Society covering business partnering, planning and strategy. I was appointed Deputy Finance Director in March 2016. I chair the Society's Finance and Model Governance Committees and I am a member of the Executive Committee and the Executive Risk Committee.

I am a qualified Chartered Accountant and bring over 20 years' experience in finance to my role. Prior to joining the Society, I held a number of finance roles across a range of industries including commercial property, infrastructure and the legal profession along with 5 years with PwC in Cardiff and Sydney.

Robert Michael Jones BA [Hons] MBA, ACIB (age 60)
Chief Risk Officer (CRO)

I joined the Society's Board in February 2013. Having worked for the Society since 1997, I was appointed Head of Group Risk in 2005 and promoted to the role of Director of Group Risk (now CRO) in 2009. I have attended full Board meetings since September 2009 and attend all meetings of the Audit and Board Risk Committees. I am a member of the Executive Committee and chair the Executive Risk Committee. I also attend meetings of the Model Governance Committee.

I have spent almost 40 years working in financial services, starting my career at Midland Bank and subsequently at HSBC, undertaking a number of managerial roles in both the retail and corporate banking divisions. I hold a degree in Economics, an MBA from Henley Management College, and I am an Associate Member of the Chartered Institute of Bankers.

Julie-Ann Haines MSC, BA [Hons] (age 45)

Chief Customer Officer (CCO)

I was appointed to the Board in May 2016 and was appointed as Society's Customer Director in 2012 (now Chief Customer Officer). I attend all meetings of the Customer, Conduct and Transformation Committee and the Board Risk Committee and am a member of the Executive Committee and Executive Risk Committee.

Prior to Principality, I held a number of senior roles in sales, marketing and technology, working in leading customer-centric businesses including Sainsbury's, Reckitt Benckiser and HBOS.

I am the current Chair of UK Finance Cymru Mortgage Committee which represents mortgage lenders and promotes sustainable housing finance in Wales. I also sit on the End Youth Homelessness Steering group.

Stephen Hughes ACMA (age 46)

Chief Executive Officer (CEO)

I was appointed CEO in March 2017. I joined the Society as Group Deputy Finance Director in December 2011 and was appointed to the Society's Board in March 2013 as Group Finance Director with responsibility for Finance, IT and Business Change. I chair the Executive Committee and I am a member of the Executive Risk Committee. I also attend all meetings of the Audit, Customer, Conduct and Transformation, Remuneration and Board Risk Committees.

I am a qualified Management Accountant and bring over 25 years' experience in finance from a range of industries including manufacturing, retail and insurance. Prior to joining the Society, I performed the role of Finance Director of the Lloyds Banking Group General Insurance business.

I am the Chairman of the Wales Advisory Board for Business in the Community (BITC) and the Deputy Chair of the Mortgages Product and Service Board of UK Finance.

Corporate governance report

for the year ended 31 December 2018

The governance arrangements operated by the Society are based on the principles and provisions contained in the UK Corporate Governance Code (the Code), in so far as the Code can be applied to the Society. The Code was published by the Financial Reporting Council (FRC) in April 2016. A new Corporate Governance Code was published by the FRC in July this year and takes effect for reporting periods commencing 1 January 2019. The Society will report on adherence to the new Code in next year's annual report.

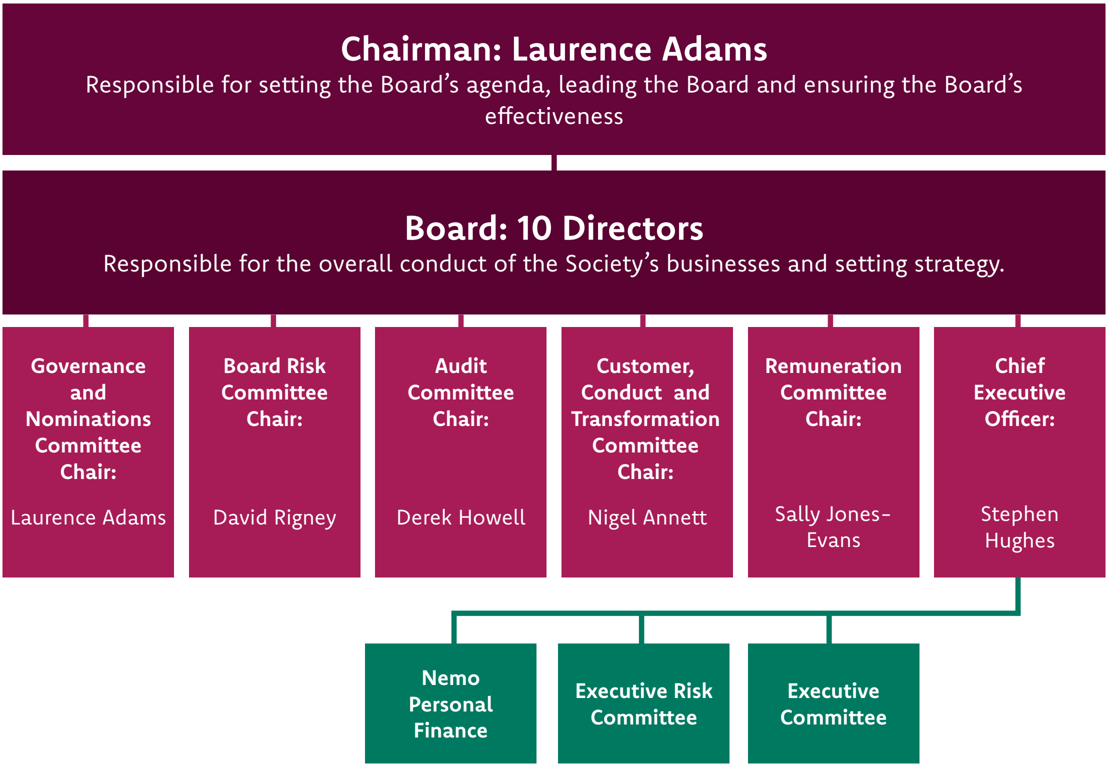
The Board is responsible for promoting the long-term success of the Society, which means it has a responsibility to act in the best interests of both current and future Members, and is committed to ensuring good standards of governance are in place within the Society. The Chairman is responsible for ensuring that the Board operates effectively within a sound governance framework and that there is appropriate oversight of governance arrangements at Board level.

In the past year the Board has devoted a considerable amount of time to monitoring the progress of the Society's ongoing transformation programme and work connected with establishing a more modern working environment. These topics will continue to be areas of particular focus for the Board in 2019 and beyond. The Board is responsible for:

- Formulating the Society's strategy.
- Ensuring that there is an appropriate culture in place across the Society which aligns with its purpose, values and strategy. The Chief Executive Officer and the Executive team are responsible for embedding the agreed culture and the Board takes regular steps to assess and ascertain that the Society's culture is fit for purpose.
- The proper conduct of all aspects of the Society's affairs.
- Fostering transparency and honesty and ensuring that good standards of behaviour permeate throughout all levels of the Society.
- Ensuring the sustainability of the Society's business model.
- Maintaining a sound system of control and setting the Society's appetite for risk. The Board delegates the responsibility for monitoring performance against risk appetite to the Board Risk Committee. The Board delegates responsibility for reviewing the adequacy and effectiveness of the Society's internal controls to the Audit Committee.

Corporate Governance Framework

The Board recognises that ensuring effective corporate governance is integral to the successful delivery of the Society's goals. The work of the Board is supplemented by the work performed by a number of Board committees. Reports on the work of those committees can be found on pages 71 to 87.



How the Board operates

At 31 December 2018, the Board comprised six Non-Executive Directors and four Executive Directors. The offices of Chairman and Chief Executive Officer are separate and held by different individuals.

The Chairman is responsible for:

- the leadership, operation and governance of the Board;
- ensuring the effectiveness of the Board;
- setting the agenda, style and tone of Board discussions;
- ensuring that Directors receive accurate, timely and clear information;
- developing the Board Succession Plan;
- ensuring that a comprehensive induction programme for new Non-Executive Directors joining the Board is maintained and that existing Non-Executive Directors receive the necessary ongoing training to be able to contribute fully to the Board; and
- ensuring that the performance of Non-Executive Directors is subject to annual appraisal.

The Chairman is not involved in the day-to-day management of the Society. The Chairman's role profile is subject to review and approval by the Board. The Senior Independent Director (Derek Howell) is responsible for acting as a sounding board for the Chairman, serving as an intermediary for other Directors, and being available to Members if they have concerns which they have not been able to resolve through the normal channels of the Chairman, Chief Executive Officer or other Executive Directors, or for which such contact is inappropriate. The Chief Executive Officer's responsibilities are set out in a role profile, which is approved by the Board. He is responsible for managing the day-to-day operation of the Society, implementing the Board approved strategy and policies, and chairing the Executive Committee. The Chairman and Chief Executive Officer maintain a close working relationship.

In order to ensure that adequate time is devoted to Board business, the Board operates through a number of Board committees. The Board delegates a number of oversight activities to five committees – Audit, Risk, Remuneration, Governance and Nominations and Customer, Conduct and Transformation. In addition, the Board has a formal schedule of matters reserved for it's decision which is reviewed annually.

Each Board committee has written terms of reference which are reviewed annually by the Board. The terms of reference for all Board committees can be found on the Society's website: www.principality.co.uk

The Board focuses its work on setting the longer-term strategic direction of the Society, challenging the performance of the senior management team in the day-to-day management and control of the business, setting risk appetite limits, monitoring adherence to risk appetite limits and ensuring that effective risk management systems are in place. The Board maintains oversight of the effectiveness of the internal system of control through:

- Receiving regular reports on the matters being considered by the Chairs of Board committees.
- Monitoring a range of key performance indicators (KPIs) and key risk indicators (KRIs).
- Receiving regular reports from the Chief Executive Officer, Chief Financial Officer, Chief Customer Officer, Chief Operations Officer and Chief Risk Officer on performance and risk matters.
- Receiving reports on the progress of the Internal Audit team and Conduct Monitoring team from the Chairs of the Audit Committee and the Customer, Conduct and Transformation Committee respectively.

The Board also receives regular updates on specific areas of strategy, allowing the Board to keep up to date with developments and challenge progress. It receives regular updates from Non-Executive Directors on Member and colleague engagement activities and from the Chief People Officer on progress with work being undertaken to put in place a more modern working environment and to embed a more diverse and inclusive culture.

The following table provides a sample of some of the matters the Board has considered during the year:

Responsibility	Key activity
Strategy and Performance	The Board is responsible for assessing the basis on which the Society generates and preserves value over the long-term. The Board remains committed to broadening the range of retail savings and mortgage products available to Members.
People, Culture and Remuneration	The Board believes a diverse and inclusive culture is integral to the Society's core values, fostering an environment where everyone is able to perform well and fulfil their potential.
Members and Customers	The Board has continued to receive regular reports from Non-Executive Directors on attendance at Member Talkback and Member Forum meetings.
Risk Management	The Board has continued to oversee the setting of the Society's appetite for risk and the ongoing implementation of an Enterprise Wide Risk Management framework. In addition, the Board has approved the Society's ICAAP, ILAAP and RRP.
Finance	The Board has monitored carefully the level of liquid assets in light of the higher than usual levels of swap volatility which have been a feature of the financial markets in 2018.
Technology and Change	The Board has continued to monitor closely the progress of work being taken forward to modernise the business. In addition to the five-year investment programme which will allow the Society to introduce a wider suite of retail savings and mortgage products, good progress has been made with work to modernise the working environment and working practices in 2018.
Governance	The Board annually reviews its own terms of reference and the terms of reference for Board committees to ensure that they evolve in line with the regulatory and operating environments in which the Society operates. The Board continues to monitor adherence and compliance with the FRC's Corporate Governance Code and continues to monitor and authorise directors' outside interests.

To enable the Board to use its time effectively, a forward looking programme of meetings and a rolling Board agenda is maintained. There is sufficient flexibility in the Board's programme to ensure that the Board can address emerging matters in a timely manner. A framework of delegated authority is in place, which extends to the Society's officers, management and management committees.

During the year the Board received regular presentations from members of the Society's senior leadership team as part of a wider programme to enable Non-Executive Directors to meet and interact directly with members of that team.

Board composition

The Board consists of ten Directors including the Chairman, five independent Non-Executive Directors (including Derek Howell – Senior Independent Director and Board appointed Whistleblowing Champion) and four Executive Directors. This composition is designed to be able to meet the needs of the business and allow for efficient operation of the Board's committees. The Non-Executive Directors are expected to have a broad range of business knowledge and experience and to exercise independent judgement on strategy, performance, risk management and corporate governance. In addition, their role is to:

- constructively challenge strategy proposals presented by the Chief Executive Officer and Executive Directors;
- scrutinise and challenge operational performance;
- assess the integrity of the financial information and controls;
- assess the adequacy of the Society's risk management framework;
- assess whether current and future resources are commensurate with future plans;
- determine the broad policy for executive remuneration; and
- be satisfied that an appropriate culture is in place.

During the year Natalie Elphicke retired from the Board having completed six years on the Board. During her tenure she served as a member of the Audit Committee, Governance and Nominations Committee and as both a member then Chair of the Board Risk Committee.

Claire Hafner joined the Board as a new Non-Executive Director in April 2018. She now serves as a member of the Audit Committee, Remuneration Committee and Governance and Nominations Committee. David Rigney was appointed Chair of the Board Risk Committee with effect from August 2018.

Candidates to fill Non-Executive Director vacancies on the Board are sought in various ways, including through press advertisements and with the assistance of external search consultants. Candidates must meet the tests of fitness and propriety as prescribed by the FCA and must receive approval from the PRA and FCA before taking up their role. The Society's Rules require that all new Directors must stand for election at the Annual General Meeting (AGM) in the year following their appointment to the Board. Members of the Society have the right to nominate candidates for election to the Board, subject to the Society's Rules and compliance with PRA and FCA requirements. No such nominations were received prior to the Society's 2018 AGM.

Membership of Board committees is reserved to Non-Executive Directors. The Chairman is responsible for regularly reviewing and refreshing the membership of Board committees in order to broaden the experience of Non-Executive Directors. This is also an important aspect of the Board succession planning process.

Tenure of Non-Executive Directors

The UK Corporate Governance Code recognises that length of tenure is an important factor which should be considered when determining the independence of Non-Executive Directors. The table below shows the tenure and independence of each Non-Executive Director.

	Date first joined the Board	Considered to be independent by the Board
Nigel Annett	October 2013	Yes
Derek Howell	April 2014	Yes
Sally Jones-Evans	February 2015	Yes
David Rigney	March 2015	Yes
Claire Hafner	April 2018	Yes

GOVERNANCE

Directors' fitness and propriety

The Society has a framework in place to ensure that individuals appointed to relevant senior manager positions have the appropriate fitness and propriety to properly discharge their responsibilities, both at the time of their appointment and during the tenure of their appointment.

The Chairman is responsible for assessing annually the fitness and propriety of the Society's independent Non-Executive Directors and the Chief Executive Officer. Fit and proper assessments were carried out in respect of each independent Non-Executive Director and the Chief Executive Officer during the course of 2018. The Senior Independent Director is responsible for evaluating the Chairman's performance and for conducting his annual fit and proper assessment.

The Chief Executive Officer is responsible for carrying out the annual performance appraisal and fit and proper assessment for each of the Executive Directors.

The Board continues to receive regular assurance on adherence to the Senior Managers and Certification Regime from the Chief Risk Officer and his team.

Conflicts of interest

The Board has established procedures leading to the disclosure of outside interests and the identification of potential conflicts of interest. The procedure is as follows:

- Changes to the commitments of all Directors are reported to the Board.
- Directors are responsible for notifying the Society's Secretary if they become aware of any actual or potential conflict situations.
- Actual or potential conflicts of interest are noted in the minutes of Board meetings as appropriate.
- The Society's Secretary maintains a register of potential conflicts of interest which is reviewed periodically.

No conflicts of interest were reported to the Board during the year.

At the time of his appointment as Chairman, the Board was satisfied that Laurence Adams met the independent criteria. The Chairman's role requires him to commit a substantial proportion of his time to the affairs of the Society. Consequently, the Chairman is not expected to remain independent following appointment. All of the Society's Non-Executive Directors are considered by the Board to be independent in judgement and free of any relationships likely to affect his or her judgement.

Board and Committee membership and attendance

	Board	Audit	Customer, Conduct and Transformation	Board Risk	Governance and Nominations	Remuneration
Laurence Adams	11/11	–	–	–	3/3	5/5
Natalie Elphicke[2]	5/6	–	–	1/2	2/2	–
Nigel Annett	10/11	–	5/5	5/5	3/3	5/5
Derek Howell	11/11	6/6	–	5/5	3/3	–
Sally Jones-Evans	11/11	5/6	5/5	–	3/3	5/5
David Rigney	11/11	6/6	5/5	5/5	3/3	–
Claire Hafner[1]	9/9	4/4	–	–	2/2	2/2
Stephen Hughes	11/11	–	–	–	–	–
Mike Jones	11/11	–	–	–	–	–
Julie-Ann Haines	11/11	–	–	–	–	
Tom Denman	11/11	–	–	–	–	–

1 Claire Hafner joined the Board 1 April 2018
2 Natalie Elphicke stepped down from the Board 20 July 2018

Culture

As in previous years, Non-Executive Directors have devoted a significant amount of time to meeting Members and colleagues from across the business as a means of experiencing the culture in the business at first hand. By visiting branch offices and attending meetings of the Member Forum and Member Talkback meetings, Non-Executive Directors are able to hear from Members and a broad range of colleagues at all levels of the business to better understand matters which are of direct interest to them.

The Board also gains insight into the culture within the business through reviewing the outcome of colleague surveys and information presented from a wide range of sources including the HR, Compliance and Conduct and Internal Audit teams.

Diversity

During the year the Board Composition Policy was reviewed and the Board remains satisfied that this policy appropriately reflects the importance attached by it, to building a culture in which the whole organisation works together and in which diversity is valued. More information on this topic is provided within the Governance and Nominations Committee report on pages 50 to 51.

Board information

The Board has full and timely access to all relevant information to enable it to discharge its duties effectively. The Chairman is responsible for ensuring that all Directors are properly briefed on issues arising at Board meetings. The content of management information presented to the Board is reviewed regularly to ensure that it remains relevant to the Society business model and operating environment, and to ensure it is sufficient to enable the independent Non-Executive Directors to assess and monitor the Society's progress.

All Directors have access to the advice and services of the Society's Secretary. Members of the Board may take independent professional advice at the Society's expense in the furtherance of their duties. The Society's Secretary is responsible for ensuring that Board procedures are followed.

Board induction and ongoing training programme

The Chairman is responsible for ensuring that each new Non-Executive Director receives induction training on joining the Board and ensuring that the subsequent ongoing training he or she needs is tailored to their own specific requirements.

All new Non-Executive Directors undertake a tailored and extensive induction programme on joining the Board. The programme covers all aspects of the Society's operations and the regulatory environment in which the Society operates. This enables new members of the Board to function effectively as a Board member as quickly as possible. The induction programme is reviewed annually by the Governance and Nominations Committee to ensure that it remains appropriate and includes a series of meetings with both Executive and Non-Executive Directors and the Society's Secretary. As well as briefings from members of senior management, new Non-Executive Directors also have the opportunity to attend key management meetings and to visit all key areas of the business. A copy of the letter of appointment for a Non-Executive Director can be obtained on request from the Society's Secretary.

Keeping up to date with key business developments is essential in order to ensure that Directors properly discharge their responsibilities. This is achieved through:

- presentations made to the Board from industry specialists, executives and senior managers drawn from within the business on key developments and significant matters;
- providing the Board with updated financial plans, budgets and forecasts which are regularly reviewed and discussed;
- providing Board members with access to external training sources; and
- providing the Board with regular updates on the economic and regulatory environments within which the Society operates and providing Non-Executive Directors with briefings and meetings with senior executives and managers.

The Society's Secretary maintains an ongoing Board training and development programme and during 2018 the following areas were addressed:

- cyber risks;
- legal and regulatory developments;
- corporate governance developments;
- economic environment;
- marketplace developments; and
- operational resilience.

As Chairman I continue to be satisfied that each Non-Executive Director has the requisite knowledge and skills to be able to discharge their responsibilities effectively.

Performance evaluation

The effectiveness of the Board is subject to an external evaluation every three years. The 2018 Board Effectiveness Evaluation was undertaken in the final quarter of 2018 and was performed by Praesta Partners (a firm of specialist corporate advisors) who have no other relationship with the Society. The principal findings contained in the report include (but are not limited to):

- the Board fulfils its governance role strongly;
- there is a healthy culture of openness and transparency across the Board and its committees; and
- Board members possess a diverse range of individual styles that bring different perspectives to bear on the work of the Board.

The report contains a number of suggestions about ways in which the work of the Board could evolve going forward. These suggestions were considered by the Board at its last meeting of 2018 and work to develop an implementation plan is underway at the time of writing this report.

During 2018, good progress was made with work to address the areas for improvement which were identified as requiring attention as a consequence of conducting the 2017 Board Effectiveness Review which was facilitated by the Society's Secretary.

Communication with Members and the Annual General Meeting (AGM)

As a mutually owned organisation the Board is answerable and accountable to the Society's Members. The Board is committed to and proud of the Society's mutual status and proactively works to balance Member interests with those of other stakeholder groups, such as the communities served by the Society, colleagues employed within the business, its suppliers and the regulatory authorities.

The Society is committed to fostering and maintaining good communications with Members. During the year four meetings were held by the Members' Forum as well as two Member Talkback sessions with groups of Members. These meetings were attended by a number of the Society's Executive and Non-Executive Directors. These meetings provide valuable means for Members' opinions about the Society to be canvassed directly by members of the Board.

All Directors who stood for election or re-election in 2018 were duly elected or re-elected. All Directors will again stand for election or re-election at the 2019 AGM. The Society seeks to encourage all eligible Members to participate in the AGM, either by attending in person or by voting by proxy. The AGM provides Members with the opportunity to hold the Board to account through raising questions and voting either for or against Directors standing for election, or through voting for or against the other resolutions on the agenda at that meeting. A resolution on the Report on Directors' Remuneration is included on the agenda.

Voting is encouraged through a donation to charity for each vote cast (up to 20,000 votes). The voting process is overseen by independent scrutineers, who also attend the Meeting in person to count votes cast by Members. The results of the vote are published on the Society's website. In accordance with the Society's rules, all eligible Members are sent the Notice of the AGM at least 21 days prior to the meeting. All Directors attend the meeting unless their absence cannot be avoided.

Laurence Philip Adams
Chairman
5 February 2019

Report of the Governance and Nominations Committee

for the year ended 31 December 2018

The Governance and Nominations Committee is responsible for oversight of the Board and Executive Management Succession Plan and making recommendations for new appointments to the Board.

All Non-Executive Directors serve as members of the Committee. In addition, meetings of the Committee are also usually attended by the Chief Executive Officer, Chief People Officer and the Society's Secretary. The Committee met on three occasions in 2018.

The Society's Board strongly supports the principle of boardroom diversity and is committed to making appointments on merit, against objective criteria. The Committee monitors the structure, size and composition of the Board to ensure due regard is given to diversity. It is responsible for determining the skills and experience required to ensure that the Board is well placed to address the future needs of the business and for maintaining the Board and Executive Management Succession Plan.

The appointment process is designed to ensure that the Board collectively possesses the right range and combination of skills and expertise to oversee the full range of business activities undertaken by the Society and brings appropriate objectivity and independent judgement. The recruitment process is rigorous and involves the use of independent search consultants (the Board usually endeavours to use only the services of those search firms who have signed up to the voluntary code of conduct on gender diversity and best practice). Due regard is given to the benefits of diversity, including gender, ethnicity and other characteristics protected by the provisions of the Equality Act 2010. All Board vacancies are advertised in the national press. Candidates for appointment as Non-Executive Directors will be drawn from diverse sources and 'long lists' will always include female and minority candidates. All appointments are subject to extensive external checks and regulatory approval. All new Non-Executive Directors undergo a tailored and comprehensive induction programme on appointment.

During the year the Committee appointed the Miles Partnership to lead the recruitment process which resulted in the appointment of Claire Hafner to the Board. The Miles Partnership led the initial assessment process and also carried out for assurance purposes an external calibration assessment.

These assessments were followed by a number of interviews with the Chairman, certain Non-Executive Directors (Sally Jones-Evans, Nigel Annett and David Rigney) and Executive Directors. The Committee was satisfied with the selection process and endorsed the proposed appointment at its February 2018 meeting. Following Claire's appointment to the Board a tailored induction programme was arranged for her. The Committee also agreed the appointment of Rhian Langham to the role of Chief People Officer following the completion of an externally facilitated recruitment process which was led by the Free Partnership.

During 2018 the Committee:

- Continued to monitor whether the existing complement of Non-Executive Directors is sufficient.
- Conducted a review of the Board Succession Plan.
- Conducted a review of the approach used to assess the skill sets across the Non-Executive Director team and agreed that a revised approach should be introduced.
- Continued to ensure that overall the Board continues to have the right combination of skills, diversity and independence to enable it to operate effectively.
- Conducted a review of the induction programme for new members joining the Non-Executive Director team.
- Received a number of reports on the impact of changes to the Corporate Governance Code taking effect for reporting periods commencing on 1 January 2019. In light of those changes a full review of the Board Succession Plan has been initiated. The Society continues to adhere to the Code to the extent that it can be reasonably applied to a mutual building society.

Below Board level there is a structured approach to succession planning, designed to ensure a pipeline of talented and capable people who could ultimately progress to Executive Committee and Board positions. The Executive Succession Plan encompasses potential succession to all senior roles including that of Chief Executive Officer and is regularly reviewed by the Executive Management Committee. As part of this work, the Committee reviews the health of the leadership talent pipeline and the investment being made in developing the most senior people within the Society.

The Committee is responsible for monitoring progress with work to meet the gender diversity targets set out in the Board Diversity Policy and the wider target for gender diversity put in place by the Board on agreeing to support the Women in Financial Services Charter. In September 2016, the Board agreed to establish a five-year diversity target of 33% sitting a alongside a minimum floor threshold at 25%. At 31 December 2018, 30% of Board members were female. The Society continues to make good progress with wider work to address equality, diversity and inclusivity particularly in relation to raising awareness of these issues and through providing appropriate training for colleagues. The table below shows the ratio of women to men in senior management positions within the Society over the period 1 January 2018 to 31 December 2018:

Diversity Target Ratio (September 2021)	Ratio as at 1 January 2018	Ratio as at 31 December 2018
33%	23%	28%

Laurence Philip Adams
Chair of the Governance and Nominations Committee
5 February 2019

Risk management report

for the year ended 31 December 2018

Risk overview

The Society is exposed to a diverse range of risks in the execution of its strategy and in undertaking its day-to-day business. The Society actively manages the principal risks that arise from its activities and its culture and risk management philosophy reflects a strong awareness of the current and emerging risks which could affect delivery of the Society's strategy. The Society addresses these risks by:

- operating a single integrated business model underpinned by strong risk governance;
- adopting a risk management framework which covers all risks and is supported by a clearly defined 'three lines of defence' model;
- managing risks within risk appetite as set by the Board; and
- operating a business model where the Society's capital and liquidity would enable it to survive severe but plausible market and institution specific stresses.

The three lines of defence

The Society operates 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

Day-to-day risk management

Every employee is responsible for managing the risks which fall within their day-to-day activities. The first line of defence ensures all key risks within their operations are identified, monitored and mitigated by appropriate controls within an overall control environment.

Second line of defence

Risk oversight and compliance

Dedicated teams within the Society's Risk and Compliance functions are responsible for providing independent oversight and challenge of activities conducted in the first line.

Third line of defence

Audit

The Society's Internal Audit function provides independent assurance of the activities in both the first and second lines of defence.

Risk Management and Governance

There is a formal structure for managing risks across the Society which is documented in detailed risk management policies. These policies, and associated limits, are owned and reviewed at least annually by functional risk committees, which report to the Board Risk Committee and the Board.

Risk governance is provided by a structure consisting of seven key risk management committees. Each committee includes appropriate representation drawn from the Executive (ExCo), divisional management and risk specialists:

- **Board Risk Committee (BRC)** is chaired by a Non-Executive Director, and has responsibility for ensuring a Society-wide co-ordinated approach towards the oversight and management of principal risks.

- **Executive Risk Committee (ERC)** is chaired by the Chief Risk Officer and is responsible for oversight and monitoring of all prudential and conduct risks across the Society and reviewing risk exposures.

- **Model Governance Committee (MGC)** is chaired by the Chief Financial Officer and is responsible for the approval and oversight of models used by the Society to assess and quantify exposure to credit risk and to determine the level of impairment provisions required under IFRS 9.

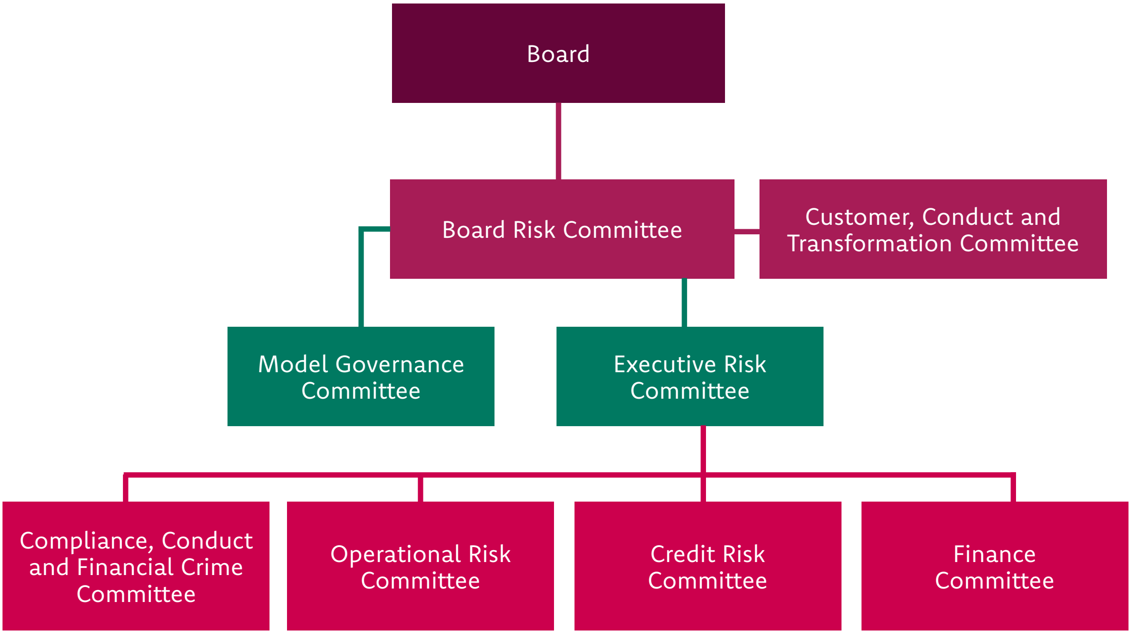
- **Credit Risk Committee (CRC)** is chaired by the Head of Credit Risk and is responsible for monitoring and reviewing exposure to credit risks in the Society's retail and commercial loan portfolios.

- **Operational Risk Committee (ORC)** is chaired by the Head of Financial and Operational Risk and is responsible for monitoring and reviewing exposure to operational risks arising from the Society's day-to-day activities.

- **Compliance, Conduct and Financial Crime Committee (CCFC)** is chaired by the Chief Compliance and Conduct Officer and is responsible for monitoring and reviewing exposure to conduct and financial crime risks arising from the Society's day-to-day activities.

- **Finance Committee (FC)** is chaired by the Chief Financial Officer and, in addition to its financial management responsibilities, has responsibility for the assessment and management of financial risks and relevant risk appetites.

In addition, the Customer, Conduct and Transformation Committee (CCTC), a separate Board committee, is responsible for providing oversight of the Society's conduct framework and strategy. Key conduct risks are reviewed by the Committee and reported to the Board Risk Committee.



Risk Management and Governance

Primary responsibility for the identification, control and mitigation of risk rests with each strategic business unit. Oversight and governance are provided through specialist support functions including Risk, Finance and Compliance and Conduct. The role of these functional specialists is to maintain and review policies, establish quantitative limits and qualitative standards which are consistent with the Society's risk appetite, monitor and report on compliance with those limits and standards and generally to provide an oversight role to the management of risk.

The Society's Internal Audit function provides independent assurance regarding the activities of the strategic business units and the specialist functions across the Society and reports on the effectiveness of the control environment to the Audit Committee on a quarterly basis. The BRC monitors the arrangements for assessing risk inherent in the Society's business activities on behalf of the Board. The Board receives risk reports at each of its meetings and regularly considers the impact of major strategic risks, taking account of changes in the macro-economic environment, changes in regulation, competitor strategy, customer preferences and emerging technology.

Enterprise Risk Management Framework

The Society operates an Enterprise Risk Management Framework (ERMF), which sets out the Board's approach to managing risk and the provision of oversight by defining and documenting the Society's purpose and objectives; risk appetite and risk tolerance and governance and control systems, linked to the principles upon which the framework is based.

Risk appetite

The Board 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 it's strategic goals; and

- establish a framework for business decision making.

The Board risk appetite statements are linked to the Society's strategy and are supported by a broad suite of Board level risk metrics, appetites and tolerances, designed to monitor the Society's exposure to key prudential and conduct related risks. These are set in a hierarchy that links the Board's tolerance for risk to its strategic goals, medium-term plans and 'business as usual' activities.

Risk culture

The Society operates a simple business model and senior management places significant emphasis on ensuring a high level of engagement is maintained between individual business functions and colleagues at all levels with regard to the awareness and effective management of risk. The 'three lines of defence' model is key in ensuring that risk management is embedded across the Society, encouraging staff to take ownership for the identification and management of risk falling within their respective areas of operation. A key element of the Society's risk culture is a genuine emphasis on putting Members' interests and needs first and this is reflected for instance in the absence of sales-related incentives for any colleagues.

Stress testing and planning

The Society engages in thorough stress testing, scenario analysis and contingency planning programmes, allowing it to understand the impact of remote but potentially severe risks and to ensure that it remains financially and operationally resilient. This includes a range of multi-risk category stress tests, reverse stress tests and operational risk scenario analyses. Stress testing is an integral part of the annual planning process, the adequacy assessment processes for liquidity and capital, and the annual review of the Society's risk appetite.

Outputs from stress testing are used to inform capital and liquidity appetite and planning, articulate potential management actions within contingency plans, and further improve the management of the Society's risk profile.

Annual internal assessments are undertaken of the adequacy of the Society's capital and liquidity. The Internal Capital Adequacy Assessment Process (ICAAP) assesses the Society's capital position and requirements under the Capital Requirements Regulation and Capital Requirements Directive (CRD IV) framework. The ICAAP provides details of the current approaches used to manage risk within the Society. As part of that process, the ICAAP assesses current capital requirements and potential requirements in a severe but plausible stress. Other, more severe, stresses are considered in support of the overall capital assessment.

The Internal Liquidity Adequacy Assessment Process (ILAAP) is undertaken annually to assess the Society's liquidity position and requirements, taking into account regulatory requirements and the firm's risk tolerance. An integral component of the approach to liquidity risk management is stress testing, some of which is prescriptive, using very detailed rules and guidance issued by the Prudential Regulation Authority (PRA). In addition, the Society undertakes its own stress tests and sets limits on these that typically extend beyond minimum regulatory requirements.

Reverse stress testing is a key component of the Society's existing stress testing framework and considers extreme events that could result in failure of the Society. As such, it complements the existing ICAAP and ILAAP processes, helping to improve risk identification and risk management more generally. A qualitative approach is used to explore potential scenarios, which, if crystallised, could result in failure of the Society. This is supplemented with a quantitative assessment of the risks that explores the level of capital or liquidity utilised in these scenarios. A key outcome from the process is to consider whether any of the scenarios considered are sufficiently plausible to necessitate a change to the Society's strategy, require mitigating actions to be taken, or require supplementary management information to monitor the likelihood of crystallisation.

Recovery and resolution plans

The UK and European regulatory authorities require all banks and building societies to formulate plans to minimise both the risk of failure and the impact of failure on the wider economy. The recovery plan outlines the steps the Society can take to prevent failure whilst the resolution plan includes the data required by the Bank of England to establish an orderly resolution of the Society's affairs, in the event that recovery cannot be achieved. The process of preparation for such extreme events enables the Board to plan actions it would take to recover from adverse conditions which would otherwise lead to failure. The recovery plan represents a 'menu of options' for the Society to deal with firm-specific or market-wide stresses and which can be incorporated into a credible and executable plan.

Significant and emerging risks

The Society's exposure to current and emerging risks is closely tracked through the formal risk governance structure. The Society continues to keep these risks under close observation through risk reporting and measuring performance against key risk indicators. The Society conducts regular horizon scanning activity to identify any new or emerging risks that could impact delivery of the Board's strategy, or threaten the long-term viability of the business. The most significant risks to the Society's strategy are detailed in the table below, together with actions being taken to mitigate those risks:

Risk	Risk description	Mitigating actions
Macroeconomic and geopolitical environment	The nature of business undertaken by the Society means that it is inherently exposed to changes in the macroeconomic environment. An economic downturn, for example, has the potential to impact levels of unemployment and consequently the ability of mortgage borrowers to meet their obligations. This, combined with a fall in property values, could result in increased credit losses. Current uncertainty in the macroeconomic environment is being driven by a number of factors, the most significant of which is the ongoing negotiations in respect of the UK's withdrawal from the EU. In addition, there remains significant international geopolitical tensions which have the potential to cause further disruption to the domestic economy.	The Society prepares medium-term financial plans on an annual basis which incorporate scenarios which reflect the impact of changes in the economic environment. Key economic early warning indicators are closely monitored, the purpose of which is to alert management to signs of increasing risk in the economy. In addition, the Society has modelled different financial plans centred on the potential outcome of the UK's exit from the EU. This includes, but is not limited to, the stress test scenarios published by the Bank of England. Continuing review, at Board level, of key political and macroeconomic developments.

Competitive environment	The nature of, and demand for, financial services has altered significantly over recent years. In particular, this has been characterised by the development of innovative digital products offered by new entrants, as well as more established institutions. These changes are likely to result in an intensification of competition in the Society's core markets, although represent the provision of increased choice for consumers in general. Competitive pressures are expected to increase into the future, particularly as new propositions are developed utilising Open Banking technology.	The Society's transformation programme is primarily intended to ensure that its core offering remains appropriate and relevant to its target market. The successful delivery of these investment plans will help mitigate the risks arising as a consequence of increased competition. The markets in which the Society operates are constantly monitored, to ensure the business can respond to changes in customer requirements.
Cyber security	The threat represented by cyber-attacks is expected to remain at an elevated level, taking into account the frequency and severity of reported attacks instigated against other financial services providers both within the UK and wider markets. These attacks represent a material risk to the provision of services to Members as well as to member data.	The Society continues to develop its cyber risk management capability alongside the investment in its core product offering. The Society continues to regularly review the availability of preventative and detective controls.
Operational resilience	The nature and pace of technological change, represents a risk to the continued resilience of the financial services sector. The Society's ability to maintain and further develop operational resilience and operational risk management capabilities is vital to ensure it can continue to provide Members with a secure and stable service.	The Society's transformation programme incorporates appropriate levels of investment in systems capability and underlying resilience. The Board maintains regular oversight of programme delivery and in ensuring the ongoing effectiveness of business level operational risk management capability and associated controls.

Principal risks

The key risks to which the Society is exposed are consistent with the prior year and outlined below:

Risk category	Brief defintion
Credit risk	The risk that borrowers or counterparties do not meet their financial obligations as they fall due.
Market risk	The risk that the value of income derived from the Society's assets and liabilities is adversely impacted as a result of changes in interest rates.
Liquidity and funding risk	Liquidity risk is the risk that the Society has insufficient funds to meet its obligations as and when they fall due. Funding risk is the risk that the Society is unable to access funding markets or to do so only at excessive cost.
Conduct risk	The risk that the Society does not treat its customers fairly resulting in inappropriate or unfair outcomes.
Operational risk	The risk of loss arising from inadequate or failed internal processes, systems, human error or from external events.
Business risk	The risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geographical, regulatory or other factors.
Solvency risk	The risk that the Society does not maintain sufficient capital resources in excess of minimum regulatory requirements.
Legal and regulatory risk	The risk that the Society does not comply with legislation and regulation.

In addition to the principal risks, the Society is also exposed to model risk which is defined as the risk that an adverse outcome (incorrect or unintended decision or financial loss) occurs as a result of weaknesses or failures in the design or use of a model. Given that internal models are frequently used by the Society this risk could potentially arise in assessing and managing exposure to a number of the principal risks outlined above. The Society uses a variety of techniques to mitigate model risk, including sensitivity analysis to key assumptions, independent model validation and applying shock stresses.

Credit risk

Credit risk is the potential risk that a customer or counterparty will fail to meet its financial obligations to the Society as they become due. Credit risk arises primarily from loans to retail and commercial customers and from the investments held by the Society's Treasury function for liquidity requirements and for general business purposes.

Market background and uncertainties

The global and economic outlook remains uncertain with downside risks rising over the past six months. Ongoing political uncertainty triggered by protracted Brexit negotiations continue to cause a drag on business investment and consumer sentiment which challenges steady economic growth. This has manifested itself in declining retail sales figures and falling levels of growth in the property sector. Nevertheless Consumer Price Inflation (CPI) has fallen to a 23-month low point in December 2018 providing some relief in real incomes and therefore debt affordability.

The current economic climate poses a threat to the longer-term prosperity of the UK and, therefore, to the financial performance of the Society. As a result, the Society's plans, forecasts and stress testing continue to take into account scenarios which model stresses on the ability of members and counterparties to meet their financial obligations, particularly in light of potential Brexit outcomes. The impact of short and longer term deteriorations in the macroeconomic environment are assessed, including the impact on the Society of changes in the path of interest rates, increases in inflation, decreases in property prices, reduction in the ability to re-finance at maturity and the impact of rising unemployment rates.

Risk mitigation

The controlled management of credit risk is critical to the success of the Society's lending strategy. The quality of individual lending decisions and subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the Society, have a direct impact on the achievement of the Society's strategy. Each of the business areas, residential first and second charge lending, commercial lending and treasury, has its own individual Credit Risk Policy Statement setting out the Board's risk appetite including policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring.

Day-to-day management of credit risk is undertaken by specialist teams 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 Board. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

First and second charge retail credit risk

The Society continues to focus on the underlying quality of new lending in the first charge retail market ensuring that the mix of overall portfolio exposures is within the prudent limits and risk appetite set by the Board. Applicant quality is monitored closely, defined in terms of creditworthiness, loan to value (LTV) and loan to income (LTI) ratios, and affordability profile. The Society is no longer originating new lending in the second charge retail market. The CRC receives regular reports on the performance of retail credit risk portfolios with further oversight provided by the BRC. The Society assesses affordability using a stressed, higher interest rate to protect the borrower from entering into a mortgage commitment which could prove unsustainable in a higher interest rate environment.

Lending is secured against properties in the UK. This concentration in the UK market could be exacerbated by overexposure to one geographical location or reliance on particular product types within the portfolio. The Society manages this risk by monitoring the geographical distribution of lending, the distribution of gross lending by channel of acquisition and by setting new lending risk limits in specific segments of the mortgage market.

Regular stress testing seeks to establish the extent to which losses may emerge under a range of macroeconomic and specific stress scenarios and to ensure that the Society continues to remain within its retail credit risk appetite. These stress tests primarily consider the impact of economic events on the probability of default and on house price movements.

The Society's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. Early two-way communication with borrowers is encouraged with the aim of seeking their commitment to maintain payment obligations, typically through repayment plans and forbearance measures. Experience in these areas informs the underwriting process. Customers in financial difficulties need support at what may be a difficult time so careful consideration is given to the most appropriate strategy likely to result in the best outcome for the customer and the Society. Repossession of a property is only sought where all reasonable efforts to regularise matters have failed or the mortgage is considered unsustainable in the longer term.

Regular reviews of the Society's arrears management function and processes are independently undertaken to ensure that borrowers are being treated fairly, appropriately, sympathetically and in line with established policies, procedures and regulatory guidance.

Commercial credit risk
Commercial risk appetite is regularly reviewed in the light of changing economic and market conditions and is also subject to a formal annual review. The Society remains cautious with regard to commercial lending which is undertaken on a prudent basis and management continues to adopt a strategy of maintaining long-term relationships whilst reducing larger, single counterparty loans. Commercial lending continues to operate within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

Concentration risk within the commercial portfolio is controlled and monitored via a series of credit exposure limits which are aimed at producing a diverse portfolio. Commercial lending relationships are subject to regular reviews to ensure that facilities are fully performing in accordance with the terms of original sanction. Watch-list procedures are in place which grade borrowers in line with the perceived severity of the risk and are designed to identify cases of potential cause for concern to facilitate early risk mitigation or forbearance activity where appropriate. When accounts are in default, careful consideration is given to the most appropriate exit strategy where the Society will engage in a detailed review of the options. In particular the commercial lending division will engage in extensive dialogue with customers and advisors but enlist external professional support where required to ensure that the optimal approach is chosen taking account of the needs of all stakeholders.

Responsibility for the overall quality of the lending book and the adequacy of credit procedures and controls rests with the commercial lending division with oversight provided by the Society's Credit Risk function, CRC and BRC.

Treasury credit risk

Treasury credit risk arises from the investments held by the Society's Treasury function in order to meet liquidity requirements and for general business purposes. The Treasury function is responsible for managing this aspect of credit risk within operational limits as set out in the Society's Treasury Policy Statement.

Treasury counterparty lines of credit are reviewed on a weekly basis by the Finance Committee. This entails an analysis of the counterparties' 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 BRC within a framework prescribed by the Board.

Liquidity and funding 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. Funding risk is the inability to access sources of funding or to do so only at excessive cost.

Determining the appropriate mix and amount of liquidity to hold is a key decision for the Board, which recognises the Society must remain a safe and attractive home for Members' retail deposits. However, the more assets that are held in liquid form, the less is available for the Society to lend to borrowing Members. The more liquidity that is held, the lower the potential profitability of the Society and the less capital it may generate. If capital is reduced, then the capacity for new mortgage lending is restricted. Therefore, it is in the best interests of the Society as a whole for it to hold sufficient but not excessive levels of liquid assets to cover cash flow imbalances and fluctuations in funding.

Market background and uncertainties

The Society has demonstrated a strong track record of being able to attract and retain retail funding. The external credit ratings held by the Society continue to support access to wholesale funding markets.

In August 2016 the Bank of England launched the Term Funding Scheme (TFS). This was designed to help facilitate the transmission of Bank Rate cuts to interest costs actually faced by borrowing households and businesses by providing medium term funding to banks and building societies at rates close to Bank Rate. The TFS provide participants with a cost effective source of funding in the form of central bank reserves to support additional lending to the real economy. The Society became a participant in the TFS in October 2016 and has drawn down a total of £675m from the Scheme. The TFS closed in February 2018.

Risk mitigation

The day-to-day management of liquidity is the responsibility of the Society's Treasury function, which oversees the Society's portfolio of liquid assets and wholesale funding facilities. The Finance Committee exercise control over the Society's liquidity through the operation of strict liquidity policies and close monitoring, receiving weekly reports on current and projected liquidity positions.

The Board determines the level of liquid resources required to support the Society's strategy through undertaking an annual ILAAP as part of the development of the Society's Corporate Plan. Stress tests consider a range of severe but plausible scenarios and their impact on the Society, particularly with respect to retail saving outflows. The Board approved the most recent ILAAP in June 2018.

As at 31 December 2018, the Society held a Liquidity Coverage Ratio (LCR) ratio well in excess of 100%. Based on current interpretations of the Net Stable Funding Ratio (NSFR) regulatory guidance, the Society held an NSFR ratio well in excess of the full 100% ratio requirement.

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 element being interest rate risk, including the use of derivatives.

The Treasury function is responsible for managing the Society's exposure to all aspects of market risk within the operational limits set out in the Treasury Policy Statement. Oversight is provided by the Financial Risk function, ERC and BRC which approves the interest rate risk policy and receives regular reports on all aspects of market risk. Reporting lines and terms of reference are set out by the Board which also receives monthly reports from the Chief Financial Officer covering the most material issues considered by the Finance Committee.

The Society's defined benefit pension scheme is also subject to market risk, which is managed by the Scheme's Trustees.

Interest rate risk

Interest rate risk is the risk of loss resulting from adverse movements in market interest rates.

The Society is exposed to interest rate risk, principally arising from the provision of fixed rate lending and savings products. The various interest rate features and maturity profiles for these products, and the use of wholesale funds to support their delivery, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments.

Another significant form of interest rate risk arises from the imperfect correlation between re-pricing of interest rates on different assets and liabilities. This is referred to as basis risk. The basis risk on the Society's statement of financial position arises from administered rate liabilities, the pricing of which is influenced by competition for retail savings which are used to fund mortgages, and other assets priced relative to the Bank of England Base Rate, or LIBOR, albeit for relatively short durations.

The Society continues to ensure that it maintains a significant proportion of discretionary variable rate savings and mortgages on its balance sheet, which provides flexibility to manage a prolonged low interest rate environment, or the possible impacts from a change in Bank of England Base Rate.

The Society has a series of Board approved limits that ensure the impact of a change in base or market interest rates has limited effects on both the net interest income generated and the present value (PV) of its statement of financial position.

Market background and uncertainties

The Bank of England's stated expectation is that interest rates will remain relatively low and slowly rise in the medium-term. However, any resulting increase in the Consumer Price Index (CPI) materially above the Bank of England's own target may necessitate a rate rise sooner in order to restore CPI to an acceptable level.

Customer demand for fixed rate mortgages remains strong. Interest earned on fixed rate mortgages will not increase; however, it is possible that interest payable on variable savings could increase and the Society's plans take account of the need to mitigate this potential risk to margin.

The Board believes that it has the necessary tools to manage a protracted low rate environment and the Society's risk management activities take into account the possibility of such a scenario.

Risk mitigation

Interest rate risk is subject to continual review and management, within the risk appetite set by the Board. Risks relating to specific products are mitigated through appropriate related product terms and conditions, offer procedures, and close analysis of the mortgage pipeline and early redemption behaviour. Derivative instruments are used to manage various aspects of interest rate risk including the net basis positions where appropriate.

On a monthly basis, the Finance Committee considers the impact of a number of interest rate risk and basis risk stress tests on the Society's statement of financial position considering both earnings and value measures. In addition, ERC and BRC review the Society's options and strategies available to manage the impact of any potential future increases in interest rates. The Society's forecasts and plans take account of the risk of interest rate changes and are stressed accordingly.

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.

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. Currency risk is not currently considered to be material as almost all transactions are conducted in Sterling.

Conduct risk

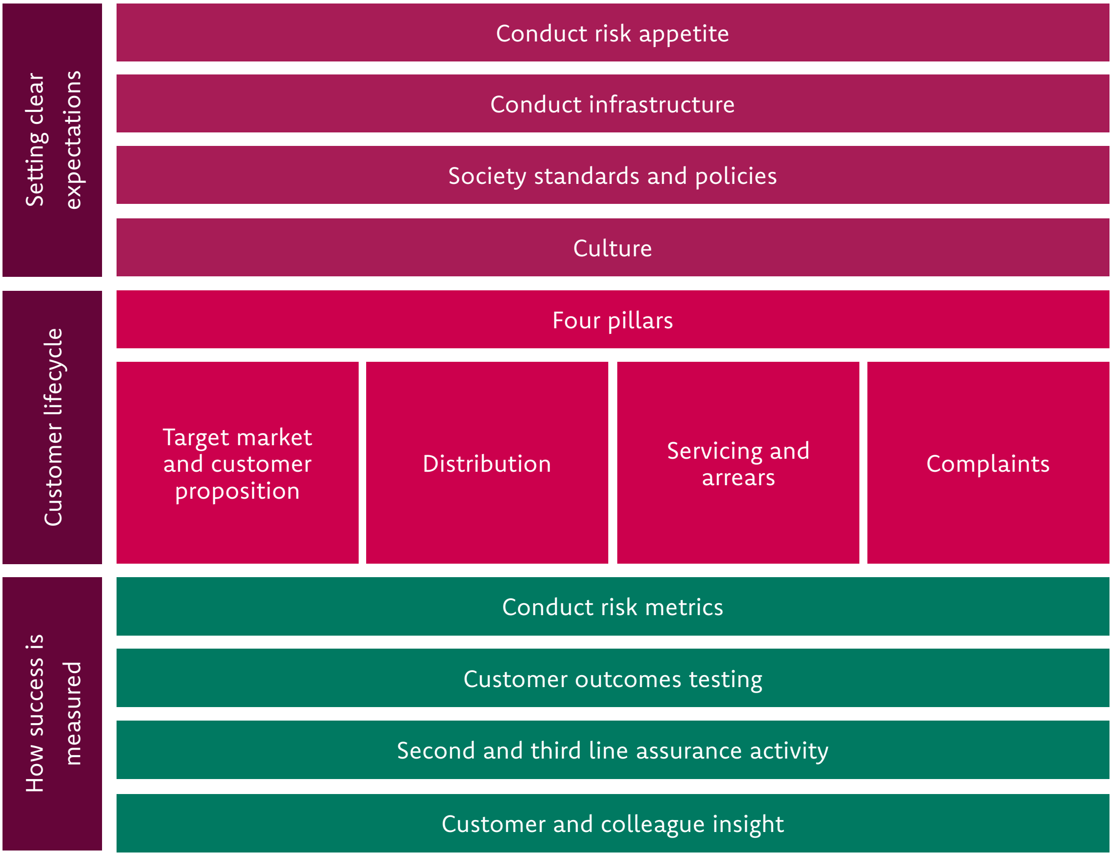
Conduct risk is the risk of the Society treating its customers unfairly resulting in the delivery of inappropriate outcomes.

Market background and uncertainties

The sustainability of the Society's business model and achievement of its longer-term strategy are dependent upon the consistent and fair treatment of Members and customers. The Society has always been committed to ensuring that Members and customers are treated fairly. 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.

Risk mitigation

The Society's framework for managing risk is outlined in the following diagram:



The Society's Conduct Strategy was last updated and approved by the Board in December 2016. At this time, it was agreed that it would be considered and approved on a triennial basis going forward, unless warranted by material changes in the external environment or in the Society's strategy. The conduct strategy sets out the Society's approach to managing conduct risk and also articulates the Board's risk appetite in relation to conduct risk.

The Society's Compliance and Conduct function advises on the management of conduct risks and oversees the effectiveness of controls in place to manage the risk of unfair customer outcomes. The Customer, Conduct and Transformation Committee is a Board committee and forms part of the overall governance and control framework. Chaired by a Non-Executive Director, and supported by the Customer Operational Committee, an operational committee which meets monthly, the Customer, Conduct and Transformation Committee is responsible for overseeing the execution of the conduct strategy and all aspects of conduct risk management.

The Compliance and Conduct Policy sets out the Society's high level expectations in relation to the management of conduct risks and this is supported by a suite of eleven customer treatment standards which cover specific areas of conduct such as the treatment of vulnerable customers, handling of complaints, servicing and the provision of help to customers in financial difficulty.

Key conduct metrics, which align to the Society's conduct risk appetite and the four pillars outlined above are reported on a monthly basis to key committees and the Board. In addition, outcome testing enables an assessment of the extent to which the Society is achieving its aim of consistently delivering fair outcomes for Members and customers. Regular feedback from Members and customers is also obtained.

Operational risk

Operational risk is the risk of a loss arising from inadequate or failed internal processes or systems, human error or external events.

The Society assesses its exposure to and management of operational risks by reference to eight categories:

Risk category	Brief defintion
Change management	The risk of non-delivery of strategic change programme objectives or disruption to business as usual activity resulting from the implementation of change.
Financial crime	The risk of loss to the business arising from activities which circumvent controls, the unauthorised use of assets or services or illegal activities.
Financial management	The risk of losses or reputational damage arising from weak financial management or inadequate management information to support decision-making.
Data management	The risk of losses or reputational damage arising from the mismanagement of personal data or poor quality data.
Infrastructure and resilience	The risk of loss arising from an inability to service customers and key stakeholders due to a cyber-attack or failure of operational IT infrastructure including the protection of information from unauthorised access, use, disclosure, modification or destruction.
People	The risk of failure to maintain and develop the appropriate level of skilled resource, maintain employee relations, provide a safe environment in line with legislative requirements and comply with ethical, diversity and discrimination laws.
Physical assets, safety and security	The risk of loss arising from the ownership, management and security of and threats to, the property and facilities used by the Society.
Supplier and procurement	The risk of loss arising from the failure of a key supplier or outsourcing arrangements or in the failure of third party service providers to meet agreed target levels of service.

Market background and uncertainties

The external environment continues to evolve with challenges arising from technological innovation, increased customer expectations and emerging regulatory standards. The sector as a whole has become exposed to increased levels of operational risk, with greater reliance placed upon the resilience and security of technology platforms and staff capability. Growing levels of financial and cyber-crime require the adoption of increasingly sophisticated anti-fraud controls. The Society recognises that the cyber threat remains a key industry concern and will continue to adopt additional controls in line with industry best practice. Notwithstanding recent and substantial investments by financial institutions in technological solutions aimed at combating the more sophisticated financial crime and cyber threats, there is a continuing trend of financial deception targeting consumers directly. The Society continues to strengthen its control environment to protect those who are most vulnerable to financial abuse, and works collaboratively with industry partners to further improve controls and enhance both staff and customer education.

The Society recognises that failure to keep pace with developments in technology could introduce risk to the stability, security and resilience of technology systems. As a result, the Society continues to invest in upgrading its IT estate. Undertaking any change programme carries risk, as new systems and processes are introduced and integrated with existing ones. The Society has a strong focus on change governance and programme management to minimise these risks.

Risk mitigation

The role of the Society's Enterprise Risk Management function is to ensure appropriate strategies are in place to manage and mitigate the risks that could impact the ability of the Society to achieve its strategy whilst protecting its reputation and the interests of its Members. The Society manages its exposure to operational risk by assessing the nature of external incidents, information sharing with peer organisations and by the review of internal risk events analysed by reference to the operational risk categories described on page 65. In addition to any direct loss attributable to risks in these categories, the reputational impact of such an event may damage the Society leading to secondary impacts.

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 impact on each business area and for embedding appropriate controls to mitigate those risks. The framework is updated periodically to take account of changes in business profile, new product development, the external operating environment and best practice guidance.

Oversight is provided by the ORC, and the assessment of the Society's exposure to operational risks is based on both quantitative and qualitative considerations.

The crystallisation of operational risks is captured through the recording of risk events including those which result in financial losses or near misses. The analysis of events is used to identify any potential systemic weaknesses in operational processes. The ICAAP includes a series of hypothetical scenarios designed to assess the ability of the Society to mitigate or withstand the impact of a range of operational failures. The scope of this analysis is reviewed at least annually by the ORC, to ensure it continues to reflect emerging potential operational weaknesses or threats.

Business risk

Business risk is the risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geopolitical, regulatory or other factors. The Society considers strategic risk, the risk to the delivery of the Society's Corporate Plan, to be the principal business risk. Whilst all business areas are responsible for managing their own risks, management of strategic risk is primarily the responsibility of the Board and the BRC whose remit encompasses all risk categories on a Society wide basis.

The management of strategic risk is intrinsically linked to the corporate planning and stress testing processes. In addition, a risk to reputation is inherent in all risk categories where actions and incidents can affect the extent to which people trust, and wish to do business with the Society. Reputational risk is assessed via incident reporting, media monitoring, business performance, complaints monitoring and both internal and external benchmarking.

All principal risks have the potential to affect more than one specific risk category and could have a significant impact on the business model if these were to crystallise concurrently. In particular, increased regulatory demands could significantly change capital or liquidity requirements which may, in extreme circumstances, threaten the viability of the Society's business model.

Market background and uncertainties

In the short term, the Society recognises the increasing competition in its core savings and lending markets from 'Challenger' and mainstream UK banks as they focus on service delivery and non-investment banking activities. Whilst the Society will continue to focus on efficiency and cost control through its Continuous Improvement Programme, cost pressures within the business will continue to arise from the pace and complexity of regulatory change, required levels of investment in technology and organic growth.

In the longer term, the Society acknowledges that in order to meet the needs of a more technologically demanding customer demographic, it must continue to invest in new technology to support the delivery of new products and services.

Risk mitigation

The Board maintains a robust strategic planning process which is subject to oversight by the risk function and capital and liquidity stress testing. Consolidated business performance and risk reporting is provided to Board and senior risk committees whose remit encompasses the oversight of all risk categories.

The Board considers that whilst there are strategic risks that impact the Society, it is well placed to manage in a prolonged low interest rate environment, it has options to respond effectively to competition and changes in regulation, and continue to fulfil its strategic purpose whilst generating sufficient capital to remain safe and secure.

In recent years, there have been a number of material risk events impacting the reputation of the financial services industry. The mutual sector has not been immune to these. Although the Society has been less impacted than many organisations, it will continue to manage its reputational risk carefully and invest significant resources in enhancing the robustness of its systems, controls and governance.

Legal and regulatory risk

Legal and regulatory risk is the risk that the Society does not deliver and maintain legislative and regulatory compliance in all material aspects.

Market background and uncertainties

Several key pieces of regulation came into force in 2018, including the General Data Protection Regulation (GDPR), the Payment Services Directive II (PSD II), Competition and Markets Authority (CMA) remedies and the Basel Committee on Banking Supervision (BCBS) Standard 239 on principles for effective risk data aggregation and risk reporting. Implementation of each of these is complex and has resulted in significant industry-wide challenges to enable firms to demonstrate and maintain compliance. The Society's business model and strong Member focus ensures it is well placed to meet current and emerging requirements.

The following matters pose potential risks to the achievement of the Society's strategy:

- Unknown legacy conduct issues may emerge. Regulation relating to the fair treatment of Members and customers continues to be a focus for the financial services industry and the interpretation of fair treatment evolves over time and is influenced by developing case law.

- The regulatory landscape continues to evolve and may lead to as yet unidentified risks. As a Member and customer focussed business operating in highly regulated markets, the Society is subject to complaints in the ordinary course of business. In addition, at a sector level, the incidence of regulatory reviews, challenges and investigations is increasing. Regulatory expectations in respect of conduct standards increase the risk of future sanctions, fines or customer redress.

Risk mitigation

The Society has developed processes to monitor and record legal and regulatory pronouncements and notifications. These are assessed by the relevant subject-matter experts in the Society, and where appropriate, action plans are developed to ensure compliance by the required deadline. The register of pronouncements and notifications is reviewed by the ERC on a regular basis to ensure that a coordinated approach is adopted to ensure compliance.

The Society manages implementation of regulatory changes through dedicated prioritised programmes that are closely monitored by the Board to ensure appropriate compliance.

Solvency risk and capital management

Capital is held to protect depositors, by ensuring that there will be sufficient assets to repay liabilities even in the event of unexpected losses. When assessing the adequacy of available capital, the Board considers the material inherent risks to which the Society is exposed and the need for capital to be available to support the growth of the business. Post CRD IV, the regulatory capital framework comprises:

- A risk weighted capital requirement.
- A Pillar 2 capital requirement; an internal assessment and stress testing process designed to assess current risk exposure and additional capital required to provide resilience against future adverse scenarios.
- A counter-cyclical capital buffer designed to further enhance the resilience of the banking sector by requiring firms to build in additional capital buffers during the peak of economic cycles to be released during financial downturns.
- A leverage ratio set in proportion to exposures regardless of their relative risk.
- A minimum requirement for eligible liabilities and own funds (MREL) to be phased in by 2022.

Capital requirements are met through reserves and eligible capital instruments.

Capital requirements
In 2013, the Society obtained permission to use the Internal Ratings Based (IRB) approach for calculating capital requirements that has been applied to the first charge retail and commercial lending portfolios. This approach allows the Society to calculate regulatory capital requirements using internally developed models that reflect the credit quality of the Society's mortgage book and reflects the Society's detailed understanding of its customer base and credit risk profile. For other exposures and risk areas, the Society follows the standardised approach that uses capital risk weighting percentages set by the PRA.

CRD IV sets minimum capital requirements: a Common Equity Tier 1 (CET 1) ratio of 4.5%, a Tier 1 capital ratio of 6% and a total minimum capital ratio of 8%. These ratios must be calculated as percentages of risk exposure amounts, principally in relation to credit and operational risk, and are known as the Pillar 1 requirement.

Pillar 2 capital requirement
The Pillar 2 capital requirement encompasses firms' internal capital assessment and the supervisory review of those assessments and is intended to ensure that firms have adequate capital to support all the relevant risks in their business. The Pillar 2 requirement is divided into capital held against risks not captured or not fully captured by Pillar 1 (Pillar 2A), and risks to which a firm may become exposed over a forward-looking planning horizon (Pillar 2B). As with Pillar 1, the total Pillar 2A capital requirement should be met with at least 56% CET 1 capital, up to 44% Additional Tier 1 (AT 1) capital, and a maximum of 25% Tier 2 capital.

To promote the conservation of capital and the build-up of adequate buffers that can be drawn down in periods of stress, CRD IV requires firms to hold supplementary common equity capital buffers from 1 January 2016. These comprise a Capital Conservation Buffer (CCoB); a Systemic Risk Buffer (SRB); and a macro-prudential Countercyclical Buffer (CCyB). The CCyB is currently equivalent to 1.0% of RWAs.

The new PRA Buffer (replacing the former capital-planning buffer from 1 January 2016) will only be applied to the extent that the PRA considers the CRD IV buffers to be insufficient. The PRA has stated that it believes that for most firms, most of the time, the CRD IV buffers are likely to be sufficient once fully phased in.

Leverage ratio
CRD IV introduces a non-risk based leverage ratio that is supplementary to the risk based capital requirements and was originally proposed as a 'backstop' measure. The calculation determines a ratio based on the relationship between Tier 1 capital and total exposures, including off-balance sheet items. The leverage ratio does not distinguish between unsecured and secured loans, nor recognise the ratio of loan to value of secured lending. A binding requirement is expected to be introduced at the EU level in 2019. The Society does not meet the minimum asset size requirement of £50 billion of retail deposits to be captured in the scope of the UK leverage ratio framework.

The maximum theoretical leverage ratio regulatory requirement for the Society would be 3.9%. The Board is confident that the Society will meet this requirement with an appropriate level of headroom.

Minimum Requirement for Own Funds and Eligible Liabilities (MREL)
The Bank of England announced rules in November 2016 designed to manage the failure of banks and building societies in a more orderly and effective way. These represent one element of a series of wider reforms intended to prevent future taxpayer bail-outs in the UK.

MREL requirements are split into two elements. Firstly a loss absorption amount, to cover losses up to and in resolution, based on a firm's minimum going concern capital requirement, and secondly a recapitalisation amount, to enable the firm to continue post resolution, likely to be at least equal to minimum going concern capital requirement.

The Bank of England sets MREL requirements on a firm-specific basis, informed by the resolution strategy for each firm and for the Society, this has been set as the modified insolvency process whereby in the event of failure of the Society the FSCS would compensate depositors covered by its guarantee. This reflects the perceived risk the Society poses to the UK Financial system. Notwithstanding this, the actual approach taken, should the Society require resolution, will depend on the circumstances at the time of a failure, and all available options would be considered.

To meet Basel III Pillar 3 requirements, the Society publishes further information about its exposures and its risk management procedures and policies. This will be published on the Society's website www.principality.co.uk in March 2019.

R. Michael Jones
Chief Risk Officer
5 February 2019

Report of the Audit Committee

for the year ended 31 December 2018

The Audit Committee's responsibilities include:

- Monitoring the integrity and clarity of the group's financial reporting.
- Reporting to the Board on the appropriateness of the group's accounting policies.
- Assessing the acceptability of any significant financial judgements.
- Advising the Board on whether the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the necessary information for the Society's Members to assess the group's performance, business model and strategy.
- Oversight of the group's system of internal control, including the work performed by the Internal Audit function.
- Considering whether a significant control failing has occurred.
- Monitoring the relationship between management and the external auditor.
- Monitoring the external auditor's adherence to the professional ethical standards expected of audit firms.

Membership of the Audit Committee remained largely constant in the year with Derek Howell (Chair), Sally Jones-Evans and David Rigney continuing as members of the Committee. Claire Hafner was appointed a member of the Committee, following her appointment to the Board in April 2018. All members of the Committee are independent Non-Executive Directors.

The Committee's Chair has recent and relevant experience as required by the Corporate Governance Code. David Rigney and Claire Hafner are both qualified accountants and Sally Jones-Evans has previous audit committee experience. The Board is satisfied that the Committee has the requisite levels of knowledge and understanding relevant to the markets in which the Society operates. The Chief Executive Officer, the Chief Financial Officer, the Chief Risk Officer, the Chief Internal Auditor, and representatives of Deloitte, the external auditor, attend each meeting. The Society's Deputy Secretary acts as Secretary to the Committee. Other relevant colleagues from across the business are also invited to attend meetings of the Committee in order to provide a deeper level of insight into key issues and developments. The Committee acts as an Audit Committee for both the Society and its subsidiary business, Nemo Personal Finance Limited, and has met on six occasions during the year.

The overlap in membership between the Committee, the Board Risk Committee and the Remuneration Committee is one of the mechanisms for ensuring that the linkage between the Audit Committee and other Board committees avoids gaps or unnecessary duplication between the remit of each Board committee.

GOVERNANCE

Activity during the year

The Committee has continued to focus its work on ensuring that the Annual Report and Accounts taken as a whole are fair, balanced and understandable and that internal audit processes are rigorous. In addition, during the year the Committee has also focussed on the oversight of work being undertaken to embed new systems following the transition to the IFRS 9 regime which took effect in January 2018 and introduced new requirements on the classification and measurement of financial assets and impairment.

The Committee has conducted detailed reviews of the interim and year-end financial statements and Pillar 3 Disclosures (which are published on the Society's website). The review included consideration of the narrative reports, together with the description of the Society's business model, strategy and risks. Following its review, the Committee has recommended these documents to the Board for approval. As a result of discussions with both management and the external auditor, the Committee determined that the key risks of misstatement of the group's financial statements related to the following areas where judgements are required.

Areas of judgement

Going Concern and Viability Assessment

During the year, the Committee has received regular reports from the Chief Financial Officer outlining the basis on which it is reasonable for the group to continue to prepare its financial statements on a going concern basis and has continued to be satisfied that it is appropriate to consider the Viability Assessment over a three-year planning horizon. As part of this process, the Committee monitors closely the scale of off-balance sheet contingency funding available to the Society and has satisfied itself as to the quality of the assets in which surplus funds are invested. As part of its assessment, the Committee has considered carefully the risk that the decision to leave the EU could adversely affect the availability and cost of wholesale funding.

Impairment provisions on loans

During the year, the Committee has monitored the output from the Society's IFRS 9 impairment provision models together with the rationale for subsequent adjustments proposed by management. The assumptions which inform the models, level of impairment suggested by the models and determination of any post model adjustments are key areas of judgement. The Committee has given careful consideration to the appropriateness of the methodologies used by management to assess the likelihood of losses, the severity of losses expected to be incurred and the selection and probability weighting assigned to forward-looking economic scenarios, in order to assess the overall adequacy of provisions held against the loan books. The Committee concluded that the assumptions used to inform management's assessment as to the adequacy of impairment provisions are appropriate.

Provisions for regulatory and customer redress

The Committee has considered carefully the assumptions made by management in connection with the scale of the provision recognised for this purpose. In doing so, the Committee has had regard to the FCA's Rules and Guidance on the management of PPI complaints and the decision made by the Supreme Court in the case of Plevin v Paragon Personal Finance Limited. The Committee has also considered actual and estimated claims volumes, uphold rates and costs of redress. The Committee continues to be satisfied that the scale of the provision recognised for this purpose is appropriate.

Retirement benefit obligations

The Committee considered the key assumptions used by the Scheme Actuary to determine the liability under IAS 19 in connection with the Society's defined benefit pension scheme obligation. The Committee agreed that the assumptions used for this purpose were reasonable.

In addition to these key judgements, the Committee considered:

Hedge Accounting and Fair Value Measurements

The Committee has considered the methodology adopted by management leading to the calculation of fair values for derivative instruments including compliance with requirements for hedge accounting for those instruments. The Committee is satisfied that appropriate accounting entries have been made in the Society's financial statements for this purpose.

After reviewing reports by management and after consulting with the Society's auditors, the Committee is satisfied that the financial statements appropriately address the critical judgements and key estimates. The Committee is also satisfied that the significant assumptions used for determining the value of the assets and liabilities have been appropriately scrutinised, challenged and are sufficiently robust.

Deloitte, as the Society's external auditor, has reported on both the interim and year-end financial statements and those reports were considered by the Committee prior to recommending approval of the financial statements to the Board. Deloitte has reported to the Committee on the work carried out in relation to the most significant areas of audit risk and where accounting assumptions and estimates have been applied by management. Management confirmed to the Committee that it was not aware of any material misstatements or immaterial misstatements made intentionally to achieve a particular presentation. Deloitte calculated its materiality level and the clearly trivial threshold which were presented to the Committee at the planning stage, and these were accepted by the Committee. The Auditor provided the Committee with a summary of misstatements which exceeded that threshold which had been identified during the course of the testing and no material amounts remain unadjusted. The Committee is also responsible for considering the annual Deloitte Management Letter and has received reports from management on progress with work to address findings set out in the Management Letter.

Assessment of internal controls

Good systems of control help to facilitate the effectiveness and efficiency of day to day operations and to help safeguard assets. Management is responsible for establishing and maintaining the control environment. The control environment is designed to evolve as the risks faced by the Society change over time. The Committee is responsible for monitoring the effectiveness of those controls. This work is primarily performed by the Internal Audit function. Members of the Committee are actively involved in planning the work undertaken by the Chief Internal Auditor and his team which is designed to reflect a risk based approach, having regard to the risks embedded in the Society's operations. The Committee receives regular reports on the effectiveness of the systems and controls framework. As part of the reporting process, the Chief Internal Auditor provides the Committee with a summary of the most significant matters being monitored by the Internal Audit team and items of thematic interest which warrant the Committee's attention.

The Committee is responsible for approving the annual Internal Audit plan and receives regular reports from the Chief Internal Auditor on the adequacy of resources available to that department, the results of any unsatisfactory audits and associated action plans; and progress of management's implementation of audit recommendations and on adherence to the control framework. In order to preserve the independence of the Chief Internal Auditor, the individual performing that role continues to have a dual reporting line to the Chief Executive and Chair of the Audit Committee. In addition, the Chief Internal Auditor also has direct access to the Society's Chairman. The Committee has held three private meetings with each of the Chief Internal Auditor and Deloitte during the year. In addition, the Committee also monitors the effectiveness of the Internal Audit function. This work includes monitoring the progress of the Internal Audit team against the Audit Plan and reviewing progress with work to implement audit recommendations. During the year the Committee received a report on the effectiveness of the Internal Audit function from the Chief Internal Auditor and has reviewed the Internal Audit Charter.

The Committee has considered carefully the risk associated with management circumventing the control framework. Work undertaken by both Deloitte, as part of the annual audit cycle, and the work performed by the Internal Audit function during the year has enabled the Committee to be satisfied that the control framework remains robust. The Committee was satisfied that no significant control failings or weakness were identified during 2018.

Whistleblowing Policy

The Committee is responsible for reviewing and approving the Whistleblowing Policy annually. The Committee continues to be satisfied that the Whistleblowing Policy remains appropriate and that the requisite arrangements are in place to enable colleagues, contractors and third-party suppliers to raise concerns about possible improprieties on a confidential basis.

Whether the Annual Report taken as a whole is fair, balanced and understandable and provides the necessary information for the Society's Members to assess the Society's performance, business model and strategy

The Committee is responsible for considering on behalf of the Board whether the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary to Members to assess the group's performance, business model and strategy. In justifying this statement the Committee has considered the robust process which operates in creating the Annual Report and Accounts which includes the following:

- Revisions to regulatory requirements, including the UK Corporate Governance Code, are considered on an ongoing basis.
- Key accounting judgements are presented to the Audit Committee for approval.
- Whether the description of the group's business model is accurate; whether the narrative reports explain the financial statements; whether the principal risks and uncertainties faced by the group are clearly described, together with mitigating actions and whether the group's projected solvency and liquidity positions over the next three years are adequate to support the going concern assessment.
- Whether there are any significant control weaknesses, or failings which should be brought to the attention of the Society's Members.
- A thorough process of review and evaluation of the inputs into the accounts to verify accuracy and consistency, including review by senior management.
- A meeting of the Committee to review and consider the draft Annual Report and Accounts in advance of the final sign-off. The Chair of the Committee reports its conclusions to the Board which provides the approval and final sign-off.

As part of the Committee's assessment of the Annual Report and Accounts, prior to reporting to the Board on this topic, the Committee draws on reports prepared by, and discussions with, the Chief Financial Officer and members of his senior management team. The Committee is satisfied that senior members of the Finance team are fully familiar with the fair, balanced and understandable requirement. Members of that team are responsible for the overall co-ordination, verification, detailed review and challenge of the content of the Annual Report itself. The Committee receives assurance from members of the Executive team that they consider the content for which they are responsible is fair, balanced and understandable. The Committee also receives an early draft of the Annual Report to enable Members of the Committee to conduct a timely review and challenge the content of the report. The Committee is committed to continually improving the transparency of reporting to the Society's Members.

Auditor independence

The Committee is responsible for assessing the effectiveness of the annual audit process, for monitoring the independence and objectivity of the external auditor and making recommendations to the Board in relation to the appointment of the external auditor. The Committee is also responsible for making recommendations to the Board on the appointment, reappointment, remuneration and removal of the external auditor and for the maintenance of an appropriate relationship with the Society's auditors. Following a successful re-tendering process in 2016 Deloitte LLP remain as statutory auditor. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 12 years, covering the years ending 31 December 2007 to 31 December 2018. During the year, the Committee has reviewed and approved the external auditor's overall work plan and considered in detail the results of the audit, the performance and independence and the effectiveness of the overall audit process.

The Committee assesses annually the qualification, expertise, resources, independence and objectivity of the external auditor. The Committee conducts a formal review of the effectiveness of the external audit. Members of the Committee and senior members of the Finance team consider a number of relevant questions. The Committee conducts this evaluation without the auditor being present. There is periodic rotation of the audit partner responsible for the audit engagement, and each year the external audit firm confirms to the Committee that it considers itself to be independent as defined by the current rules of the Financial Reporting Council.

In order to safeguard auditor objectivity and independence, the Committee maintains a formal policy which governs the engagement of the external auditor for non-audit services. The policy is designed to ensure that the provision of such services does not have an impact on the external auditor's independence and objectivity. This policy identifies engagements that can only be undertaken with appropriate authority from the Committee Chair or the Committee where non-audit fees will exceed pre-set thresholds. The auditor may only provide such services if such advice does not conflict with their statutory responsibilities and ethical guidance. Non-audit services prohibited by ethical standards are not permitted to be undertaken under any circumstances.

The Committee receives a schedule of fees for non-audit work paid to the audit firm at each meeting, an annual report on the non-audit services being provided and the cumulative total of non-audit fees. The audit fee for the year in respect of the group was £265k. Non-audit fees, mainly in relation to further assurance services, were £91k.

Other matters

The Chair of the Committee provides an oral update to the Board on matters considered by the Committee. In addition, the Board receives a summary of the minutes of meetings of the Committee which sets out the principal matters considered by the Committee.

Effectiveness of the Audit Committee

The effectiveness of the Committee is assessed as part of the annual Board and Committee effectiveness review, further details of which are set out in the Corporate Governance Report on page 41. The 2018 review, recently completed, concluded that the Committee operated effectively during the year. Members of the Committee are expected to undertake relevant training as part of their on-going development as an individual Board member. Each year, as considered appropriate, the Committee as a whole receives training on current topics. In 2018, this included updates on changes as a result of the implementation of IFRS 15 (revenue recognition) and IFRS 16 (leases), regulatory themes, corporate governance reforms and financial statement disclosures.

Derek Howell
Chair of the Audit Committee
5 February 2019

Report of the Customer, Conduct and Transformation Committee

for the year ended 31 December 2018

The Customer, Conduct and Transformation Committee is primarily responsible for the oversight of the Society's conduct strategy. Its task is to be satisfied that the Society's range of savings and mortgage products are designed to be suitable for the needs and circumstances of Members and customers and to be satisfied that training and leadership is in place to uphold and foster the culture required to ensure that Members and customers are treated fairly and well. The Committee is also responsible for providing oversight of the Society's transformation programme which will modernise and improve the range of product and services that the Society is able to offer.

Committee meetings are chaired by Nigel Annett, with Non-Executive Directors, Sally Jones-Evans and David Rigney, as members. In addition, other members of the Board were invited to specific meetings during the year to challenge and debate aspects of the transformation programme which are subject to Board decision. The Committee met on five occasions in 2018.

The Committee Chair provides regular updates to the Board summarising the discussions held at each Committee meeting. The Board recognises that transformation is vital in order for the Society to achieve sustainable long-term growth whilst reducing its cost of service. During the year, the Committee supported the Board with oversight of customer and conduct matters to ensure the delivery of fair outcomes. In particular, the Committee provided oversight and challenge in respect of:

- The framework under which the Society manages conduct risk.
- The Society's conduct risk appetite and Conduct Strategy.
- The framework under which the Society manages risks relating to its product offering and those of its third-party product providers, such as Legal & General and Dignity.
- Principles relating to the fees and charges the Society charges its Members and customers.
- Policies, processes and training relating to the conduct of colleagues when dealing with Members and customers, including those who are vulnerable.
- Regulatory change.
- Any mistakes or shortcomings which needed to be corrected by the Society.

During the year, the Committee also provided oversight and challenge in respect of the following transformation programme matters:

- The business case for the programme, including the costs and benefits of transforming.
- The transition to and from the different phases of the programme.
- The key milestones and the plans to achieve these.
- The strategic risk profile of the programme.
- Future resourcing needs of the programme and of business as usual operations.
- Key decisions made in the day to day running of the programme.
- Internal and external assurance of the programme.

The Committee provides oversight and challenge by monitoring a range of key performance and key risk indicators, receiving regular reports from the Chief Customer Officer, Chief Operating Officer and the Head of Customer Oversight. It also receives updates, where relevant, from the Chief Internal Auditor.

Nigel Annett
Chair of the Customer, Conduct and Transformation Committee
5 February 2019

Report of the Remuneration Committee

for the year ended 31 December 2018

I am pleased to present the Remuneration Committee report including detail of the Executive and Non-Executive Directors pay for 2018. Our role as a committee is to ensure that all of our remuneration policies align with the Board-approved strategy to ensure that the business is run safely and successfully for our Members.

I look forward to meeting many of you at the Annual General Meeting, and to taking your comments and answering your questions about this report and the work of the Remuneration Committee. As usual, we will be holding an advisory vote on our remuneration policy and I hope that you will support this.

Sally Jones-Evans
Chair of the Remuneration Committee
5 February 2019

Performance in 2018 and its impact on variable pay

As you have read in other sections of this annual report, the Society's performance has been good despite a challenging external environment. Assets and new lending have grown successfully, profitability is good despite competitive market conditions, customer and Member feedback is very positive, and important steps have been taken to invest in the Society over the coming years.

Details of our two variable pay schemes, the Rewarding Excellence Award (a single scheme for all staff) and the Long Term Incentive Plan (for Executive Directors and a small number of senior members of staff), are shown on page 80. As the long-term strength and safety of the Society are paramount to our strategy, initial risk 'gateways' are set for our capital and liquidity position for both schemes, and these have been met in 2018. Performance against the customer service measures on both schemes have been achieved, reaching the stretch performance level. Given the competitive market conditions the financial measure of profit before tax was slightly below the target for the purposes of the Rewarding Excellence Award. I am pleased to confirm awards have been made under both schemes. Our hard working staff have received an award of 8.8% of their salary to thank them for their considerable contribution to this success. The awards made to Executive Directors under both schemes are shown in the tables on page 82.

GOVERNANCE

Remuneration Policy

Our Remuneration Policy is designed to ensure that the business is run safely and successfully for our Members. This ensures that consideration is given to clarity, simplicity, risk, predictability, proportionality and the alignment to culture when dealing with all aspects of remuneration. As a consequence of this consideration the Remuneration Committee has agreed to change the variable pay scheme for Executives and further details can be found on page 85 to 86.

The Remuneration Policy aims to:

- Attract, motivate, reward and retain high quality people who can ensure that Principality continues to deliver value to Members and to be profitable in a competitive, and often uncertain, marketplace by positioning basic salaries and benefits, both in terms of total amount and structure (i.e. the balance of fixed and variable pay), at around market levels for similar roles within the UK mutual building society sector, as well as more broadly where this is appropriate.

- Promote the right behaviours that align with the Society's position on risk, as well as its culture as a Member owned mutual Building Society.

- Encourage sound conduct and risk management practices by setting capital and liquidity hurdles that must be met before any variable pay award can be made, and by ensuring our Long Term Incentive Plan (LTIP) scheme for senior executives rewards consistent performance over multiple years.

- Share the success of the Society in line with Members' interests by offering Directors and colleagues (except our leaders of Risk, Audit and Conduct) the chance to share in a variable pay award of up to 12% of salary based on the achievement of stretching targets based on customer service and financial performance, and for some senior executives, an additional long term incentive scheme of up to 28% based on performance over three years.

During the year the Committee continued to use PwC to provide independent advice on executive remuneration.

GOVERNANCE

How this policy is applied to Executive Directors

The table below provides a summary of the different elements of remuneration for Executive Directors for 2018:

Component	Purpose	Operation	Opportunity
Base Salary	To attract and retain executives of sufficient calibre through the payment of competitive rates.	Reviewed annually (or more frequently if required).	Set at a level considered appropriate, taking into account: - Role and experience; - Personal performance; - Benchmarking comparisons; and - Salary increases awarded across the Society.
Benefits	Part of being a responsible employer and to assist in the performance of the job.	Benefits include a car allowance, private medical care for Executive Directors and their family, critical illness insurance and life insurance.	Set at a level considered appropriate by the Committee.
Pension or pension allowance	To provide for longer-term savings to fund retirement.	Executive Directors may join the Society's pension plan or be provided with an equivalent cash allowance.	Pension contribution of 15% of base salary or paid as a cash allowance.
Rewarding Excellence Award	To share the benefits of teamwork, financial discipline and customer service with all staff.	Annual targets based on risk gateways, group profit before tax and customer service measures.	Maximum annual payment is 12% of base salary.
Long Term Incentive Plan	To align selected senior executives to the Society's longer-term goals and objectives.	Targets set over three years based on risk gateways, Return on Assets and Net Promoter Score. Transitional arrangements apply for the 2016 and 2017 LTIP.	Maximum annual payment is 28% of salary. Personal performance is taken into account.

Note: The Chief Risk Officer, Chief Internal Auditor and Chief Compliance and Conduct Officer do not participate in any variable pay scheme.

How we apply this policy to the Chairman and Non-Executive Directors

The Chairman and Non-Executive Directors are paid a fee for Board participation and additional fees for serving on Board committees. These fees are reviewed annually and in February 2018 the Board fees were increased by 2% in line with colleagues' basic pay increase.

The Chairman and Non-Executive Directors do not receive any employee benefits, pension contributions or participate in any variable pay schemes. The Chairman and Non-Executive Directors do not have service contracts and are all subject to election or re-election at each year's Annual General Meeting.

Gender Pay Gap and Women in Finance Charter

The Board is clear that diversity helps to improve the quality of decision making and therefore, improving diversity at all levels remains a priority for the Society. A five year Diversity and Inclusion strategy was agreed by the executive team and the Board in 2016. Our focus for the first two years of the plan has been to embed diversity and inclusion throughout the organisation and Employee Value Proposition; educating colleagues and promoting the benefits of having a workforce that reflects the communities we serve. This enhances our service to our customers by creating a culture that enables all colleagues to reach their full potential.

Principality signed up to the Women in Finance Charter in July 2016, setting ourselves a target of having at least 33% of women in our senior leadership team by 2021. Positive steps towards this target continue to be made with 28% of this population now made up of female colleagues, compared to 23% last year.

The Society's mean gender pay gap has reduced since last year. It is encouraging to see the Diversity and Inclusion strategy having a positive impact, and we will continue to embed and develop this throughout the Society.

Principality's gender pay gap comparison:

	2018		2017	
	Mean %	Median %	Mean %	Median %
Hourly pay gap	29.23	27.16	31.33	31.52
Bonus pay gap	37.76	33.26	38.03	32.24

Principality's bonus payment gender split:

	2018		2017	
	Men %	Women %	Men %	Women %
Proportion receiving bonus payment	93.00	95.24	93.16	93.70

GOVERNANCE

Annual Report on Remuneration

The business complies where appropriate with the Corporate Governance Code and aims to make the remuneration policy as transparent, clear and simple as possible. The design of remuneration considers appropriateness for a Member owned organisation and alignment to our culture, whilst the quantum is carefully designed to be proportionate to the challenges and to encourage the right behaviours and discourage excessive risk taking. We therefore set out in this section the following information.

1. What the Executive Directors earned for 2018's performance compared with 2017
2. What the Chairman and the Non-Executive Directors were paid in 2018 compared with 2017
3. What the Executive Directors can earn for 2019

What the Executive Directors earned for 2018's performance

The following table shows a single total figure of remuneration for the 2018 financial year for each of the Executive Directors and compares this figure to the prior year. In February 2018, the Remuneration Committee decided that the base salary of all Executive Directors should increase by 2%. This was equal to the average pay increase awarded to all other colleagues.

Annual Variable Pay is the total of both the Rewarding Excellence Award and the Long Term Incentive Plan.

The normal performance period of the LTIP is three years and the 2016 LTIP operated for the performance period 1 January 2016 to 31 December 2018.

Audited Information Individual	Year £000	Salary and Fees[1] £000	Benefits[2] £000	Pensions[3] £000	Annual variable pay £000	Total £000
Chief Executive Officer **Stephen Hughes**	2018	316	15	47	116	494
	2017	300	14	45	114	473
Chief Financial Officer **Tom Denman (from 10/08/17)**	2018	193	12	29	71	305
	2017	75	4	11	27	117
Chief Risk Officer **R Michael Jones**	2018	249	13	37	n/a	299
	2017	244	12	37	n/a	293
Chief Customer Officer **Julie-Ann Haines**	2018	224	12	34	83	353
	2017	215	12	32	82	341
Former Chief Executive Officer[6] **Graeme Yorston (to 03/03/17)**	2018	-	-	-	38	38
	2017	235	15	35	62	347

1. The review date for salary is 1 February 2019. 2. Benefits comprise a car allowance, life assurance, critical illness insurance and private medical insurance. 3. A cash allowance of equal value (15% of salary) may be taken in lieu of pension. 4. Awards under the variable pay schemes are non-pensionable. 5. The Chief Risk Officer, Chief Internal Auditor and Chief Compliance and Conduct Officer do not participate in the variable pay scheme. 6. Under terms of his departure agreement, Graeme Yorston is entitled to receive awards under the 2016 Long Term Incentive Plan which will be pro rated by reference to service. For 2018 the award will be £38k, which will be paid in February 2019. He is also entitled to receive a further award in 2020 under the LTIP, calculated pro rata based on the Remuneration Committee award for those years.

How the annual variable pay for 2018 was calculated

The 2018 annual variable pay awards for Executive Directors for each of the two schemes were calculated by reference to performance against challenging targets set by the Board for financial and customer measures. Performance in the year was demonstrated in the outcomes set out in the table below:

Rewarding Excellence Award 2018

Variable Pay Scheme Target	Proportion of variable pay	Actual 2018 Performance	Threshold	Target	Stretch	Award
Group Profit before tax*	50%	£43.8m	£37.6m	£44.2m	£50.8m	2.8%
Customer Service Net Promoter Score	50%	78.6%	72%	75%	77% or above	6%
Total Award						8.8%

* Profit measure adjusted for items which are non-trading or performance related.

Long Term Incentive Plan 2018

Variable Pay Scheme Target	Proportion of variable pay	Actual 2018 Performance	Threshold	Target	Stretch	Award
Return on Assets	50%	0.41%	0.33%	0.35%	0.37%	14%
Net Promoter Score	50%	Top 8%ile	Below 60%ile	Top 25%ile	Top 15%ile	14%
Total Award						28%

GOVERNANCE

GOVERNANCE

The Chairman and Non-Executive Directors' fees for 2018

Non-Executive Directors are paid a basic fee for participation on the Society Board and additional fees payable for providing services on Board Committees and/or for their membership of subsidiary company Boards. The fees paid to the Non-Executive Directors are set at a level which allows the Society to attract and retain the required calibre of independent directors.

Fees paid to the Chairman and the Non-Executive Directors were as follows:

Audited information Non-Executive Directors	Fees	
	2018 £000	2017 £000
Laurence Philip Adams	117	114
Nigel Annett CBE (Chair of Customer, Conduct and Transformation Committee)	62	60
Derek Howell (Chair of Audit Committee and Senior Independent Director)	70	70
Sally Jones-Evans (Chair of Remuneration Committee)	62	58
David Rigney (Chair of Board Risk Committee)	62	63
Claire Hafner[1]	39	-
Natalie Elphicke OBE[2]	31	52
Total	443	417

[1] Claire Hafner joined the Board on 1 April 2018
[2] Natalie Elphicke stepped down from the Board on 20 July 2018

What the Executive Directors can earn for 2019

Base salary

The Committee reviews the Executive Directors' base salaries on 1 February of each financial year, taking into account factors such as individual and corporate performance, an assessment of market conditions, and the salary increases applicable to other colleagues. For 2019, they have been awarded a 2% increase, the same as to all other colleagues.

Following this review, the Executive Directors' 2019 salaries are:

- Stephen Hughes £322,524
- R Michael Jones £253,939
- Tom Denman £197,676
- Julie-Ann Haines £228,888

Benefits

No changes have been made to the benefits in kind provided to the Executive Directors, namely a car allowance, life assurance, critical illness insurance and private medical insurance.

Pension

The Business pays its Executive Directors a pension contribution of 15% of salary, which may be taken as a cash allowance. The provision remains unchanged.

Annual variable pay

The all-colleague annual incentive plan, the Rewarding Excellence Award, will continue to operate from 1 January 2019. A summary is set out below:

Performance period	1 January 2019 to 31 December 2019
Participants	All employees of Principality, except the Chief Risk Officer, Chief Internal Auditor and Chief Compliance and Conduct Officer
Administrator	Remuneration Committee
Initial gateway conditions	Capital and liquidity conditions and the absence of any material regulatory breaches
Performance measures	Group Profit before Tax – 50% of bonus award percentage (max.6%) Customer Net Promoter Score – 50% of bonus award percentage (max.6%)
Potential payments	Nil for threshold performance 6% of salary for meeting challenging target performance 12% of salary for attaining highly stretching targets
Payment date	Subject to Audit and Remuneration Committee approval in February 2020. There will be no partial deferral of payment
Clawback (demanding repayment)	The Remuneration Committee can apply clawback to an award to an Executive Director and other senior executives if it is discovered that the award should not have been paid, in the event of a material misstatement of the group's annual results or in the event of a serious regulatory breach

Leading Excellence Award

The Remuneration Committee have undertaken a full review of the Long Term Incentive Plan that launched in 2016 to address some of its challenges, including the difficulties of setting meaningful targets for a three year period amongst so much economic uncertainty. The Remuneration Committee also wanted to take the opportunity for the scheme to be more inclusive, reflecting the effort required by many senior managers to deliver the transformation programme over the next few years. As a result, there will be two levels of participation for senior leaders and Executive Directors, as shown in the table overleaf.

The Leading Excellence Award will replace the Long Term Incentive Plan from January 2019. The Leading Excellence Award is an annual variable pay award with deferral, which has been designed to make setting meaningful targets more effective, enabling the Society to reward, attract and retain our most senior leaders.

A summary is set out below:

Performance period	1 January 2019 to 31 December 2019
Participants	Executives and Senior Leaders, except leaders of control functions
Administrator	Remuneration Committee
Initial gateway conditions	Capital and liquidity conditions and the absence of any material regulatory breaches
Performance measures	Return on Assets – 25% Customer Service Net Promoter Score (GFK) – 25% Colleague Engagement – 25% Individual Personal Performance – 25%
Potential payments	**Executives** Nil for threshold performance 19% of salary for meeting challenging target performance 38% of salary for attaining highly stretching targets **Senior Leaders** Nil for threshold performance 9% of salary for meeting challenging performance targets 18% of salary for attaining highly stretching targets
Payment date	Subject to Audit and Remuneration Committee approval, 60% of the award will be paid to eligible participants in February 2020. Following this, Executives will receive a deferred payment of 20% in February 2021 and a final deferred payment of 20% in February 2022. Senior Leaders will receive a final deferred payment of 40% in February 2021.
Clawback (demanding repayment)	The Remuneration Committee can apply clawback to an award to an Executive or Senior Leader if it is discovered that the award should not have been paid, in the event of a material misstatement of the group's annual results or in the event of a serious regulatory breach.

The Committee will have absolute discretion to adjust the awards under both schemes if necessary including withholding vested awards under "malus" arrangements or recovering monies paid under clawback. No variable pay awards at the Society are pensionable.

Directors' service contracts

The Chief Executive has a service contract that can be terminated by either party on one year's notice or by the payment by the Society of an amount equivalent to one year's remuneration. The other Executives have service contracts that can be terminated by the Society on one year's notice or by the payment by the Society of an amount equivalent to one year's remuneration, and by the Executive giving six months' notice.

Approval

This report was approved by the Remuneration Committee and signed on its behalf by:

Sally Jones-Evans
Chair of the Remuneration Committee
5 February 2019

Directors' report

for the year ended 31 December 2018

The Directors are pleased to present the Annual Report and Accounts and Annual Business Statement of the Society and its subsidiary undertakings for the financial year ended 31 December 2018. The Directors confirm that, to the best of their knowledge, the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary to Members to assess the group's performance, business model and strategy. Further information is provided in the Report of the Audit Committee on pages 71 to 75.

Directors

The names of the Directors at the date of this report, together with brief biographical details, are listed on pages 36 to 40. Details of changes affecting the composition of the Board are set out in the Governance Report on pages 41 to 49. In accordance with the UK Corporate Governance Code, and as permitted by Society Rule 26(1), all of the Directors retire and stand for re-election at the Annual General Meeting apart from Claire Hafner, who is due to stand for election for the first time. All are eligible and willing to continue serving on the Board and there have been no other nominations.

During the year no Director of the Society was, or has since been, beneficially interested in the share capital of, or any debentures of any connected undertaking of the Society.

Auditor

At the Annual General Meeting on 27 April 2018 the Members passed a resolution that Deloitte LLP be reappointed as auditor for the ensuing year.

Responsibilities of the Directors

The following statement, which should be read in conjunction with the statement of the auditor's responsibilities on page 101, is made by the Directors to explain their responsibilities in relation to the preparation of the Annual Accounts, the Report of the Remuneration Committee, the Annual Business Statement and the Directors' Report.

The Directors are required by the Building Societies Act 1986 to prepare, for each financial year, Annual Accounts which give a true and fair view of the income and expenditure of the Society and the group for the financial year and of the state of affairs of the Society and the group as at the end of the financial year and which provide details of Directors' emoluments in accordance with Part VIII of the Act and regulations made under it. In preparing the Annual Accounts, the Directors are required to:

- select appropriate accounting policies and apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed; and

- prepare the Annual Accounts on the going concern basis, unless it is inappropriate to presume that the Society will continue in business for the next 12 months.

In addition to the Annual Accounts, the Act requires the Directors to prepare, for each financial year, an Annual Business Statement and a Directors' Report, each containing prescribed information relating to the business of the Society and its connected undertakings.

Directors' responsibilities for accounting records and internal controls

The Directors are responsible for ensuring that the group:

- keeps accounting records in accordance with the Building Societies Act 1986; and
- takes reasonable care to establish, maintain, document and review such systems and controls as are appropriate to its business in accordance with the rules made under the Financial Services and Markets Act 2000.

The Directors have general responsibility for safeguarding the assets of the Society and for taking reasonable steps for the prevention and detection of fraud and other irregularities. So far as each Director is aware, there is no relevant audit information of which the Society's auditors are unaware. Each of the Directors, whose names and functions are listed in the Governance section on pages 36 to 40, have taken all steps that he or she ought to have taken as a Director in order to make himself/herself aware of any relevant audit information and to establish that the Society's auditors are aware of that information.

The Directors are also responsible for the integrity of the Society's website www.principality.co.uk. The work carried out by the auditor does not involve consideration of these matters and, accordingly, the auditor accepts no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website. Information published on the internet is accessible in many countries with different legal requirements relating to the preparation and dissemination of financial statements. Information in these financial statements is provided under the legislation of the United Kingdom.

Long-term viability statement and going concern

The Directors have assessed the viability of the group over a three-year period taking into account the business strategy and the principal risks as set out in the Strategic Report and the Risk Management Report. The Directors have a reasonable expectation that the business can continue in operation and meet its liabilities as they fall due over the three-year period of their assessment. In making this statement the Directors have considered the resilience of the group, taking account of its current position, the principal risks facing the business in severe but plausible scenarios, and the effectiveness of any mitigating actions. The assessment has considered the potential impacts of these risks on the business model, future performance, capital adequacy and liquidity over the period. The strategy and associated principal risks underpin the group's three-year plan and scenario testing, which the Directors review at least annually. The three-year plan makes certain assumptions about the macroeconomic environment, the performance of the group's lending portfolios and the availability of funding. The plan is stress tested through the group's Internal Capital Adequacy Assessment Process ('ICAAP') and Internal Liquidity Adequacy Assessment Process ('ILAAP'). These processes use both scenarios determined by the Bank of England and internal scenarios which reflect the specific nature of the group's business. Included within these scenarios are substantial falls in residential and commercial property prices, increases in unemployment, changes to interest rates and reduced funding availability within wholesale and retail markets.

The Directors have determined that a three-year period of assessment is an appropriate period over which to provide its viability statement. The three-year period is considered to be most appropriate as it is the longest period over which the Board considers that it can form a reasonable view of the likely macroeconomic environment and associated key drivers of business performance. Having considered the plans and forecasts for the group, the Directors are satisfied that there are adequate resources and no material uncertainties that lead to significant doubt about the group's ability to continue in business for the foreseeable future. Accordingly, the financial statements continue to be prepared on a going concern basis.

The group's strategic report information required by Schedule 7 to the Accounting Regulations and the capital structure of the group are set out in the Strategic Report on pages 12 to 29.

Anti-Corruption and Anti-Bribery matters

The Society is committed to maintaining the highest standards of ethics and integrity in the way it operates and abiding by the law. The Society complies with the UK Bribery Act which came into force in July 2011. Any act of fraud, bribery or corruption is treated seriously by the Society. The Society expects its business partners to adopt the same approach.

All colleagues including the Chief Executive Officer and members of the senior leadership team have been trained in recognising and understanding potential bribery and corruption risks. The Society's exposure to potential bribery and corruption risks is reviewed annually and the outcome of that review is reported to the Society's Audit Committee. Everyone in the business must comply with the Society's Bribery and Conflicts of Interest Policy.

The Chief Executive Officer is responsible for reminding all colleagues of the Society's values and zero tolerance approach to all forms of bribery and corruption. The Society uses an e-learning solution to support anti-bribery training and assessments.

Details of the Audit Committee's remit which include adherence to the Bribery and Conflicts of Interest Policy can be found on the Society's website.

Country by country reporting

The following information is disclosed in accordance with the Regulations of Article 89 of the Capital Requirements Directive IV (CRD IV) country-by-country reporting (CBCR):

a) Name, nature of activities and geographical location

Principality Building Society is the parent company and a list of the subsidiaries can be found in note 20 of these accounts. The principal activities of the group can be found in the Strategic Report and in note 20. All group companies operate in the United Kingdom only.

b) Average number of employees

The average number of employees is disclosed in note 9.

c) Annual turnover

Net operating income is set out in the Consolidated Income Statement.

d) Pre-tax profit or loss

Profit before taxation is set out in the Consolidated Income Statement.

e) Corporation tax paid

Corporation tax paid is set out in the Consolidated Statement of Cash flows.

f) Public subsidies received

No public subsidies were received in 2018.

Charitable and political donations

In 2018 the Society made donations to charities of £0.2m (2017: £0.1m). More information on this topic can be found at pages 30 to 32. No political donations were made by the Society in the current or prior year.

On behalf of the Board of Directors.

C. P Adams

Laurence Philip Adams
Chairman
5 February 2019

Financial statements

Independent Auditor's Report to the Members of Principality Building Society

Report on the audit of the financial statements

Opinion

In our opinion:

- **the financial statements of Principality Building Society (the 'Society') and its subsidiaries (the 'group') give a true and fair view of the state of the group's and Society's affairs as at 31 December 2018 and of the group's and the Society's income and expenditure for the year then ended;**

- **the group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;**

- **the Society's financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the requirements of the Building Societies Act 1986; and**

- **the financial statements have been prepared in accordance with the requirements of the Building Society's Act 1986 and, as regards the group financial statements, Article 4 of the IAS Regulation.**

We have audited the financial statements which comprise:

- the group and Society income statements;
- the group and Society statements of comprehensive income;
- the group and Society statements of financial position;
- the group and Society statements of movements in member's interests;
- the group and Society cash flow statements; and
- the related notes 1 to 35.

The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the group and the Society in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the 'FRC's') Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the group or the Society.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters	The key audit matters that we identified in the current year were: • IFRS 9 Financial Instruments – Expected Credit Loss provisioning; and • Regulatory provisioning Within this report, any new key audit matters are identified with and any key audit matters which are the same as the prior year are identified with
Materiality	The materiality that we used in the group financial statements was £2.0m which was determined on the basis of 5% of income before tax as per the consolidated income statement.
Scoping	All material entities in the group are within our audit scope and audited to a local materiality for the purposes of individual entity reporting. Audit work to respond to the risks of material misstatement was performed directly by the group audit engagement team.
Significant changes in our approach	After an evaluation of the group's regulatory provisions, its material and judgemental nature, we have identified the valuation of the group's provision for regulatory matters as a new key audit matter. As part of this evaluation we also removed the following key audit matters identified in the prior year: revenue recognition and the defined benefit pension scheme.

Going concern

We have reviewed the Directors' statement on page 89 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the group's and Society's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

Principal risks and viability statement

Based solely on reading the Directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the Directors' assessment of the group's and the Society's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to:

- the disclosures on pages 58-70 that describe the Principal risks and explain how they are being managed or mitigated;

We confirm that we have nothing material to report, add or draw attention to in respect of these matters.

• the Directors' confirmation on page 89 that they have carried out a robust assessment of the Principal risks facing the group, including those that would threaten its business model, future performance, solvency, liquidity;

• the Directors' explanation on page 89 as to how they have assessed the prospects of the group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

As part of the risk assessment process we no longer consider revenue recognition and the defined benefit pension scheme as a key audit matter as reported in the prior year.

IFRS 9 Financial Instruments – Expected Credit Loss provisioning

Key audit matter description

This is a new and complex accounting standard which has required considerable judgement and interpretation in its implementation. These judgements have been key in the development of new models which have been built and implemented to measure the expected credit losses on loans measured at amortised cost. The models developed estimate the expected loss provisions against loans to customers within the group's:

- Residential mortgage book;
- Commercial lending book; and
- Secured personal lending book.

The group held £30.5m of impairment provisions against such loans at year-end in accordance with IFRS 9 (2017: £30.3m in accordance with IAS 39) against total loans and advances to customers of £8,498.7m (2017: £7,864.1m). The transition adjustment on adoption of IFRS 9 at 1 January 2018 was an increase of £3.2m (resulting in a total provision of £33.5m).

Estimating these expected losses requires judgement and estimation on assumptions relating to customer default rates, likelihood of repossession, future property values, forced sale discounts and indicators of significant increases in credit risk.

Key audit matter description	These assumptions are informed using historical behaviour and experience as well as credit bureau data. They are also affected by management's consideration of the future economic environment including the potential effect of the withdrawal of the United Kingdom from the European Union. The model related to the commercial book has further specific judgements and estimates. Specific commercial lending provisions are based on a case by case assessment for individual accounts considered to be in default. Judgement is required in such cases to determine the estimated recoverable property value. Judgement is also required to determine the risk grading of commercial loans which drives the modelled provision calculation. In addition, management also consider whether overlays to the model are required to capture other specific risks that are not captured in the model. Given the material effect of the significant judgements taken by management in the measurement of the provision, we also considered that there is a potential for fraud risk through possible manipulation of this balance. The group's loan loss provision balances are detailed within note 16. Management's associated accounting policies are detailed on pages 111-123 with detail about judgements in applying accounting policies and critical accounting estimates on pages 128-129. Management's consideration of the effect of the future economic environment is disclosed on pages 128-129. The audit committees' consideration of the matter is described on page 72.
How the scope of our audit responded to the key audit matter	We first obtained an understanding of management's processes for the group's loan loss provision balances by performing a walkthrough, and evaluated the design, and assessed the implementation of key internal controls in place. We engaged credit risk and accounting specialists to assess the compliance of the modelling approach with the requirements of the standard. We also engaged IT and credit risk specialists to determine whether the documented modelled approach was implemented in practice.

FINANCIAL STATEMENTS

How the scope of our audit responded to the key audit matter

For the group's residential mortgage and secured personal lending books, we have tested the accuracy of the loss given default, probabilities of default and possession given default applied comparing the recent historical performance against model forecasts. In addition, we have made an assessment of the collateral valuation techniques used by management to estimate an appropriate provision balance. We recalculated certain components of the provision calculation using underlying data for which we tested the completeness and accuracy.

We challenged management's consideration of the future economic environment including the potential effect of the withdrawal of the United Kingdom from the European Union by engaging our economic experts to review management's approach as well as comparing modelled assumptions to publically available data from the Office of National Statistics and comparable peer data.

For the group's commercial book, we have undertaken detailed case reviews of accounts to check the accuracy of their reported risk grades. We used information provided by customers and other internal data to recalculate risk grades. Through testing the operating effectiveness, we have relied on management's review control that assures loan managers are accurately recording risk grades.

We have assessed the valuation of the underlying commercial property collateral of selected cases by reviewing information provided by independent third parties or through review of recent sales histories for similar properties.

We challenged the appropriateness of each of management's commercial provision overlays by using our understanding of the book and the external environment, testing the completeness and accuracy of the data used for the overlays and independently recalculating a sample of provisions.

We reconciled each book to the general ledger and substantively tested a sample of loans to assess whether the data used in the provision calculation was complete and accurate.

Key observations	Based on the evidence obtained, we found that the assumptions underpinning all the impairment models were determined and applied appropriately and the recognised provision was reasonably stated. We noted that the residential and secured book provisions were highly sensitive to the expectation of future house prices and has been materially affected by the expectation of the future economic environment, the effect of which has been disclosed by management on pages 128-129. As a result of this effect, we consider that the provisions held are at the conservative end of a reasonable range.
Regulatory provisioning	
Key audit matter description	This is a new key audit matter in the year given the continued high level of public and regulatory scrutiny of building societies and banks, as well as the magnitude of legal and regulatory claims. As disclosed in Note 30a (Other Provisions for Liabilities and Charges) the group held a provision of £3.3m at 31 December 2018 (31 December 2017: £3.8m) for Payment Protection Insurance ("PPI"). The most significant conduct issue relates to PPI. Management's judgements in assessing the valuation of the PPI provision is a key audit matter, particularly the judgement required to assess the current provision levels against the most recent claims experience, regulatory guidance and management's expectations of future claims. The group's regulatory provision balances are detailed within note 19. Management's associated accounting policies are detailed on page 128 with detail about judgements in applying accounting policies and critical accounting estimates on page 129. The audit committees' consideration of the matter is described on page 72.
How the scope of our audit responded to the key audit matter	We first obtained an understanding of management's processes for the group's loan loss provision balances by performing a walkthrough, and evaluated the design, and assessed the implementation of key internal controls in place. We have assessed the design and implementation of key controls relating to the valuation of the PPI provision, specifically the internal review and challenge of management's valuation assumptions.

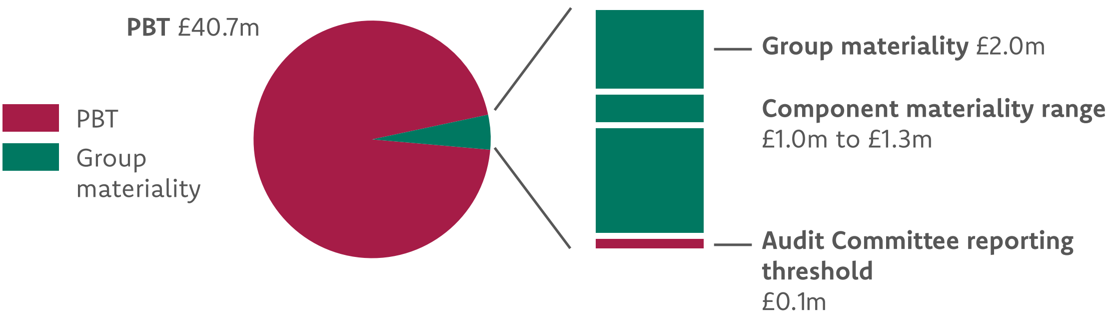
How the scope of our audit responded to the key audit matter	We challenged the adequacy of the provision recognised by critically assessing the key assumptions used in the provision model, such as those relating to claims volumes and average redress, by comparing against recent redress experience as well as the nature of expected future claims. This allowed us to determine a reasonable range of outcomes and assess management's position against this range. This work also included reviewing regulatory correspondence and the group's complaint logs, discussing the expectations of future claims with the in-house legal team and using our understanding of the market.
Key observations	Based on the procedures performed, we concur with management that the provision as at 31 December 2018 of £3.3m represents a reasonable best estimate of the probable economic outflow albeit towards the more conservative end of a reasonable range based on recent activity.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Society financial statements
Group materiality	£2.0m (2017: £2.9m)	£1.3m (2017: £1.9m)
Basis for determining materiality	5% of income before tax (2017: 5%)	5% of income before tax (2017: 5%)
Rationale for the benchmark applied	The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the group to invest in activities for its Members. We have therefore selected profit before tax as the benchmark for determining materiality.	The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the Society to invest in activities for its Members. We have therefore selected profit before tax as the benchmark for determining materiality.



We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £101,000 (2017: £144,000) for the group, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

All material entities in the group are within our audit scope and have been audited to a local materiality for the purpose of individual entity reporting, resulting in an audit of over 99% of all the balances in the group. All balances in the group that are above our materiality threshold have been audited for the purpose of group reporting. We have performed testing over the consolidation of group entities. These audits were performed directly by the group audit team and executed at levels of materiality applicable to each individual entity which were lower than group materiality and ranged from £1.0m to £1.3m (2017: £1.3m to £1.9m).

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our
report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

- Fair, balanced and understandable – the statement given by the directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and rovides the information necessary for Members to assess the group's and Society's performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or

- Audit Committee reporting – the section describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We have nothing to report in respect of these matters.

Responsibilities of Directors
As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the Directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Directors are responsible for assessing the group's and the Society's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the Directors either intend to liquidate the group or the Society or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements
Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Extent to which the audit was considered capable of detecting irregularities, including fraud
We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

Identifying and assessing potential risks related to irregularities
In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, our procedures included the following:

- enquiring of management, internal audit and the Audit Committee, including obtaining and reviewing supporting documentation, concerning the group's policies and procedures relating to:
    - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
    - enquiring of management, the Audit Committee and in-house legal counsel concerning actual and potential litigation claims;
    - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud;
    - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations;

- discussing among the engagement team and involving relevant internal specialists, including tax, financial instrument, pensions, and IT regarding how and where fraud might occur in the financial statements and any potential indicators of fraud. As part of this discussion, we identified potential for fraud in the determination of management's estimates of expected credit loss; and
- obtaining an understanding of the legal and regulatory frameworks that the group operates in, focusing on those laws and regulations that had a direct effect on the financial statements or that had a fundamental effect on the operations of the group. The key laws and regulations we considered in this context included those set by the Financial Conduct Authority in respect of the misselling of Payment Protection Insurance. In addition, we considered the regulation set by the Prudential Regulatory Authority relating to regulatory capital and liquidity requirements which are fundamental to the group's ability to continue as a going concern.

Audit response to risks identified

As a result of performing the above, we identified IFRS 9 Financial Instruments – Expected Credit Loss provisioning as a key audit matter. The key audit matters section of our report explains the matter in more detail and also describes the specific procedures we performed in response to that key audit matter.

In addition to the above, our procedures to respond to the risks identified included the following:

- reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with relevant laws and regulations discussed above;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with the Prudential Regulation Authority; and
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists, and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Building Societies Act 1986

In our opinion, based on the work undertaken in the course of the audit:

- the annual business statement and the Directors' report have been prepared in accordance with the requirements of the Building Societies Act 1986;
- the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the information given in the annual business statement (other than the information upon which we are not required to report) gives a true representation of the matters in respect of which it is given.

In the light of the knowledge and understanding of the group and the Society and their environment obtained in the course of the audit, we have not identified any material misstatements in the Directors' report.

Opinion on other matters prescribed by the Capital Requirements (Country-by-Country Reporting) Regulations 2013

In our opinion, the information given on page 90 for the financial year ended 31 December 2018 has been properly prepared, in all material respects, in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

Under the Building Societies Act 1986 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the Society; or
- the Society's financial statements are not in agreement with the accounting records; or
- we have not received all the information and explanations and access to documents we require for our audit.

We have nothing to report in respect of these matters.

Other matters

Audit tenure

Following the recommendation of the Audit Committee, we were appointed at the Annual General Meeting by the Members of the Society on 27 April 2007 to audit the financial statements for the year ending 31 December 2007 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 12 years, covering the years ending 31 December 2007 to 31 December 2018.

Consistency of the audit report with the additional report to the Audit Committee

Our audit opinion is consistent with the additional report to the Audit Committee we are required to provide in accordance with ISAs (UK).

Use of our report

This report is made solely to the Society's Members, as a body, in accordance with section 78 of the Building Societies Act 1986. Our audit work has been undertaken so that we might state to the Society's Members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Society and the Society's Members as a body, for our audit work, for this report, or for the opinions we have formed.

K. J. Cooper

Kieren Cooper (Senior statutory auditor)
For and on behalf of Deloitte LLP
Statutory Auditor
Cardiff, United Kingdom
5 February 2019

Consolidated income statement *for the year ended 31 December 2018*

	Notes	2018 £m	2017 £m
Interest receivable and similar income	4	226.0	214.2
Interest payable and similar charges	5	(106.4)	(88.3)
Net interest income		119.6	125.9
Fees and commission receivable	6	5.7	7.1
Fees and commission payable		(1.6)	(1.0)
Net fee and commission income		4.1	6.1
Other operating income		1.5	1.4
Other fair value (losses)/gains	7	(2.4)	4.3
Net operating income		**122.8**	**137.7**
Administrative expenses	8	(75.7)	(76.4)
Depreciation and amortisation	21 & 22	(5.8)	(13.2)
Operating expenses		(81.5)	(89.6)
Impairment provision (charge)/release on loans and advances	18	(0.6)	10.0
Provision for other liabilities and charges	19	–	(0.5)
Operating profit and profit before taxation		**40.7**	**57.6**
Taxation expense	12	(7.8)	(14.1)
Profit for the year		**32.9**	**43.5**

Consolidated statement of other comprehensive income

	Notes	2018 £m	2017 £m
Profit for the year		32.9	43.5
Items that will not be reclassified subsequently to profit and loss:			
Actuarial gain on retirement benefit obligations	11	1.1	–
Tax on retirement benefit obligations	12	(0.2)	–
Items that may be reclassified subsequently to profit and loss:			
Loss on fair value through other comprehensive income		(0.7)	–
Tax on fair value through other comprehensive income	12	0.1	–
Loss on available-for-sale assets		–	(1.9)
Tax on available-for-sale assets	12	–	0.4
Total comprehensive income for the year		**33.2**	**42.0**

All items dealt with in arriving at the profit before tax and the profit for the financial year, and the preceding financial year, relate to continuing operations.

The accounting policies and notes on pages 111–180 form part of these accounts.

Income statement of the Society *for the year ended 31 December 2018*

	Notes	2018 £m	2017 £m
Interest receivable and similar income	4	211.4	195.6
Interest payable and similar charges	5	(106.3)	(88.3)
Net interest income		105.1	107.3
Fees and commission receivable	6	5.5	6.8
Fees and commission payable		(1.5)	(0.9)
Net fee and commission income		4.0	5.9
Other operating income		1.9	2.0
Other fair value (losses)/gains	7	(4.3)	1.4
Net operating income		**106.7**	**116.6**
Administrative expenses	8	(73.7)	(71.7)
Depreciation and amortisation	21 & 22	(5.8)	(13.0)
Operating expenses		(79.5)	(84.7)
Impairment provision (charge)/release on loans and advances	18	(1.9)	4.6
Provision for other liabilities and charges	19	–	1.0
Operating profit and profit before taxation		**25.3**	**37.5**
Taxation expense	12	(5.2)	(10.8)
Profit for the year		**20.1**	**26.7**

Statement of other comprehensive income of the Society

	Notes	2018 £m	2017 £m
Profit for the year		20.1	26.7
Items that will not be reclassified subsequently to profit and loss:			
Actuarial gain on retirement benefit obligations	11	1.1	–
Tax on retirement benefit obligations	12	(0.2)	–
Items that may be reclassified subsequently to profit and loss:			
Loss on fair value through other comprehensive income		(0.7)	–
Tax on fair value through other comprehensive income	12	0.1	–
Loss on available-for-sale assets		–	(1.9)
Tax on available-for-sale assets	12	–	0.4
Total comprehensive income for the year		**20.4**	**25.2**

All items dealt with in arriving at the profit before tax and the profit for the financial year, and the preceding financial year, relate to continuing operations.

The accounting policies and notes on pages 111–180 form part of these accounts.

Consolidated statement of financial position *as at 31 December 2018*

	Notes	2018 £m	2017 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		931.8	1,026.3
Loans and advances to credit institutions	13	147.8	168.8
Debt securities	14	32.9	124.9
		1,112.5	1,320.0
Derivative financial instruments	15	24.8	29.6
Loans and advances to customers:			
Loans fully secured on residential property		8,220.6	7,582.4
Other loans		278.1	281.7
	16	8,498.7	7,864.1
Intangible fixed assets	21	4.6	0.8
Property, plant and equipment	22	34.8	32.7
Non current assets classified as held-for-sale	23	-	4.2
Deferred tax assets	28	3.1	3.5
Other assets		3.0	1.6
Prepayments and accrued income		5.9	6.1
Total assets		**9,687.4**	**9,262.6**
Liabilities			
Shares	24	6,989.8	6,563.8
Deposits and debt securities:			
Amounts owed to credit institutions	25	867.1	573.5
Amounts owed to other customers		141.4	216.7
Debt securities in issue	26	1,010.9	1,245.7
		2,019.4	2,035.9
Derivative financial instruments	15	31.6	29.2
Current tax liabilities		2.8	7.0
Other liabilities	27	6.2	6.9
Provision for liabilities	19	5.1	6.1
Accruals and deferred income		13.7	17.5
Deferred tax liabilities	28	0.6	0.4
Retirement benefit obligations	11	3.9	8.9
Subscribed capital	29	63.6	66.5
Total liabilities		9,136.7	8,742.2
General reserve		550.1	519.3
Other reserves		0.6	1.1
Total equity and liabilities		**9,687.4**	**9,262.6**

The accounting policies and notes on pages 111-180 form part of these accounts. These accounts were approved by the Board on 5 February 2019. Signed on behalf of the Board:

C. P Adams

Laurence Philip Adams
Chairman

Stephen Hughes
Chief Executive Officer

Tom Denman
Chief Financial Officer

Statement of financial position of the Society *as at 31 December 2018*

	Notes	2018 £m	2017 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		931.8	1,026.3
Loans and advances to credit institutions	13	67.6	61.4
Debt securities	14	32.9	124.9
		1,032.3	1,212.6
Derivative financial instruments	15	21.2	27.8
Loans and advances to customers:			
Loans fully secured on residential property		7,984.4	7,270.6
Other loans		278.1	281.7
	16	8,262.5	7,552.3
Investments in subsidiary undertakings	20	135.3	218.8
Intangible fixed assets	21	4.6	0.8
Property, plant and equipment	22	34.2	32.0
Non current assets classified as held-for-sale	23	-	4.2
Deferred tax assets	28	2.8	3.3
Other assets		2.9	1.5
Prepayments and accrued income		5.8	6.3
Total assets		**9,501.6**	**9,059.6**
Liabilities			
Shares	24	6,989.8	6,563.8
Deposits and debt securities:			
Amounts owed to credit institutions	25	1,499.9	1,398.8
Amounts owed to other customers		141.4	216.7
Debt securities in issue	26	297.7	313.6
		1,939.0	1,929.1
Derivative financial instruments	15	31.3	28.2
Current tax liabilities		1.5	5.3
Other liabilities	27	5.7	5.5
Provision for liabilities	19	1.8	2.2
Accruals and deferred income		12.4	15.7
Deferred tax liabilities	28	0.6	0.4
Retirement benefit obligations	11	3.9	8.9
Subscribed capital	29	63.6	66.5
Total liabilities		9,049.6	8,625.6
General reserve		451.4	432.9
Other reserves		0.6	1.1
Total equity and liabilities		**9,501.6**	**9,059.6**

The accounting policies and notes on pages 111-180 form part of these accounts. These accounts were approved by the Board on 5 February 2019. Signed on behalf of the Board:

C. P. Adams

Laurence Philip Adams
Chairman

Stephen Hughes
Chief Executive Officer

Tom Denman
Chief Financial Officer

FINANCIAL STATEMENTS

Statement of changes in Members' interests *for the year ended 31 December 2018*

	2018			2017		
	General Reserve £m	Fair Value through OCI Reserve £m	Total equity attributable to Members £m	General Reserve £m	Available-for-sale Reserve £m	Total equity attributable to Members £m
Group						
At 1 January	519.3	1.1	520.4	476.0	2.4	478.4
Changes on initial application of IFRS 9	(4.0)	0.1	(3.9)	-	-	-
Tax effect of IFRS 9 implementation	0.7	-	0.7	-	-	-
Changes on initial application of IFRS 15	0.3	-	0.3	-	-	-
Restated balance at 1 January 2018	516.3	1.2	517.5	-	-	-
Comprehensive income for the year	33.8	(0.6)	33.2	43.3	(1.3)	42.0
At 31 December	**550.1**	**0.6**	**550.7**	**519.3**	**1.1**	**520.4**
Society						
At 1 January	432.9	1.1	434.0	406.4	2.4	408.8
Changes on initial application of IFRS 9	(3.4)	0.1	(3.3)	-	-	-
Tax effect of IFRS 9 implementation	0.6	-	0.6	-	-	-
Changes on initial application of IFRS 15	0.3	-	0.3	-	-	-
Restated balance at 1 January 2018	430.4	1.2	431.6	-	-	-
Comprehensive income for the year	21.0	(0.6)	20.4	26.5	(1.3)	25.2
At 31 December	**451.4**	**0.6**	**452.0**	**432.9**	**1.1**	**434.0**

Consolidated statement of cash flows *for the year ended 31 December 2018*

	2018 £m	2017 £m
Net cash (outflow)/inflow from operating activities (see below)	(198.7)	210.8
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(11.8)	(5.0)
Purchase of investment securities	(6.3)	(16.0)
Proceeds from sale and maturity of investment securities	97.1	278.1
Proceeds from sale of non current assets	4.2	–
(Decrease)/increase in cash and cash equivalents	(115.5)	467.9
Cash and cash equivalents at the beginning of year	1,195.1	727.2
Cash and cash equivalents at the end of year	**1,079.6**	**1,195.1**
Represented by:		
Cash and balances with the Bank of England	931.8	1,026.3
Loans and advances to credit institutions repayable on demand	147.8	168.8
	1,079.6	**1,195.1**
Net cash (outflow)/inflow from operating activities		
Profit before taxation	40.7	57.6
Adjusted for:		
Depreciation and amortisation	5.8	13.2
Charge on defined benefit scheme	0.8	0.3
Impairment charge/(release) on loans and advances to customers	0.6	(10.0)
Change in fair values	(2.2)	13.6
Equity adjustment for accounting policy changes	(3.7)	–
Other non cash movements	0.8	1.4
Changes in net operating assets		
Increase in loans and advances to customers	(640.4)	(806.8)
(Increase)/decrease in other assets	(1.4)	0.1
Decrease in prepayments and accrued income	0.2	2.1
Change in derivative financial instruments	7.2	(15.7)
Increase in shares	427.8	409.5
Increase/(decrease) in deposits	218.4	(47.5)
Proceeds from debt securities in issue	0.3	804.5
Redemption of debt securities in issue	(233.0)	(191.4)
(Decrease)/increase in other liabilities	(0.7)	0.1
Decrease in provisions for liabilities	(1.0)	(0.9)
Decrease in accruals and deferred income	(3.7)	(1.3)
Contributions paid into defined benefit scheme	(4.6)	(6.7)
Movement in subscribed capital	0.1	0.1
Taxation paid	(10.7)	(11.4)
	(198.7)	**210.8**

The group is required to maintain interest-free balances with the Bank of England which at 31 December 2018 amounted to £21.4m (2017: £12.9m).

Statement of cash flows of the Society *for the year ended 31 December 2018*

	2018 £m	2017 £m
Net cash (outflow)/inflow from operating activities (see below)	(171.6)	182.8
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(11.8)	(5.0)
Purchase of investment securities	(6.2)	(16.0)
Proceeds from sale and maturity of investment securities	97.1	278.1
Proceeds from sale of non current assets	4.2	–
(Decrease)/increase in cash and cash equivalents	(88.3)	439.9
Cash and cash equivalents at the beginning of year	1,087.7	647.8
Cash and cash equivalents at the end of year	**999.4**	**1,087.7**
Represented by:		
Cash and balances with the Bank of England	931.8	1,026.3
Loans and advances to credit institutions repayable on demand	67.6	61.4
	999.4	**1,087.7**
Net cash (outflow)/inflow from operating activities		
Profit before taxation	25.3	37.5
Adjusted for:		
Depreciation and amortisation	5.8	13.0
Charge on defined benefit scheme	0.8	0.3
Impairment charge/(release) on loans and advances to customers	1.9	(4.6)
Change in fair values	(2.2)	13.6
Equity adjustment for accounting policy changes	(3.1)	–
Other non cash movements	0.2	1.4
Changes in net operating assets		
Increase in loans and advances to customers	(717.3)	(904.3)
Decrease in loans to subsidiary companies	83.5	109.5
Increase in other assets	(1.4)	(0.1)
Decrease in prepayments and accrued income	0.5	1.7
Change in derivative financial instruments	9.7	(12.7)
Increase in shares	427.8	409.5
Increase in deposits	25.8	240.2
Proceeds from debt securities in issue	0.3	329.6
Redemption of debt securities in issue	(13.5)	(33.1)
Increase in other liabilities	0.2	0.3
Decrease in provisions for liabilities	(0.4)	(2.1)
Decrease increase in accruals and deferred income	(3.3)	(1.4)
Contributions paid into defined benefit scheme	(4.6)	(6.7)
Movement in subscribed capital	0.1	0.1
Taxation paid	(7.7)	(8.9)
	(171.6)	**182.8**

1. Accounting policies

Basis of preparation

These financial statements for the year ended 31 December 2018 have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the IFRS Interpretations Committee as adopted by the European Union (EU), and those parts of the Building Societies (Accounts and Related Provisions) Regulations 1998 applicable to Societies reporting under IFRS.

The financial statements have been prepared under the historical cost convention, except for certain financial assets and liabilities held at fair value and all derivative contracts, and on a going concern basis, as discussed in the Directors' Report on page 89, under the heading 'Long Term Viability Statement and Going Concern'.

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements unless noted otherwise.

New and amended standards adopted by the group

The group has adopted IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers, with effect from 1 January 2018, the impact from which is set out below. In addition, to reflect the differences between IFRS 9 and IAS 39, IFRS 7 Financial Instruments: Disclosures was updated and has been adopted from 1 January 2018.

IFRIC 22 Foreign Currency Transactions and Advance Consideration was also adopted from 1 January 2018, with no significant impact on the financial statements. Amendments to existing standards and other new interpretations did not have any impact on the group's accounting policies and did not require retrospective adjustments.

Adoption of IFRS 9 Financial Instruments

The adoption of IFRS 9 from 1 January 2018 has resulted in changes to accounting policies and adjustments to the amounts recognised in the financial statements. As permitted by the transitional provisions of IFRS 9, comparative figures have not been restated and comparative period notes disclosures repeat those made in the prior year. The group has also elected to continue to apply the hedge accounting requirements of IAS 39 on adoption of IFRS 9.

Classification and measurement

On transition to IFRS 9, management has assessed both the business models for managing financial assets and the cashflow characteristics of the assets. This has resulted in the following classifications and measurement for the company's financial assets:

1. Accounting policies

Financial Instrument	IAS 39 measurement basis	IFRS 9 measurement basis	IAS 39 carrying amount 31 December 2017 £m	IFRS 9 carrying amount 1 January 2018 £m
Loans and advances to customers				
Retail Financial Services	Amortised cost	Amortised cost	6,775.5	6,774.2
Secured Personal Lending	Amortised cost	Amortised cost	311.8	311.3
Commercial Lending	Amortised cost	Amortised cost	763.9	762.5
Total loans and advances to customers			7,851.2	7,848.0
Cash in hand and balances with Bank of England	Amortised cost	Amortised cost	1,026.3	1,025.8
Loans and advances to credit institutions	Amortised cost	Amortised cost	168.8	168.6
Debt securities	Available-for-sale	FVOCI	124.9	124.9
Derivative financial instruments	FVTPL	FVTPL	27.8	27.8

All changes to the carrying amount of financial assets are due to changes in impairment provisioning. Classification changes have had no impact on the carrying amount.

The principal change in classification is in respect of the group's debt securities. Listed and unlisted gilts and bonds were reclassified from available-for-sale to FVOCI, as the group's business model is achieved both by collecting contractual cash flows and sale of these assets. The contractual cash flows of these investments are solely principal and interest. As a result, listed and unlisted gilts and bonds with a fair value of £124.9m were reclassified from available-for-sale financial assets to financial assets at FVOCI.

There were no changes to the classification or measurement of financial liabilities.

The following table reconciles the prior period's closing impairment allowance measured in accordance with the IAS 39 incurred loss model to the new impairment allowance measured in accordance with the IFRS 9 expected credit loss model at 1 January 2018:

Financial Instrument	Loan loss allowance under IAS 39 £m	Re-measurement £m	Loan loss allowance under IFRS 9 £m
Loans and receivables (IAS 39)/Financial assets at amortised cost (IFRS 9)			
Cash in hand and balances with the Bank of England	-	0.5	0.5
Loans and advances to credit institutions	-	0.2	0.2
Loans and advances to customers	30.3	3.2	33.5
Debt securities	-	0.1	0.1
Total	30.3	4.0	34.3

Loans and advances to customers
IFRS 9 outlines a three stage model for impairment based on changes in credit quality since initial recognition. Each stage represents a change in the credit risk of a financial instrument since origination. Credit risk is measured using probability of default (PD), exposure at default (EAD) and loss given default (LGD). If a significant increase in credit risk (SICR) since initial recognition is identified but the asset is not yet deemed to be credit impaired, the financial instrument is moved from stage 1 to stage 2. Financial instruments that are deemed to be credit impaired are moved to stage 3.

Financial instruments in stage 1 have their expected credit loss (ECL) measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible within the next 12 months. Financial instruments in stages 2 or 3 have their ECL measured based on expected credit losses on a lifetime basis.

Significant increase in credit risk

Retail Financial Services and Secured Personal Lending
There are three main components to the staging criteria for the retail financial services and secured personal lending portfolios. In order to move from stage 1 to stage 2, a loan is required to meet at least one of the following criteria:

1. Forbearance activity;
2. PD grade deterioration over a predetermined threshold relative to the starting point; or
3. 30 days past due.

Loans are moved from stage 2 to stage 3 when they are credit impaired. Loans are considered to be credit impaired if they are 90 days past due or the borrower has been declared bankrupt.

Subject to the characteristics of the borrower, a loan will move back from stage 2 or stage 3 following a reversal of the criteria described above.

1. Accounting policies (continued)

The split of loans between stages 1, 2 and 3 is as follows:

Stage	On transition on 1 January 2018 %	31 December 2018 %
1	92	92
2	7	7
3	1	1

The split of the loans within stage 2 by staging reason is as follows:

Staging reason	On transition on 1 January 2018 %	31 December 2018 %
PD grade deterioration	85	85
30-60 days past due	14	14
Forbearance	1	1

Commercial Lending

There are two main components to the Commercial Lending staging criteria. In order to move from stage 1 to stage 2 a loan is required to meet at least one of the following criteria:

1. Risk grade deterioration - all loans are assigned a risk grade between 1-10 based on a range of qualitative and quantitative factors. A risk grade deterioration of between 1 and 2 risk grades relative to the starting point will trigger a stage movement; or

2. 30 days past due.

Loans subject to forbearance are included with the Commercial Lending model although forbearance does not automatically trigger a stage movement.

Loans are moved from stage 2 to stage 3 when they are credit impaired. Loans are considered to be credit impaired if they are 90 days past due or the borrowers risk grade has increased beyond a predetermined threshold.

Subject to the characteristics of the borrower, a loan will move back from stage 2 or stage 3 following a reversal of the criteria described above.

The split of loans between stages 1, 2 and 3 is as follows:

Stage	On transition on 1 January 2018 %	31 December 2018 %
1	92	90
2	6	9
3	2	1

The split of the loans within stage 2 by staging reason is as follows:

Staging reason	On transition on 1 January 2018 %	31 December 2018 %
Risk grade deterioration	92	100
30-60 days past due	8	-

Expected Credit Loss Models

Expected credit losses are the discounted product of the Probability of Default (PD), Exposure at Default (EAD), and Loss Given Default (LGD), defined as follows:

- PD is the likelihood of a borrower defaulting on its financial obligation either in the next 12 months or over the remaining lifetime of the obligation.
- EAD is based on the amounts the group expects to be owed at the time of default.
- LGD represents the group's expectation of the extent of loss on defaulted exposures.

The calculation of PD is specific to each loan portfolio as set out below:

Portfolio	Approach to PD calculation
Retail financial services and Secured personal lending	Calculated via a behavioural scorecard approach, using internal account level specific data including arrears history and external credit profile data provided by credit reference agencies.
Commercial Lending	Based on defined internal risk grading methodologies, using a combination of qualitative and quantitative measures including forward looking factors.

1. Accounting policies (continued)

Significant judgements included within the debt securities expected credit loss model include the credit default swap (CDS) price and the haircut applied within the LGD model. Significant judgements will be reviewed on an ongoing basis as part of the IFRS 9 model governance process.

Asset class	Significant increase in credit risk	Expected credit loss model
Cash in hand and balances with the Bank of England	A significant increase in credit risk is deemed to have occurred if the credit rating of UK Treasury drops below investment grade. All balances with the Bank of England are in stage 1.	Balances with the Bank of England PD's are based on the CDS price of UK Treasury.
Loans and advances to credit institutions	A significant increase in credit risk is deemed to have occurred if the credit rating of the credit institution drops below investment grade. All loans and advances to credit institutions are in stage 1.	Loans and advances to credit institutions PDs are based on the (CDS) price of the credit institution.
Debt securities	A significant increase in credit risk is deemed to have occurred if the credit rating of the debt issuer drops below investment grade. All debt securities are in stage 1.	Debt securities PDs are based on historical default rate of comparable rate securities.

Forward-looking information in the ECL models

The assessment of SICR and the calculation of ECL both incorporate forward looking information. The Company has performed historical analysis and identified the economic variables impacting credit risk and expected credit losses for each portfolio.

Forecasts of these economic variables together with probability weightings are supplied by an external provider. Economic scenarios have been selected which take account of a range of possible economic outcomes.

The scenarios, together with the weightings and average values of the key variables over the three years to 2021, are set out in the table below:

Scenario	Weighting on 1 January 2018 and 31 December 2018 %	GDP growth %	Unemployment growth %	House price growth %
Base	44.7	1.5	0.8	1.3
Stronger near term growth	10.7	2.7	(0.6)	5.2
Mild recession	26.8	0.9	1.5	(0.6)
Protracted slump	7.1	(0.9)	4.3	(6.8)
Stagflation	10.7	(0.1)	3.1	(2.9)

The impact of each of the economic variables varies according to the portfolio. For example, retail mortgages and secured personal lending are most sensitive to house prices, whilst commercial lending is more sensitive to GDP.

In addition to applying the scenarios and weightings set out above, further allowance has been made for the impact of the UK not achieving an orderly exit from the EU by the deadline of 29 March 2019. This allowance, which totalled £3.6m at 31 December 2018, has been determined by increasing the probability that factors impacting the determination of ECLs will be more to the downside than the existing weightings assume. These include a 3.0% average fall in house prices, 2.8% increase in unemployment and GDP remaining largely flat between 2019 and 2021.

Adoption of IFRS 15 Revenue from Contracts with Customers

The adoption of IFRS 15 from 1 January 2018 has resulted in the earlier recognition of insurance trail commission arising from the performance of previous sales of insurance products on behalf of third parties. In 2017 and earlier periods, this income was recognised when the payment was received; however, it is now recognised when it is highly probable that the income will be received. This change in policy resulted in a £0.3m increase in the general reserve as at 1 January 2018. As permitted by the transitional provisions of IFRS 15, the group has elected not to restate comparatives.

Impact of standards issued but not yet applied

At the date of authorisation of these financial statements, a number of new standards and interpretations, which have not been applied in these financial statements, were in issue but not yet effective. Of these, only IFRS 16 Leases, is expected to have a significant impact.

IFRS 16 Leases

IFRS 16 specifies how an entity will recognise, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases. This will bring those leases previously classified as 'operating leases' on balance sheet. IFRS 16's approach to lessor accounting is substantially unchanged from its predecessor, IAS 17.

The estimated impact of adopting IFRS 16 is to increase both assets and liabilities by c. £5.5m at 1 January 2019. The majority of the adjustment to assets and liabilities relates to the group's branch property portfolio.

The group expects to apply the modified transition approach and the value of the right-of-use assets will be set equal to the value of the lease liabilities on the date of adoption, with no change to prior financial periods. The discount rate applied will be based on the group's incremental borrowing rate, as allowed by the standard.

1. Accounting policies (continued)

Basis of consolidation

The group financial statements consist of the financial statements of the ultimate parent (Principality Building Society) and all entities controlled by the Society (its subsidiaries and special purpose entities).

A subsidiary is an entity, the operating and financing policies of which, are controlled directly or indirectly by the Society. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commenced. Intra-group balances and transactions are eliminated in preparing the consolidated financial statements.

Investments in subsidiaries

Investments in subsidiaries are recorded in the Society's statement of financial position at cost, less impairment for cost of shares, and amortised cost for loans to subsidiaries.

Securitisation transactions

The group has securitised certain mortgage loans by the transfer of the loans to special purpose entities (SPEs) controlled by the group. The securitisation enables a subsequent issuance of debt by the SPEs to investors who gain the security of the underlying assets as collateral. The SPEs are fully consolidated into the group's accounts under IFRS 10 - Consolidated Financial Statements.

The transfer of the mortgage loans to the SPEs is not treated as a sale by the Society. The Society continues to recognise the mortgage loans on its own statement of financial position after the transfer because it retains their risks and rewards through the receipt of substantially all of the profits or losses of the SPEs. In the accounts of the Society, the proceeds received from the transfer are accounted for as a deemed loan repayable to the SPEs. To manage interest rate risk, both the Society and the SPEs enter into derivative transactions in the form of interest rate swaps. Interest rate swaps with external counterparties in relation to securitisation transactions are recognised in accordance with IAS 39.

Interest receivable and payable

Interest receivable and payable for loans and advances to customers and customer accounts are recognised in the income statement using the effective interest method.

The effective interest method calculates the amortised cost of a financial asset or a financial liability, and allocates the interest income or interest expense over the expected product life. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the product or, when appropriate, a shorter period, to the net book value of the financial asset or financial liability. Where calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the product (for example prepayment options) but does not consider future credit losses. The calculation includes all amounts received or paid by the group that are an integral part of the overall return and the direct incremental transaction costs related to the acquisition or issue of a product.

Interest income on debt securities, derivatives and other financial assets accounted for at either fair value through the statement of other comprehensive income or fair value through profit or loss is included in interest receivable and similar income.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Fees and commission and other income

Loan origination fees are reflected in the calculation of the effective interest rate on a loan.

Fees received for loan servicing and other business processes is reflected in the income statement in the period in which the activity is carried out.

The group receives trail commission based on the performance of previous sales of insurance products. In 2017 and earlier periods, this income was recognised when the payment was received; however, from 1 January 2018, under IFRS 15, it is now recognised when it is highly probable that the income will be received.

Other fees and commissions and other income are recognised on an accruals basis when the service has been provided.

Measurement of financial assets and liabilities

From 1 January 2018 – IFRS 9 Financial Instruments

Classification and measurement

Financial assets

At initial recognition, the group measures a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss (FVTPL), transaction costs that are directly attributable to the acquisition of the financial asset. Transaction costs of financial assets carried at FVTPL are expensed in profit or loss. Thereafter, financial assets are classified and measured in one of the three following measurement categories:

- those to be measured at amortised cost;
- those to be measured subsequently at fair value through other comprehensive income (FVOCI); or
- those to be measured subsequently at fair value through profit or loss.

The classification and subsequent measurement of financial assets depends on the business model for managing the financial assets and the contractual terms of the cash flows.

Debt instruments

Debt instruments comprise the group's cash in hand and balances with the Bank of England, loans and advances to credit institutions, debt securities and loans and advances to customers.

Subsequent measurement of debt instruments depends on the group's business model for managing the asset and the cash flow characteristics of the asset. There are three measurement categories into which the group classifies its debt instruments:

- Amortised cost: Assets that are held for collection of contractual cash flows where those cash flows represent solely payments of principal and interest are measured at amortised cost using the effective interest method, net of provision for impairment. Interest earned from these financial assets is included in interest receivable and similar income. Impairment losses are presented as a separate line item in the income statement.

1. Accounting policies (continued)

- FVOCI: Assets that are held for collection of contractual cash flows and for selling the financial assets, where the assets' cash flows represent solely payments of principal and interest, are measured at FVOCI. Movements in fair value are taken through OCI and, on derecognition, the cumulative gain or loss previously recognised in OCI is reclassified to the income statement. Interest is recognised using the effective interest method and included in interest receivable and similar income.

- FVTPL: Assets that do not meet the criteria for amortised cost or FVOCI are measured at FVTPL.

Financial liabilities

Financial liabilities comprise shares, amounts owed to credit institutions and other customers, debt securities in issue and Permanent Interest Bearing Shares (subscribed capital). There has been no change to either the classification or measurement of financial liabilities between IAS 39 and IFRS 9.

From 1 January 2017 to 31 December 2017 – IAS 39 Financial Instruments: Recognition and Measurement

Financial assets

Financial assets are classified as:

i) Loans and receivables
Loans and receivables are non-derivative assets with fixed or determinable payments that are not quoted in an active market. The group's residential and commercial mortgage loans are classified as loans and receivables and are measured at amortised cost using the effective interest method, net of impairment provisions, with all movements being recognised in the income statement.

ii) Available-for-sale financial assets
Available-for-sale financial assets are non-derivative financial assets, principally but not exclusively investment securities intended to be held for an indefinite period of time and which may be sold in response to needs for liquidity. They are measured at fair value with changes in fair value being recognised in reserves except for impairment losses which are recognised in the income statement. The fair value of available-for-sale assets is derived from market data. Where this market data is not available, an independent third party provides a valuation. If the asset is sold before maturity, cumulative gains and losses recognised in reserves are recycled to the income statement.

iii) Held to maturity financial assets
Held to maturity financial assets are non-derivative financial assets that the group has the ability and intention to hold to maturity. They are measured at amortised cost using the effective interest method with all movements being recognised in the income statement.

iv) Financial assets at fair value accounted through the income statement
This category consists of derivative financial assets which are held at fair value. These financial assets are initially measured at fair value with transaction costs taken directly to the income statement. Subsequent measurement is at fair value with changes in value reflected in the income statement.

Financial liabilities

Financial liabilities are measured at:

i) Amortised cost

The group's borrowings, including Member shares, deposits, debt securities in issue and subordinated liabilities, are recognised initially at fair value, being the issue proceeds net of premiums, discounts and transaction costs incurred.

Borrowings are subsequently measured at amortised cost using the effective interest method. Amortised cost is adjusted for the amortisation of any transaction costs, premiums and discounts. The amortisation is recognised in interest expense and similar charges using the effective interest method.

Permanent Interest Bearing Shares (subscribed capital) which are redeemable at specific dates at the option of the Society are classified as liabilities.

ii) Fair value through profit and loss (FVTPL)

Financial liabilities are classified as at FVTPL when the financial liability is designated as at FVTPL.

A financial liability may be designated as at FVTPL upon initial recognition if:

a) such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise;
b) the financial liability forms part of a group of financial assets or financial liabilities or both, which is managed and its performance is evaluated on a fair value basis, in accordance with the group's documented risk management or investment strategy, and information about the grouping is provided internally on that basis; or
c) it forms part of a contract containing one or more embedded derivatives, and IAS 39 Financial Instruments: Recognition and Measurement, permits the entire combined contract (asset or liability) to be designated as at FVTPL.

Financial liabilities at FVTPL are stated at fair value, with any gains or losses arising on remeasurement recognised in profit or loss. The net gain or loss recognised in profit or loss is included in the 'other gains and losses' line item in the income statement. Fair value is determined in the manner described in note 31.

Impairment losses on loans and advances to customers and credit institutions

From 1 January 2018 – IFRS 9 Financial Instruments

From 1 January 2018, the group assesses on a forward-looking basis the expected credit losses associated with its debt instruments carried at amortised cost and FVOCI. This assessment is performed on a monthly basis. The impairment methodology applied depends on whether there has been a significant increase in credit risk. Further information on the calculation of expected credit losses can be found in the 'Adoption of IFRS 9 Financial Instruments' section earlier.

1. Accounting policies (continued)

From 1 January 2017 to 31 December 2017 – IAS 39 Financial Instruments: Recognition and Measurement

The group assesses at the date of each statement of financial position whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets is impaired. Evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments, the debt being restructured to reduce the burden on the borrower, the disappearance or depression of active markets for certain lending asset categories and other overall economic conditions.

The group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant, or collectively for assets that are not separately significant. If there is no objective evidence of impairment for an individually assessed asset it is included in a group of assets with similar credit risk characteristics. For example, accounts subject to forbearance are collectively assessed for impairment.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions are deducted from the appropriate asset values in the statement of financial position.

In the case of commercial loans that are considered individually significant, cash flows are estimated on a case-by-case basis considering the following factors:

i) total aggregate exposure to the customer including cross-collateralisation;
ii) the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
iii) the amount and timing of expected receipts and recoveries;
iv) the likely funds available on liquidation or bankruptcy including any guarantees;
v) the extent of other creditors' commitments ranking ahead of the Society, and the likelihood of other creditors continuing to support the company;
vi) the realisable value of security at the expected date of sale and likelihood of successful repossession; and
vii) the deduction of any likely costs involved in recovery of amounts outstanding.

The methodology and assumptions used for estimating future cash flows are reviewed regularly by the group to reduce any difference between loss estimates and actual loss experience.

If, in a subsequent period, the amount for the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the provision is adjusted and the amount of the reversal is recognised in the income statement.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the income statement. Loans subject to individual impairment assessment are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

For listed and unlisted investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered to be objective evidence of impairment. Loans and advances to credit institutions are reviewed on a weekly basis by the Treasury Committee for current and expected credit risk with a view to highlighting the likelihood of any future performance difficulties and losses based on emerging published data and intelligence.

Loans and advances to credit institutions

Where swaps are not centrally cleared, the International Swaps and Derivatives Association (ISDA) Master Agreement is Principality's preferred agreement for documenting derivative activity. For certain counterparties, a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions.

Derivative financial instruments and hedge accounting

The group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, forward rate agreements, and similar instruments. The group's derivative activities are entered into for the purpose of matching or eliminating risk from potential movements in interest rates, foreign exchange rates and market indices inherent in the group's assets, liabilities and positions. All derivative transactions are for economic hedging purposes. Financial instruments are initially recognised at fair value.

i) Derivative financial instruments

Derivatives are initially measured at fair value and are subsequently re-measured to fair value at each reporting date with movements recorded in the income statement. Fair values are calculated by discounted cash flow models using yield curves that are based on observable market data or are based on valuations from counterparties. Fair values are calculated using mid-prices. All derivatives are classified as assets where their fair value is positive and liabilities where their fair value is negative. Where there is the legal ability and intention to settle net, the derivative is classified as a net asset or liability, as appropriate.

Where cash collateral is received, to mitigate the risk inherent in amounts due to the group, it is included as a liability within 'amounts owed to credit institutions'. Where collateral is given, to mitigate the risk inherent in amounts due from the group, it is included as an asset in 'loans and advances to credit institutions'.

ii) Embedded derivatives

Certain derivatives are embedded within other non-derivative host instruments to create a hybrid instrument. Where the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risk of the host instrument, the group separates the embedded derivative from the host instrument and measures it at fair value with the changes in fair value recognised in the income statement.

iii) Hedge accounting

When transactions meet the criteria specified in IAS 39, the group applies fair value hedge accounting so that changes in the fair value of the underlying asset or liability that are attributable to the hedged risk are recorded in the income statement to offset the fair value movement of the related derivative.

1. Accounting policies (continued)

To qualify for hedge accounting at inception the hedge relationship must be clearly documented. At inception, the derivative must be expected to be highly effective in offsetting the hedged risk and effectiveness must be tested throughout the life of the hedge relationship. A hedge is considered to be highly effective if the changes in fair value or cash flows attributable to the hedged risk are expected to be offset by the hedging instrument in a range of 80% to 125%.

To calculate the changes in fair value of the hedged item attributable to the hedged risk, the group uses the hypothetical derivative method. The hypothetical derivative method involves establishing a notional derivative that would be the ideal hedging instrument for the hedged exposure (normally an interest rate swap or forward contract with no unusual terms and a zero fair value at inception of the hedge relationship). The fair value of the hypothetical derivative is then used as a proxy for the net present value of the hedged future cash flows against which changes in value of the actual hedging instrument are compared to assess effectiveness and measure ineffectiveness.

Within its risk management and hedging strategies, the group differentiates between macro and micro fair value hedging strategies, as set out below. In accordance with its hedging strategy, the group matches the principal of the hedging instruments to the principal of the hedged items, including prepayment expectations. The group uses pay fixed/receive floating interest rate swaps to hedge its fixed rate debt instruments and pay floating/receive fixed interest rate swaps to hedge its fixed rate liabilities.

Portfolio (macro) fair value hedges

The group applies macro fair value hedging to its fixed rate savings and mortgages. The group determines hedged items by identifying portfolios with homogenous characteristics based on their contractual interest rates, maturity and other risk characteristics. Loans or deposits within the identified portfolios are allocated to repricing time buckets based on expected, rather than contractual, repricing dates. The interest rate swaps are designated appropriately to those repricing time buckets. Hedge effectiveness is measured on a monthly basis, by comparing fair value movements of the designated proportion of the bucketed loans due to the hedged risk, against the fair value movements of the derivatives, to ensure that they are within an 80% to 125% range.

The aggregated fair value changes in the hedged loans are recognised as part of the fair value adjustment for hedged risk as detailed in note 15. At the end of every month, in order to minimise the ineffectiveness from early repayments and accommodate new exposures and regardless of the results of the retrospective hedge effectiveness testing, the group voluntarily de-designates the hedge relationships and re-designates them as new hedges. From the date of de-designation, the fair value hedge accounting adjustments are amortised on a straight-line basis over the original hedged life.

Micro fair value hedges

The group applies micro fair value hedging when the hedged item (or group of items) is a distinctively identifiable asset or liability hedged by one or a few hedging instruments. The financial instruments hedged for interest rate risk in a micro fair value hedge relationship are interest only fixed rate commercial lending mortgages. These hedge relationships are assessed for prospective and retrospective hedge effectiveness on a monthly basis. If the hedging instrument expires or is sold, terminated or exercised, or when the hedge no longer meets the criteria for hedge accounting, or the group decides to voluntarily discontinue the hedging relationship, the hedge relationship is discontinued prospectively. If the relationship does not meet the hedge effectiveness criteria, the group discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. If the hedge accounting relationship is terminated for an item recorded at amortised cost, the accumulated fair value hedge adjustment to the carrying amount of the hedged item is amortised over the remaining term of the original hedge. If the hedged item is derecognised, the unamortised fair value adjustment is recognised immediately in the income statement.

In a portfolio hedge, the adjustment is included in fair value adjustments for hedged risk. In the case of a micro hedge, the carrying value of the hedged item is adjusted for the change in value of the hedged risk.

The group discontinues hedge accounting when:

i) it is evident from testing that a derivative is not, or has ceased to be, highly effective as a hedge;
ii) the derivative expires, or is sold, terminated or exercised; or
iii) the underlying item matures or is sold or repaid.

The group may also decide to cease hedge accounting even though the hedge relationship continues to be highly effective by ceasing to designate the financial instrument as a hedge. If the derivative no longer meets the criteria for hedge accounting, the cumulative fair value hedging adjustment is amortised over the period to maturity of the previously designated hedge relationship. If the underlying item is sold or repaid, the unamortised fair value adjustment is immediately reflected in the income statement.

Intangible assets

Computer software

IAS 38 'Intangible Assets' requires the capitalisation of certain expenditure relating to software development costs. Software development costs are capitalised if it is probable that the asset created will generate future economic benefits. Costs incurred to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

Web costs are capitalised where the expenditure is incurred on developing an income-generating website.

Where software costs are capitalised, they are amortised using the straight-line method over their estimated useful lives which is three to five years. The amortisation periods used are reviewed annually.

Costs associated with maintaining software are expensed as they are incurred.

Taxation

The tax expense represents the sum of the current tax charge and deferred tax movement.

The current tax charge is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

1. Accounting policies (continued)

Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences. Deferred tax assets are defined as the amounts of income taxes recoverable in future periods. Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit. Deferred tax liabilities are generally recognised for all taxable temporary differences. In contrast, deferred tax assets are only recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilised.

Both current and deferred tax balances are calculated using tax rates that have been enacted or substantively enacted by the date of the statement of financial position and are expected to apply to the period when the liability is settled or the asset is realised.

Property, plant and equipment

Freehold and long leasehold properties comprise mainly branches and office buildings. Property, plant and equipment are stated at cost less accumulated depreciation and provision for impairment, as appropriate. Additions and subsequent expenditure are included in the asset's carrying value or are recognised as a separate asset only when they improve the expected future economic benefits to be derived from the asset. Valuations are completed annually by independent surveyors.

Properties in the course of construction for production, supply or administrative purposes, or for purposes not yet determined, are carried at cost, less any recognised impairment loss. Cost includes professional fees and, for qualifying assets, borrowing costs capitalised in accordance with the group's accounting policy. Depreciation of these assets, on the same basis as other property assets, commences when the assets are ready for their intended use.

Land is not depreciated. Depreciation on other assets is provided using the straight-line method to allocate costs less residual values over estimated useful lives, as follows:

Freehold property	2%
Leasehold property	2% or unexpired period of the lease
Major alterations to buildings	10%
Plant, equipment, fixtures and fittings	10%-15%
Computer equipment	20%-33%
Motor vehicles	25%

Residual values and useful lives of assets are reviewed, and adjusted if appropriate, at the date of each statement of financial position. Where the cost of freehold land can be identified separately from buildings, the land value is not depreciated. Fixed assets are subject to impairment testing and any impairment is recognised immediately in the income statement.

Gains and losses on disposal are determined by comparing the net disposal proceeds with the carrying amount of the asset and are included in the income statement.

Pension costs

The Society operates two pension schemes, a defined contribution scheme and a defined benefit scheme.

A defined contribution scheme is one into which the group and the employee pay fixed contributions, without any obligation to pay further contributions. Payments into the defined contribution scheme are charged to the income statement as they become payable in accordance with the rules of the scheme. The majority of the group's employees are members of this scheme.

A defined benefit scheme is one that defines the benefit an employee will receive on retirement, depending on such factors as age and length of service. Defined benefit pension scheme assets are measured using closing market values. Scheme liabilities are measured using the projected unit method and discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability. This scheme closed to future accruals on 31 July 2010.

The expected return on the scheme's assets and the increase during the period in the present value of the scheme's liabilities, arising from the passage of time, are included in other operating income.

Actuarial gains and losses are recognised in full in the statement of other comprehensive income.

Qualifying insurance policies are reflected in plan assets at their fair value, which is defined as the present value of the related defined benefit obligations. The difference between the fair value of plan assets and the cost of the policy is treated as an actuarial loss which is recognised in full in the statement of other comprehensive income.

Leases

All leases entered into by the group are operating leases. Operating leases are leases that do not transfer substantially all the risks and rewards incidental to the ownership of the lease.

i) As lessee

Operating lease payments are charged to the income statement on a straight-line basis over the life of the lease.

ii) As lessor

Lease income receivable under operating leases is credited to the income statement on a straight-line basis over the life of the lease.

Debt securities in issue, subordinated liabilities and permanent interest-bearing shares

Premiums and discounts, together with costs associated with the issue of debt securities, subordinated liabilities and permanent interest-bearing shares, are accounted for as an adjustment to the amount of the liability and amortised using the effective interest method.

Segmental reporting

A business segment is defined as a group of assets and operations providing products and services that are subject to different risks and returns from the other business segments. The group considers that business segments are its primary reporting format for segmental analysis. Business segments are reported in a manner consistent with the internal reporting provided to the Board which has been identified as the chief operating decision maker.

Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, including: cash and non-restricted balances with central banks, treasury bills and other eligible bills, loans and advances to banks, other amounts due from banks and short-term Government securities.

1. Accounting policies (continued)

Provisions and contingent liabilities

A provision is recognised when there is a present obligation as a result of a past event, it is probable that the obligation will be settled and it can be reliably estimated. Where it is not probable that the obligation will be settled and/or it cannot be reliably estimated, a contingent liability is disclosed in the notes to the accounts.

Advertising and promotional costs

Advertising and promotional costs are expensed as incurred. Where payment has been made in advance of the rendering of the service or the delivery of goods, a prepayment is recognised. The costs are then recognised in the income statement on a straight line basis over the term of the contract.

Sale and repurchase agreements

Investment and other securities may be lent or sold subject to a commitment to repurchase them (a 'repo'). Such securities are retained on the statement of financial position when substantially all the risks and rewards of ownership remain within the group, and the counterparty liability is included separately on the statement of financial position as appropriate.

Similarly, where the group borrows or purchases securities subject to a commitment to resell them (a 'reverse repo') but does not acquire the risks and rewards of ownership, the transactions are treated as collateralised loans, and the securities are not included in the statement of financial position.

Non-current assets held-for-sale

Non-current assets and disposal groups are classified as held-for-sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. For a non-current asset or disposal group to be classified as held-for-sale, it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets and its sale is highly probable.

Non-current assets and disposal groups classified as held-for-sale are measured at the lower of their carrying amount and fair value less costs to sell.

2. Judgements in applying accounting policies and critical accounting estimates

There are no significant judgements made in applying the group's accounting policies. However, there are significant estimation uncertainties which affect the amounts recognised in the financial statements. Critical accounting estimates and assumptions are made that could affect the reported amounts of assets and liabilities within the following financial year.

The most significant areas where accounting estimates are made are as follows:

Impairment provision on loans and advances

The critical accounting judgements and estimates applied in determining expected credit loss provisions are:

- determining criteria for identifying significant increase in credit risk;
- choosing appropriate models and assumptions for the measurement of expected credit losses; and
- establishing the number and relative weightings of forward-looking economic scenarios.

Critical judgements and estimates will be reviewed on an ongoing basis as part of the group's IFRS 9 model governance process.

Sensitivity analysis has been performed on the staging criteria and PD models described above. A 10% variance has been selected as this is deemed to be the maximum variation likely to occur over a 12 month period in the current economic environment. The impact of 10% of the loans currently in stage 1 moving to stage 2 and the impact of 10% of loans currently in stage 2 moving to stage 1 are as follows:

Stage	Retail financial services £m	Secured personal lending £m	Commercial lending £m
Stage 1 to stage 2	0.3	0.1	0.4
Stage 2 to stage 1	(0.6)	(0.4)	(0.2)

The impact of a 10% change to the PD rates is as follows:

Retail financial services £m	Secured personal lending £m	Commercial lending £m
0.5	0.6	0.8

The IFRS 9 models calculate expected credit losses (ECL) for each of the scenarios and then apply the weightings to generate the weighted output for each model. Sensitivity analysis has been performed on the impact of each economic scenario.

Portfolio	ECL Range £m
Retail financial services	8.6
Secured personal lending	5.4
Commercial lending	0.6

Retirement benefit obligations

The group has to make significant estimations in relation to the assumptions on the mortality and inflation when valuing its pension liability and the cost of benefits provided. Changes in these assumptions would change the reported liability, service cost and expected return on pension plan assets. Further information is included in note 11.

Customer and regulatory complaints

The group holds provisions for customer and regulatory complaints. Provisions have been made in respect of claims in relation to Payment Protection Insurance (PPI) which in the group's case relate primarily to secured personal lending PPI products. Estimations are involved in determining the level of provision to hold for customer and regulatory complaints. The level of provision is calculated based upon the estimates of complaint volumes, the rate at which these claims are upheld and the level of redress paid on each complaint. Further information can be found in note 19.

3. Business segments

The group operates three main business segments: retail financial services, secured personal lending and commercial lending. These segments are used for internal reporting to the Board which is responsible for all significant decisions. Transactions between the business segments are on normal commercial terms and conditions. All items relate to continuing operations.

	2018			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	90.6	14.6	14.4	119.6
Other income and charges	1.5	1.6	0.1	3.2
Net operating income	92.1	16.2	14.5	122.8
Operating expenses	(75.5)	(3.6)	(2.4)	(81.5)
Impairment provision for losses on loans and advances	(2.4)	0.5	1.3	(0.6)
Provision for other liabilities and charges	–	–	–	–
Operating profit and profit before taxation	14.2	13.1	13.4	40.7
Taxation expense				(7.8)
Profit after taxation				**32.9**

	2017			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	92.6	14.7	18.6	125.9
Other income and charges	9.7	1.9	0.2	11.8
Net operating income	102.3	16.6	18.8	137.7
Operating expenses	(80.5)	(3.6)	(5.5)	(89.6)
Impairment provision for losses on loans and advances	(0.3)	5.0	5.3	10.0
Provision for other liabilities and charges	1.1	(0.1)	(1.5)	(0.5)
Operating profit and profit before taxation	22.6	17.9	17.1	57.6
Taxation expense				(14.1)
Profit after taxation				**43.5**

The group operates entirely within the UK, and therefore a geographical segment analysis is not presented.

	Group	
	2018 £m	2017 £m
Total assets by business segments		
Retail financial services	8,679.4	8,169.1
Secured personal lending	236.7	312.4
Commercial lending	771.3	781.1
Total assets	**9,687.4**	**9,262.6**
Total liabilities and equity by business segment		
Retail financial services and Commercial lending	9,450.7	8,950.2
Secured personal lending	236.7	312.4
Total liabilities and equity	**9,687.4**	**9,262.6**

Retail financial services and commercial lending are part of the same legal entity and liabilities are not shown for each business segment for internal reporting purposes.

4. Interest receivable and similar income

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
On loans fully secured on residential property	222.5	216.7	201.0	189.1
On other loans	5.8	12.2	5.8	12.2
On loans to subsidiaries	–	–	7.1	9.0
On debt securities	1.1	2.3	1.1	2.3
On other liquid assets	6.5	2.7	6.3	2.7
On derivative financial instruments	(9.9)	(19.7)	(9.9)	(19.7)
	226.0	**214.2**	**211.4**	**195.6**

5. Interest payable and similar charges

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
On shares held by individuals	83.1	78.5	83.1	78.5
On deposits and debt securities	24.8	14.2	23.4	17.0
On subscribed capital	4.2	4.2	4.2	4.2
On derivative financial instruments	(5.7)	(8.6)	(4.4)	(11.4)
	106.4	**88.3**	**106.3**	**88.3**

6. Fees and commission receivable

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Insurance and related financial service products	1.6	2.6	1.6	2.6
Mortgage related fees	3.9	4.2	3.9	4.2
Other fees and commission	0.2	0.3	–	–
	5.7	**7.1**	**5.5**	**6.8**

7. Other fair value gains and losses

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
(Losses)/gains on derivatives in hedging relationships	(4.3)	17.8	(4.3)	17.8
(Losses)/gains on derivatives not in hedging relationship	(1.0)	(2.4)	(2.9)	(5.3)
(Losses)/gains on derivatives	(5.3)	15.4	(7.2)	12.5
Gains on economic hedged items	4.5	6.9	4.5	6.9
Losses on hedged items attributable to the hedged risk	(1.6)	(18.0)	(1.6)	(18.0)
Gains/(losses) on hedged items	2.9	(11.1)	2.9	(11.1)
	(2.4)	**4.3**	**(4.3)**	**1.4**

Other fair value gains and losses represent the difference between changes in the fair values excluding interest flows of the hedging derivatives and the changes in the fair values excluding interest flows of the underlying hedged items.

8. Administrative expenses

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Wages and salaries	38.8	39.8	38.8	37.5
Social security costs	3.8	3.9	3.8	3.8
Other pension costs	2.7	2.1	2.7	2.0
	45.3	**45.8**	**45.3**	**43.3**
Other administrative expenses	30.4	30.6	28.4	28.4
	75.7	**76.4**	**73.7**	**71.7**

	Group		Society	
	2018 £000	2017 £000	2018 £000	2017 £000
Other administrative expenses include:				
Auditor's remuneration				
For audit of the Society's Annual Accounts	230	312	230	312
For audit of the Society's subsidiaries	35	33	–	–
Total	265	345	230	312
For other services				
Further assurance services	91	80	91	80
Total other services	91	80	91	80
Operating lease charges – motor vehicles	214	234	214	234
– land and buildings	943	1,259	1,054	1,057

9. Employees

The average number employed including Executive Directors was:

	Full-time		Part-time	
	2018 Number	2017 Number	2018 Number	2017 Number
Society's Customer Support Centre and administration office	720	653	123	112
Society branch offices	192	191	116	125
Employed by the Society	912	844	239	237
Subsidiaries	–	43	–	5
Employed by the Group	**912**	**887**	**239**	**242**

All subsidiary employees were transferred to the Society at the start of 2018.

10. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on pages 78-87 in accordance with Schedule 5, paragraphs 4 and 5 to the Building Societies (Accounts and Related Provisions) Regulations 1998. Total Directors' emoluments for the year were £1.9m (2017: £2.0m).

11. Retirement benefit obligations

The group operates two pension schemes, a defined contribution scheme and a defined benefit scheme.

Defined contribution scheme

The group operates a defined contribution scheme, the Group Flexible Retirement Plan (GFRP). A defined contribution scheme is one into which the group and the employee pay contributions, without any obligation to pay further contributions. Staff employed after 1 January 2001 and those staff who were formerly members of the defined benefit scheme are eligible to join this scheme. The cost to the group and Society of employer's contributions (before salary sacrifice arrangements) to the scheme in 2018 was £1.9m (2017: £1.8m). There were no contributions outstanding or prepaid at the end of the year.

Defined benefit scheme

A defined benefit scheme is one that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary. Staff, including Executive Directors, who entered service before 1 January 2001 were eligible to join the Society's Defined Benefit Scheme which is designed to provide pension entitlements based on career average salary (final salary until 31 December 2005) with assets held outside the Society in a separate fund administered by the Trustees of the pension fund. Membership of the Scheme is, however, available at the discretion of the Society, and a small number of new members have been admitted to the Scheme on this basis subsequent to 1 January 2001.

The defined benefit scheme was subject to a triennial valuation by the scheme's independent actuary on 30 September 2016. This valuation was completed in December 2017.

The defined benefit scheme closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the GFRP, described in the above section.

During 2012, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the scheme with Legal and General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal and General assumed full responsibility for the benefits payable to the scheme's current pensioners. The buy-in took effect from September 2012. The pensioner liability and the matching annuity policy remain within the scheme.

During the year, £4.6m was paid into the pension scheme from the Society (2017: £6.7m). The agreed contributions to be paid by the Society in 2019 amount to £3.7m, in 2020 to £2.7m and £1.0m in 2021. The Society may, however, pay additional amounts at any time.

Scheme management consists of a Board of Trustees, comprising four individuals, three of which are Society Nominated Trustees and one Member Nominated Trustee. The power of appointment and removal of the Trustees is vested in the Society in accordance with the Trust Deed.

11. Retirement benefit obligations (continued)

The Trustees have continued to act in accordance with the Statement of Investment Principles adopted on 6 December 2013 as required by Section 35 of the Pensions Act 1995. During the period to 30 April 2018, the scheme's investment assets were managed by Standard Life, Barings and Royal London Asset Management. This excludes the insured assets which are held by Legal and General Assurance. On 30 April 2018, the scheme transitioned the remaining invested assets to a Fiduciary Management arrangement with Legal and General Investment Management (LGIM). Under the Fiduciary Management agreement, the Trustees make the key strategic decisions relating to the scheme's investments (after taking appropriate advice), and have appointed LGIM as the Fiduciary Manager, giving LGIM discretion over the implementation and day-to-day management of the scheme's investments. Barnett Waddingham were also appointed to provide oversight on the Fiduciary Manager.

The Society also funds the cost of life assurance cover for staff members, and provides unfunded pensions directly to certain Directors and employees who retired prior to 1997.

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRS is £31.7m (2017: £32.8m).

The major assumptions used for the purpose of the actuarial valuation were as follows:

	At 31 December				
	2018 %	2017 %	2016 %	2015 %	2014 %
Rate of increase of pensions in payment	2.25	2.25	2.25	2.20	2.05
Discount rate	2.80	2.40	2.55	3.75	3.55
Inflation assumption (RPI)	3.20	3.20	3.25	3.15	3.05
Inflation assumption (CPI)	2.20	2.20	2.25	2.15	2.05

The assumptions on mortality are determined by the following tables:

	2018	2017
Retired and non-retired members	S2NA CMI 2017 LTR 1.25%	S2NA CMI 2016 LTR 1.25%
The assumptions are illustrated by the following years of life expectancy at age 65:		
Retired members		
Males currently aged 65	22.1	22.3
Females currently aged 65	24.2	24.2
Non-retired members		
Males currently aged 45	23.5	23.7
Females currently aged 45	25.7	25.7

The retirement benefit obligation relating to the scheme recognised in the statement of financial position is made up as follows:

	At 31 December				
	2018 £m	2017 £m	2016 £m	2015 £m	2014 £m
Target return funds	–	29.0	27.4	27.1	26.5
Multi asset	29.0	–	–	–	–
LDI	6.7	–	–	–	–
Annuities	23.9	25.9	26.4	23.5	25.2
Bonds and cash	3.4	8.5	4.3	3.5	2.9
Total fair value of plan assets	**63.0**	**63.4**	**58.1**	**54.1**	**54.6**
Present value of funded obligations	(66.4)	(71.8)	(72.9)	(57.7)	(61.0)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net deficit recognised in the statement of financial position	**(3.9)**	**(8.9)**	**(15.3)**	**(4.1)**	**(6.9)**

The deficit has decreased primarily as a result of £4.6m contributions paid into the pension scheme by the Society in 2018, together with movements in the discount rate which impacts the scheme liabilities and an additional £0.7m defined benefit pension scheme charge for guaranteed minimum pension (GMP) equalisation.

The actual loss on plan assets was £1.3m during the year and a gain of £2.9m in 2017.

11. Retirement benefit obligations (continued)

The amounts recognised in the income statement are as follows:

	Group and Society	
	2018 £m	2017 £m
Analysis of the amounts recognised in the income statement		
Interest on pension scheme assets	(1.5)	(1.5)
Interest on pension scheme liabilities	1.7	1.8
Net interest expense	**0.2**	**0.3**
Past service cost	0.6	–
Total amount recognised in the income statement	**0.8**	**0.3**
Analysis of amount recognised in statement of other comprehensive income		
(Losses)/gains on scheme assets in excess of interest	(2.8)	1.4
Experience losses on liabilities	(0.1)	(0.4)
(Losses)/gains from changes to demographic assumptions	(0.4)	0.8
Gains/(losses) from changes to financial assumptions	4.5	(1.8)
Total remeasurement	**1.2**	**–**
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(8.9)	(15.3)
Movement in year:		
Net interest expense	(0.2)	(0.3)
Remeasurements	1.2	–
Contributions paid and accrued	4.6	6.7
Past service cost	(0.6)	–
Deficit in scheme at end of year	**(3.9)**	**(8.9)**
Analysis of the movement in the fair value of pension scheme assets		
Fair value of assets at the beginning of the year	63.4	58.1
Interest on assets	1.5	1.5
Society contributions	4.6	6.7
Benefits paid	(3.7)	(4.3)
Return on plan assets less interest	(0.8)	1.9
Change in fair value of the annuity policy	(2.0)	(0.5)
Fair value of assets at the end of the year	**63.0**	**63.4**
Analysis of the movement in the present value of the pension scheme liabilities		
Present value of liabilities at the beginning of the year	72.3	73.3
Interest expense	1.7	1.8
Remeasurement losses/(gains):		
Actuarial gains and losses arising from changes in demographic assumptions	0.4	(0.8)
Actuarial gains and losses arising from changes in financial assumptions	(4.5)	1.8
Actuarial gains and losses arising from experience adjustments	0.1	0.4
Benefits paid	(3.7)	(4.2)
Past service cost	0.6	–
Present value of liabilities at the end of the year	**66.9**	**72.3**

Significant actuarial assumptions in the determination of the defined benefit obligation are the discount rate, inflation rate and life expectancy. The sensitivity analysis below represents the net impact on the scheme liabilities taking into account the change in the value of both the scheme's liabilities and the bulk annuity contract. No allowance has been made for any changes to the non-insured asset values. The weighted average duration of the liabilities is 18 years and the duration of insured pensioners is estimated to be around 10 years.

	Group and Society	
	Increase 0.5% £m	Decrease 0.5% £m
Discount rate	(4.6)	5.1
Inflation	4.4	(4.0)
Life expectancy (+1 year/-1 year)	2.2	(2.2)

Sensitivities of 0.5% have been used to reflect a significant but reasonably likely market event that causes a one-off shock to the actuarial assumptions. The sensitivity analysis above may not be representative of the actual change in the scheme liabilities as it is unlikely that the change in assumptions would occur in isolation of one another, some of the assumptions may be correlated.

12. Taxation

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Current tax				
UK corporation tax charge for the year	7.4	13.5	4.8	10.2
Adjustments in respect of prior years	0.1	0.1	0.1	0.1
	7.5	13.6	4.9	10.3
Deferred tax				
Deferred tax charge for year	0.4	0.4	0.4	0.4
Adjustments in respect of prior years	(0.1)	0.1	(0.1)	0.1
	0.3	0.5	0.3	0.5
Taxation expense	**7.8**	**14.1**	**5.2**	**10.8**

The statutory rate of corporation tax has remained at 19.0% since December 2017. The statutory rate of corporation tax will be reduced to 17.0% from April 2020.

12. Taxation (continued)

The actual tax charge for the year differs from that calculated using the standard rate of corporation tax in the UK. The differences are explained below:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Profit before taxation	40.7	57.6	25.3	37.5
Profit multiplied by the standard rate of corporation tax at 19.0% (2017: 19.3%)	7.7	11.1	4.8	7.2
Effects of				
Expenses not deductible for tax purposes	0.1	1.4	0.4	2.0
Adjustments to prior years	-	0.2	-	0.2
Impact of banking surcharge	-	1.4	-	1.4
Taxation on profit from ordinary activities	**7.8**	**14.1**	**5.2**	**10.8**

In addition to the amount charged to the income statement, the following amounts relating to tax have been recognised in other comprehensive income:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Current tax				
Relating to retirement benefit obligations	(1.0)	(0.5)	(1.0)	(0.5)
Gain on fair value through other comprehensive income	-	-	-	-
Revaluations of available-for-sale assets	-	(0.1)	-	(0.1)
	(1.0)	(0.6)	(1.0)	(0.6)
Deferred tax				
Relating to retirement benefit obligations	1.2	0.5	1.2	0.5
Gain on fair value through other comprehensive income	(0.1)	-	(0.1)	
Revaluations of available-for-sale assets	-	(0.3)	-	(0.3)
	1.1	0.2	1.1	0.2
Total charged to other comprehensive income	**0.1**	**(0.4)**	**0.1**	**(0.4)**

13. Loans and advances to credit institutions

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Loans and advances to credit institutions	147.8	168.8	67.6	61.4

Included in the above amount for the group is £64.9m of collateral given under Credit Support Annex (CSA) agreements (2017: £72.7m).

14. Debt securities

	Group and Society	
	2018 £m	2017 £m
Issued by UK government	–	85.9
Issued by other borrowers and unlisted	32.9	39.0
At 31 December	**32.9**	**124.9**

In 2018, debt securities are held at Fair Value through other comprehensive income. In 2017, debt securities were held as available-for-sale assets carried at their fair value. All liquid assets are obtained from sources within the UK.

The movement in debt securities is summarised as follows:

	Group and Society	
	2018 £m	2017 £m
At 1 January	124.9	389.6
Additions	6.3	16.0
Disposals and maturities	(97.1)	(278.1)
Losses from changes in fair value	(0.7)	(1.9)
Decrease in accrued interest	(0.5)	(0.7)
At 31 December	**32.9**	**124.9**

15. Derivative financial instruments

The group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, forward rate agreements, and similar instruments. These are commitments to exchange one set of cash flows for another. No exchange of principal takes place.

The group only enters into derivative contracts for risk management purposes, as explained in note 1. Derivatives held for risk management purposes include hedges that either meet the hedge accounting requirements or hedges that are economic hedges, but do not meet the hedge accounting requirements. The table below shows the fair values of derivative financial instruments recorded as assets or liabilities together with their notional amounts. The notional amount, recorded gross, is the quantity of the derivative contracts' underlying instrument. The notional amounts indicate the volume of transactions outstanding at the year end and are not indicative of either the market or credit risk.

	Group			
	Contract/notional amount		Fair Value	
	2018 £m	2017 £m	2018 £m	2017 £m
Derivative assets:				
Interest rate swaps	3,776.7	3,635.0	23.9	27.0
Equity and RPI index linked interest rate swaps	6.1	16.4	0.9	2.6
Total recognised derivative assets	**3,782.8**	**3,651.4**	**24.8**	**29.6**
Derivative assets:				
Interest rate swaps	3,356.9	3,408.9	(31.6)	(29.2)
Total recognised derivative liabilities	**3,356.9**	**3,408.9**	**(31.6)**	**(29.2)**

	Society			
	Contract/notional amount		Fair Value	
	2018 £m	2017 £m	2018 £m	2017 £m
Derivative assets:				
Interest rate swaps	3,884.4	3,490.3	20.3	25.2
Equity and RPI index linked interest rate swaps	6.1	16.4	0.9	2.6
Total recognised derivative assets	**3,890.5**	**3,506.7**	**21.2**	**27.8**
Derivative assets:				
Interest rate swaps	3,863.5	2,743.9	(31.3)	(28.2)
Total recognised derivative liabilities	**3,863.5**	**2,743.9**	**(31.3)**	**(28.2)**

Derivative financial instruments held or issued for hedging purposes

As part of its asset and liability management, the group uses derivatives for economic hedging purposes in order to reduce its exposure to market risks by hedging specific financial instruments. Where possible, the group applies hedge accounting. The accounting treatment explained in note 1 depends on the nature of the item hedged and compliance with the IAS 39 hedge accounting criteria.

Derivatives in economic hedge relationships

Included in this classification are any derivatives entered into by the group in order to economically hedge its exposures for risk management purposes that are not designated in hedge relationships as they do not meet the IAS 39 hedge accounting criteria.

This table shows the split of derivatives between those in a fair value hedge relationship and those in an economic hedge relationship, this has been further split by derivative assets and liabilities.

	Group	Society
	2018 £m	2018 £m
Derivatives		
Total derivatives in economic hedge relationships		
Interest rate swaps	765.5	1,379.7
Equity swaps	6.1	6.1
	771.7	1,385.9
Total derivatives used as fair value hedges		
Interest rate swaps	6,368.1	6,368.1
Derivative assets in economic hedge relationships		
Interest rate swaps	417.4	525.1
Equity swaps	6.1	6.1
	423.6	531.2
Derivative assets used as fair value hedges		
Interest rate swaps	3,359.3	3,359.3
Derivative liabilities in economic hedge relationships		
Interest rate swaps	348.1	854.7
Equity swaps	–	–
	348.1	854.7
Derivative liabilities used as fair value hedges		
Interest rate swaps	3,008.8	3,008.8

15. Derivative financial instruments (continued)

The table below shows the breakdown of the fair value movement in the underlying hedged items between micro, macro and economic hedge relationships.

	Group	Society
	2018 £m	2018 £m
Fair value hedges		
Micro hedges		
Commercial loans	127.2	127.2
Wholesale	360.0	360.0
FV adjustment on hedged item (asset)	4.5	4.5
FV adjustment on hedged item (liability)	(4.7)	(4.7)
Macro hedges		
Residential and commercial loans	4,393.9	4,393.9
Retail savings	3,422.7	3,422.7
FV adjustment on hedged item (asset)	3.6	3.6
FV adjustment on hedged item (liability)	(1.7)	(1.7)
Other underlying adjustments		
Economic hedges – equity	(1.6)	(1.6)
Amortisation/unwinds	(2.9)	(2.9)

	Group	Society
	2018 £m	2018 £m
Hedging strategy outcome		
Micro hedge – asset		
Commercial loans – hedged items	4.5	4.5
Commercial loans – hedged instruments	(2.5)	(2.5)
Micro hedge – liability		
Wholesale – hedged items	(4.7)	(4.7)
Wholesale – hedged instruments	4.4	4.4
Macro hedge – asset		
Residential and commercial loans – hedged items	3.6	3.6
Residential and commercial loans – hedged instruments	1.1	1.1
Macro hedge – liability		
Retail savings – hedged items	(1.7)	(1.7)
Retail savings – hedged instruments	1.3	1.3
Economic hedge items		
Equity	(1.6)	(1.6)
Amortisation/unwinds	(2.9)	(2.9)
Economic hedge instruments		
Dedesignation	(0.5)	(0.5)
Economic hedges – awaiting designation	0.7	0.7
Economic hedges – basis swaps	(0.9)	(0.9)
Economic hedges – equity	1.6	1.6
Other adjustments	0.1	0.1
Economic hedges– securitisation	–	1.9

The Society's fair value gain/(loss) is shown in the table above split by hedge relationship type and whether the fair value movement was related to an asset or a liability.

The group and Society's derivatives are shown in the table below based on their remaining term to maturity and subsequently by their hedge relationship.

Group **As at 31 December 2018**	Less than 1 month £m	Between 1 months and 3 months £m	Between 3 months and 12 months £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Fair value hedges – derivatives						
Micro hedge						
Commercial interest rate swaps	–	–	–	59.1	86.0	145.1
PIBS & EMTN interest rate swaps	–	–	–	360.0	–	360.0
Macro hedge						
Retail mortgages interest rate swaps	15.0	221.0	842.0	3,225.0	–	4,303.0
Commercial interest rate swaps	–	6.8	1.4	37.2	15.6	61.0
Savings interest rate swaps	42.0	129.0	531.0	797.0	–	1,499.0
Economic hedge						
Retail mortgages interest rate swaps	–	–	–	222.0	110.0	332.0
Commercial interest rate swaps	–	–	–	4.8	–	4.8
Equity swaps	6.1	–	–	–	–	6.1
Basis interest rate swaps	–	–	232.0	183.0	–	415.0
Dedesignated swaps	0.6	0.1	7.9	–	5.1	13.8
	63.7	**356.9**	**1,614.3**	**4,888.1**	**216.7**	**7,139.7**

15. Derivative financial instruments (continued)

Society **As at 31 December 2018**	Less than 1 month £m	Between 1 months and 3 months £m	Between 3 months and 12 months £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Fair value hedges – derivatives						
Micro hedge						
Commercial interest rate swaps	–	–	–	59.1	86.0	145.1
PIBS & EMTN interest rate swaps	–	–	–	360.0	–	360.0
Macro hedge						
Retail mortgages interest rate swaps	15.0	221.0	842.0	3,225.0	–	4,303.0
Commercial interest rate swaps	–	6.8	1.4	37.2	15.6	61.0
Savings interest rate swaps	42.0	129.0	531.0	797.0	–	1,499.0
Economic hedge						
Retail mortgages interest rate swaps	–	–	–	222.0	110.0	332.0
Commercial interest rate swaps	–	–	–	4.8	–	4.8
Equity swaps	6.1	–	–	–	–	6.1
Basis interest rate swaps	–	–	232.0	183.0	–	415.0
Dedesignated swaps	0.6	0.1	7.9	–	5.1	13.8
Securitisation interest rate swaps	–	–	–	614.2	–	614.2
	63.7	**356.9**	**1,614.3**	**4,888.1**	**216.7**	**7,139.7**

16. Loans and advances to customers

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Fully secured on residential property	8,216.6	7,568.2	7,979.2	7,254.5
Fully secured on land	282.8	291.9	282.8	291.9
	8,499.4	**7,860.1**	**8,262.0**	**7,546.4**
Provision for impairment losses	(30.5)	(30.3)	(21.6)	(20.5)
Effective Interest Rate adjustments	22.2	21.4	14.5	13.5
Fair value adjustment for hedged risk	7.6	12.9	7.6	12.9
	8,498.7	**7,864.1**	**8,262.5**	**7,552.3**

17. Asset encumbrance

The wholesale funding initiatives of the group require that from time to time certain assets become encumbered as collateral against such funding. Assets that have been utilised in this way cannot be used for other purposes. The group's principal forms of encumbrance relate to secured funding transactions and third party sale and repurchase agreements, with encumbrance also arising from excess collateral balances and cash collateral posted. As at 31 December 2018, the encumbrance ratio was 22.9% (31 December 2017: 20.3%). All other assets are defined as unencumbered.

An analysis of the group's encumbered and unencumbered on-balance sheet assets as at 31 December 2018 and 2017 is set out below.

	2018		2017	
	Encumbered £m	Unencumbered £m	Encumbered £m	Unencumbered £m
Cash in hand and balances at the Bank of England	–	931.8	–	1,026.3
Loans and advances to credit institutions	145.0	2.8	158.0	10.8
Debt securities	–	32.9	–	124.9
Derivative financial instruments	–	24.8	–	29.6
Loans and advances to customers	2,072.1	6,426.6	1,719.2	6,144.9
Other assets	–	51.4	–	48.9
Total	**2,217.1**	**7,470.3**	**1,877.2**	**7,385.4**

18. Provision for impairment losses

	Retail £m	Nemo £m	Commercial Lending £m	Total £m
New loans	0.8	-	1.1	1.9
Settled loans	(0.9)	(1.1)	(8.0)	(10.0)
Changes in model assumptions	2.7	1.6	0.5	4.8
Changes in credit quality	(0.2)	(1.9)	2.5	0.4
Utilised provision	-	0.1	3.4	3.5
Income Statement Impact	**2.4**	**(1.3)**	**(0.5)**	**0.6**
Balance Sheet Impact	**2.3**	**(1.3)**	**(3.9)**	**(3.0)**

Provision for impairment losses at 31 December 2018 include £30.5m for loan loss provisioning impairment and £0.8m on other debt instruments.

The tables below set out the movements in loss allowances:

Group	Stage 1 12 month ECL £m	Stage 2 Lifetime ECL £m	Stage 3 Lifetime ECL £m	Total £m
At 1 January 2018	4.1	12.4	17.8	34.3
Transfers:				
Stage 1 transfers	0.2	-	-	0.2
Stage 2 transfers	-	1.6	-	1.6
Stage 3 transfers	-	-	0.8	0.8
New loans	0.8	1.0	-	1.8
Settled loans	(0.6)	(0.7)	(8.7)	(10.0)
Changes in credit quality	(0.7)	(0.7)	(0.7)	(2.1)
Changes in model assumptions	-	3.2	1.5	4.7
Loss allowance at 31 December 2018	**3.8**	**16.8**	**10.7**	**31.3**

Society	Stage 1 12 month ECL £m	Stage 2 Lifetime ECL £m	Stage 3 Lifetime ECL £m	Total £m
At 1 January 2018	3.7	7.0	13.3	24.0
Transfers:				
Stage 1 transfers	0.2	–	–	0.2
Stage 2 transfers	–	1.7	–	1.7
Stage 3 transfers	–	–	1.1	1.1
New loans	0.8	1.0	–	1.8
Settled loans	(0.5)	(0.4)	(8.0)	(8.9)
Changes in credit quality	(0.6)	–	–	(0.6)
Changes in model assumptions	–	2.2	0.9	3.1
Loss allowance at 31 December 2018	**3.6**	**11.5**	**7.3**	**22.4**

From 1 January, 2018 impairment provisions are now dealt with under IFRS 9. Total impairment provisions reduced from £34.3m on transition to £31.3m at 31 December 2018, primarily due to recoveries on settled loans and improvements in credit quality being greater than additional provisions recognised for new loans, stage transfers and changes in model assumptions. The majority of recoveries on settled loans related to impaired commercial loans previously categorised within stage 3. The charge in relation to changes in model assumptions principally relate to the inclusion of a probation period for movements of retail and secured personal loans between stages, together with the inclusion of a post model adjustment for the expected impact of the UK not achieving an orderly exit from the EU. Further information on the adoption of IFRS 9 and critical estimates therein can be found in notes 1 and 2.

Retail and Nemo	Sum of ECL £m	Coverage %
PD Band:		
0.00% - 0.11%	0.1	0.02
0.11% - 0.17%	0.2	0.04
0.17% - 0.25%	0.3	0.11
0.25% - 0.41%	0.6	0.12
0.41% - 0.60%	0.6	0.32
0.60% - 0.88%	0.6	0.59
0.88%- 1.49%	1.7	2.73
1.49% - 2.96%	1.9	5.92
2.96% - 6.84%	1.5	11.17
6.84%+	10.6	23.44
Grand Total	**18.1**	

FINANCIAL STATEMENTS

18. Provision for impairment losses (continued)

Commercial Lending	Sum of ECL £m	Coverage %
PD Band:		
0.28%	0.1	0.1
0.56%	0.3	0.2
1.13%	1.3	0.4
2.25%	1.6	1.3
4.50%	1.4	3.2
9.00%	1.2	7.9
18.00%	0.9	17.6
36.00%	0.9	94.0
100.00%	4.7	47.3
Grand Total	**12.4**	

	Specific £m	Collective £m	Total £m
2017			
Group			
At 1 January 2017	14.8	30.6	45.4
Amounts written off during the year	(5.1)	–	(5.1)
(Release)/charge for loan impairment	0.9	(10.9)	(10.0)
At 31 December 2017	**10.6**	**19.7**	**30.3**
Society			
At 1 January 2017	11.3	18.8	30.1
Amounts written off during the year	(5.0)	–	(5.0)
(Release)/charge for loan impairment	1.4	(6.0)	(4.6)
At 31 December 2017	**7.7**	**12.8**	**20.5**

19. Provision for liabilities

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
At 1 January	6.1	7.1	2.2	4.3
Additions/(release)	–	0.5	–	(1.0)
Utilisation	(1.0)	(1.5)	(0.4)	(1.1)
At 31 December	**5.1**	**6.1**	**1.8**	**2.2**

At 31 December 2018, the group held a provision of £3.3m (2017: £3.8m) in relation to customer redress, including (PPI). The provision considers sales of PPI via direct channels as well as via brokers, some of whom are no longer trading, as well as recent customer behaviour and reopening previously closed complaints. The contingent aspect of the provision is described in note 30.

The provision reflects management's best estimate of the costs required to settle its remaining obligations and takes account of expected customer behaviour, costs incurred with associated legal claims and an updated assessment of the remaining exposure population. The majority of the provision is expected to be utilised over the next three years.

Although a significant degree of uncertainty remains with regard to the ultimate cost of settling customer claims, in particular the claim behaviour of customers ahead of the confirmed deadline, the provision balance is expected to be sufficient to meet any remaining obligations. The provision will continue to be monitored ahead of the deadline and customer trends and behaviour analysed in order ensure the provision remains appropriate as circumstances become clearer.

Other provisions of £1.7m (2017: £1.8m) have been made in respect of various other customer claims.

20. Investments in subsidiary undertakings

	Society	
	2018 £m	2017 £m
Shares in subsidiary undertakings	0.1	0.1
Loans to subsidiary undertakings	135.2	218.7
	135.3	**218.8**

	Subsidiary undertakings	
	Shares £m	Loans £m
Movement in investments in subsidiary undertakings:		
At 1 January 2018	0.1	218.7
Loan repayment	–	(83.5)
At 31 December 2017	**0.1**	**135.2**

The Directors have reviewed the recoverability of outstanding loans and holdings in subsidiary undertakings and no impairment provision is deemed necessary.

20. Investments in subsidiary undertakings (continued)

The Society has the following subsidiary undertakings which operated in the United Kingdom during the year and are included in the group accounts:

	Place of registration	Principal activity	Class of shares held	Interest of Society	Direct or indirect
Nemo Personal Finance Limited	England and Wales	Secured personal lending	Ordinary	100%	Direct
Principality Mortgage and Insurance Services Limited	England and Wales	Provision of advisory and administration services	Ordinary	100%	Direct

Principality Building Society consolidates funding vehicles Friary No.2 Plc, Friary No.3 Plc and Friary No.4 Plc into the group accounts. These companies are not wholly owned by the Society but the Society retains substantially all of the risk and reward of the assets, and therefore the Society's interests in these entities are in substance no different than if they were 100% held subsidiary undertakings and consequently they are consolidated into the group accounts.

The Society continues to participate in the Ely Bridge development, a scheme which aims to deliver an 800 house development on a brownfield site in Cardiff being a mix of affordable, social and private dwellings ultimately funded by the capital markets. Ely Bridge Development Company Limited was incorporated on 28 March 2012. The company is not for profit and limited by guarantee. The Society holds no beneficial interest in the company but has agreed to contribute £1 to the assets of the company in the event of it being wound up.

The Society also holds 100% of the ordinary share capital of the following subsidiary undertakings. None of the subsidiary businesses listed to the right carried out business during the year. All subsidiary businesses were incorporated in the United Kingdom, at the registered address of Principality Buildings, Queen Street, Cardiff, CF10 1UA.

Brokerpoint Limited
Energy Assess Wales Limited
Home Information Pack Wales Limited
Principality Covered Bond LLP
Principality Limited
Principality Asset Management Limited
Principality Bank Limited
Principality Direct Limited
Principality Estate Agency Limited
Principality Financial Management Limited
Principality Group Limited
Principality Homes Limited
Principalty (IFA Services) Limited
Principality Life Assurance Services Limited
Principality (Life and Pensions) Limited
Principality Mortgage Corporation Limited
Principality Personal Loans Limited
Principality Property Development Services Limited
Principality Property Sales Limited
Principality Property Services Limited
Principality Property Solutions Limited
Principality Surveyors Home Condition Report Limited
Principality Surveyors Limited
Principality Syndicated Loans Limited
The Principality Home Information Pack Limited

21. Intangible assets

	Computer software	
	Group £m	Society £m
Cost:		
At 1 January 2018	8.5	8.5
Additions	4.2	4.2
At 31 December 2018	**12.7**	**12.7**
Amortisation:		
At 1 January 2018	7.7	7.7
Charge for the year	0.4	0.4
At 31 December 2018	**8.1**	**8.1**
Net book value:		
At 31 December 2018	**4.6**	**4.6**
At 31 December 2017	0.8	0.8

	Computer software	
	Group £m	Society £m
Cost:		
At 1 January 2017	8.5	8.5
Additions	–	–
At 31 December 2017	**8.5**	**8.5**
Amortisation:		
At 1 January 2017	7.2	7.2
Charge for the year	0.5	0.5
At 31 December 2017	**7.7**	**7.7**
Net book value:		
At 31 December 2017	**0.8**	**0.8**
At 31 December 2016	1.3	1.3

Computer software capitalised during the year relates to the group's transformation programme and associated technology investment. The total cost at 31 December 2018 includes £4.2m (2017: £0.1m) of assets in the course of construction which are not yet ready for use and therefore have no amortisation charged against them.

FINANCIAL STATEMENTS

22. Property, plant and equipment

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2018	61.7	60.5	32.9	25.5	94.6	86.0
Additions	1.3	1.3	6.3	6.3	7.6	7.6
Disposals	(0.5)	(0.5)	–	–	(0.5)	(0.5)
Reclassified as held-for-sale	–	–	–	–	–	–
At 31 December 2018	**62.5**	**61.3**	**39.2**	**31.8**	**101.7**	**93.1**
Depreciation:						
At 1 January 2018	37.6	37.1	24.3	16.9	61.9	54.0
Charge for the year	1.5	1.5	3.9	3.9	75.4	5.4
Impairment in the year	–	–	–	–	–	–
Disposals	(0.5)	(0.5)	–	–	(0.5)	(0.5)
Reclassified as held-for-sale	–	–	–	–	–	–
At 31 December 2018	**38.7**	**38.1**	**28.2**	**20.8**	**66.9**	**58.9**
Net book value:						
At 31 December 2018	**23.8**	**23.2**	**11.0**	**11.0**	**34.8**	**34.2**
At 31 December 2017	24.1	23.4	8.6	8.6	32.7	32.0

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2017	67.7	66.5	30.8	23.5	98.5	90.0
Additions	1.8	1.8	3.2	3.2	5.0	5.0
Disposals	(2.0)	(2.0)	(1.1)	(1.2)	(3.1)	(3.2)
Reclassified as held-for-sale	(5.8)	(5.8)	–	–	(5.8)	(5.8)
At 31 December 2017	**61.7**	**60.5**	**32.9**	**25.5**	**94.6**	**86.0**
Depreciation:						
At 1 January 2017	32.5	32.0	21.5	14.3	54.0	46.3
Charge for the year	1.9	1.9	3.9	3.7	5.8	5.6
Impairment in the year	5.8	5.8	–	–	5.8	5.8
Disposals	(1.0)	(1.0)	(1.1)	(1.1)	(2.1)	(2.1)
Reclassified as held-for-sale	(1.6)	(1.6)	–	–	(1.6)	(1.6)
At 31 December 2017	**37.6**	**37.1**	**24.3**	**16.9**	**61.9**	**54.0**
Net book value:						
At 31 December 2017	**24.1**	**23.4**	**8.6**	**8.6**	**32.7**	**32.0**
At 31 December 2016	35.2	34.5	9.3	9.2	44.5	43.7

Included within land and buildings additions is £0.2m (2017: £1.7m) on account of assets in the course of construction. The value of assets subject to operating leases where the group acts as lessor is £18.7m (2017: £22.3m).

Each year Principality employ an independent third party to complete all valuations. The appointment of the valuer is completed through a thorough tender process, including assessment of the relevant qualifications of the valuer, to ensure competence and independence.

The valuations were compared to the net book values to assess if an asset should be impaired. There were no impairments during 2018 (2017: £5.8m).

	2018		2017	
	Group £m	Society £m	Group £m	Society £m
Land and buildings:				
Freehold	21.2	20.5	32.3	31.6
Long leasehold	0.2	0.2	0.2	0.2
Short leasehold	2.7	2.7	2.7	2.7
	24.1	**23.4**	**35.2**	**34.5**
Occupied by the Society and subsidiary undertakings	13.6	13.6	18.5	18.5

23. Non current assets held-for-sale

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Non current assets held-for-sale	-	4.2	-	4.2

The Society now holds no (2017: £4.2m) property as non current assets held-for-sale. The sale process for the assets was concluded in 2018.

24. Shares

	Group and Society	
	2018 £m	2017 £m
Held by individuals	6,987.1	6,559.4
Other shares	4.1	3.9
Fair value adjustment for hedged risk	(1.4)	0.5
	6,989.8	**6,563.8**

25. Amounts owed to credit institutions

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Amounts owed to credit institutions	867.1	573.5	1,499.9	1,398.8

Included in the above amount is £0.3m of collateral held under Credit Support Annex (CSA) agreements (2017: £6.3m).

26. Debt securities in issue

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Certificates of deposit	–	13.5	–	13.5
Senior unsecured debt	297.7	299.2	297.7	299.2
Residential mortgage backed securities	713.2	932.1	–	–
Fair value adjustment for hedged risk	–	0.9	–	0.9
	1,010.9	**1,245.7**	**297.7**	**313.6**

27. Other liabilities

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Other taxation and social security	1.1	1.0	1.1	1.0
Other creditors	5.1	5.9	4.6	4.5
	6.2	**6.9**	**5.7**	**5.5**

28. Deferred tax

The movement in net deferred tax is as follows:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
At 1 January	3.1	3.8	2.9	3.6
Income statement charge	(0.3)	(0.5)	(0.3)	(0.5)
Statement of other comprehensive income charge	(0.4)	(0.2)	(0.4)	(0.2)
At 31 December	**2.4**	**3.1**	**2.2**	**2.9**

Deferred tax assets and liabilities are attributable to the following items:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Deferred tax assets				
Retirement benefit obligation	1.2	2.4	1.2	2.4
Accelerated tax depreciation	1.1	1.0	0.9	0.8
FVOCI/Available-for-sale	0.1	0.1	0.1	0.1
Other temporary differences	0.7	–	0.6	–
	3.1	**3.5**	**2.8**	**3.3**
Deferred tax liabilities				
FVOCI/Available-for-sale	–	(0.1)	–	(0.1)
Other temporary differences	(0.6)	(0.3)	(0.6)	(0.3)
	(0.6)	**(0.4)**	**(0.6)**	**(0.4)**

The deferred tax (charge)/credit in the income statement comprises the following temporary differences:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Accelerated tax depreciation	0.1	0.2	0.1	0.2
Retirement benefit obligation	-	(0.1)	-	(0.1)
Fair value volatility on financial instruments in securitisation entities	(0.4)	(0.6)	(0.4)	(0.6)
	(0.3)	**(0.5)**	**(0.3)**	**(0.5)**

The Finance No.2 Act 2015 provides that the rate of corporation tax for the 2019 financial year will be 19.0% and the rate from 1 April 2020 will be 17.0%.

The statement of other comprehensive income includes a deferred tax loss of £1.2m (2017: £0.5m loss) arising from the actuarial loss on retirement benefit obligations. The charge reflected in the income statement is not material.

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within five years. More information on the triennial valuation can be found in note 11.

29. Subscribed capital

	Group and Society	
	2018 £m	2017 £m
7.00% Permanent Interest Bearing Shares	60.0	60.0
Unamortised issue costs	(0.1)	(0.2)
Fair value adjustment for hedged risk	3.7	6.7
	63.6	**66.5**

The Permanent Interest Bearing Shares (PIBS) are unsecured and denominated in Sterling. They were issued on 1 June 2004. Net proceeds of the issue were £58.6m.

The PIBS are repayable, at the option of the Society, in full on 1 June 2020 or any fifth anniversary thereafter. Repaying the PIBS requires the prior consent of the Prudential Regulation Authority. If the PIBS are not repaid on a call date then the interest rate is reset at 1 June 2020 at 3% above the relevant equivalent gilt yield at the time.

PIBS are deferred shares of the Society and rank behind the claims of all depositors, creditors and investing Members of the Society.

The interest rate risk arising from the issuance of fixed rate PIBS has been mitigated through the use of interest rate swaps.

30. Financial commitments and contingent liabilities

a) Other provisions for liabilities and charges

At 31 December 2018, the group holds a provision of £3.3m (2017: £3.8m), which it expects to be sufficient to meet obligations in relation to previous sales of PPI. The level of provision is calculated based upon estimates of complaint volumes, the rate at which these claims are upheld and the level of redress paid on each complaint.

Although a significant degree of uncertainty remains with regard to the ultimate cost of settling customer claims, in particular the claim behaviour of customers ahead of the confirmed deadline, the provision balance is expected to be sufficient to meet any remaining obligations. The provision will continue to be monitored ahead of the deadline and customer trends and behaviour analysed in order ensure the provision remains appropriate as circumstances become clearer.

b) Commitments under non-cancellable operating leases:

	2018		2017	
	Property £m	Vehicles, plant and equipment £m	Property £m	Vehicles, plant and equipment £m
Group commitments in respect of operating lease rentals:				
Due within one year	1.7	0.1	1.6	0.2
Due between two and five years	3.3	0.2	3.9	0.1
Due after five years	2.3	–	3.0	–
	7.3	**0.3**	**8.5**	**0.3**
Society commitments in respect of operating lease rentals:				
Due within one year	1.2	0.1	1.0	0.2
Due between two and five years	2.9	0.2	3.0	0.1
Due after five years	2.3	–	3.1	–
	6.4	**0.3**	**7.1**	**0.3**

c) Income receivable under non-cancellable operating leases:

Property rental income earned during the year was £1.1m (2017: £1.1m).

At the statement of financial position date, the Society had contracted with tenants for the following future minimum lease payments:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Receivable within one year	0.7	1.0	0.7	1.0
Receivable between two and five years	2.6	3.9	2.6	3.9
Receivable after five years	6.7	12.4	6.7	12.4
	10.0	**17.3**	**10.0**	**17.3**

On 28 January 2011, a 25 year lease of floors one to four of Principality Buildings was granted to Travelodge Hotels Limited.

The reduction in income receivable is due to the sale of non-core properties in the year which were previously leased under operating leases.

d) Capital commitments:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Capital expenditure contracted for but not provided for	0.6	1.6	0.6	1.6

e) Loan commitments:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Loan commitments contracted but not paid	113.1	96.8	113.1	96.8

31. Financial instruments

Categories of financial instruments

Financial assets and liabilities are measured on an ongoing basis either at fair value or at amortised cost.

The accounting policies note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the financial assets and liabilities in the statement of financial position by the class of financial instrument to which they are assigned and by the measurement basis.

Group As at 31 December 2018	At amortised cost £m	Fair value through OCI £m	Fair value through profit and loss £m	Total £m
Group assets				
Cash in hand and balances with Bank of England	931.8	-	-	931.8
Loans and advances to credit institutions	147.8	-	-	147.8
Debt securities	-	32.9	-	32.9
Derivative financial instruments	-	-	24.8	24.8
Loans and advances to customers	8,498.7	-	-	8,498.7
Total financial assets	**9,578.3**	**32.9**	**24.8**	**9,636.0**
Total non-financial assets				51.4
Total Group assets				**9,687.4**
Group liabilities				
Shares	6,989.8	-	-	6,989.8
Amounts owed to credit institutions	859.1	-	8.0	867.1
Amounts owed to other customers	141.4	-	-	141.4
Debt securities in issue	1,012.6	-	(1.8)	1,010.9
Derivative financial instruments	-	-	31.6	31.6
Subscribed capital	63.6	-	-	63.6
Total financial liabilities	**9,066.5**	**-**	**37.8**	**9,104.4**
Total non-financial liabilities				32.3
General reserve and other reserves				550.7
Total Group reserves and liabilities				**9,687.4**

Society As at 31 December 2018	At amortised cost £m	Fair value through OCI £m	Fair value through profit and loss £m	Total £m
Society assets				
Cash in hand and balances with Bank of England	931.8	-	-	931.8
Loans and advances to credit institutions	67.6	-	-	67.6
Debt securities	-	32.9	-	32.9
Derivative financial instruments	-	-	21.2	21.2
Loans and advances to customers	8,262.5	-	-	8,262.5
Loans to and investments in subsidiaries	135.3	-	-	135.3
Total financial assets	**9,397.2**	**32.9**	**21.2**	**9,451.3**
Total non-financial assets				50.3
Total Society assets				**9,501.6**
Society liabilities				
Shares	6,989.8	-	-	6,989.8
Amounts owed to credit institutions	1,491.9	-	8.0	1,499.9
Amounts owed to other customers	141.4	-	-	141.4
Debt securities in issue	299.5	-	(1.8)	297.7
Derivative financial instruments	-	-	31.3	31.3
Subscribed capital	63.6	-	-	63.6
Total financial liabilities	**8,986.2**	**-**	**37.5**	**9,023.7**
Total non-financial liabilities				25.9
General reserve and other reserves				452.0
Total Group reserves and liabilities				**9,501.6**

31. Financial instruments (continued)

Group As at 31 December 2017	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Group assets					
Cash in hand and balances with Bank of England	1,026.3	-	-	-	1,026.3
Loans and advances to credit institutions	-	168.8	-	-	168.8
Debt securities	-	-	124.9	-	124.9
Derivative financial instruments	-	-	-	29.6	29.6
Loans and advances to customers	-	7,864.1	-	-	7,864.1
Total financial assets	**1,026.3**	**8,032.9**	**124.9**	**29.6**	**9,213.7**
Total non-financial assets					48.9
Total Group assets					**9,262.6**
Group liabilities					
Shares	6,563.8	-	-	-	6,563.8
Amounts owed to credit institutions	554.6	-	-	18.9	573.5
Amounts owed to other customers	216.7	-	-	-	216.7
Debt securities in issue	1,245.7	-	-	-	1,245.7
Derivative financial instruments	-	-	-	29.2	29.2
Subscribed capital	66.5	-	-	-	66.5
Total financial liabilities	**8,647.3**	**-**	**-**	**48.1**	**8,695.4**
Total non-financial liabilities					46.8
General reserve and other reserves					520.4
Total Group reserves and liabilities					**9,262.6**

Society As at 31 December 2017	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Society assets					
Cash in hand and balances with Bank of England	1,026.3	–	–	–	1,026.3
Loans and advances to credit institutions	–	61.4	–	–	61.4
Debt securities	–	–	124.9	–	124.9
Derivative financial instruments	–	–	–	27.8	27.8
Loans and advances to customers	–	7,552.3	–	–	7,552.3
Loans to and investments in subsidiaries	0.1	218.7	–	–	218.8
Total financial assets	**1,026.4**	**7,832.4**	**124.9**	**27.8**	**9,011.5**
Total non-financial assets					48.1
Total Society assets					**9,059.6**
Society liabilities					
Shares	6,563.8	–	–	–	6,563.8
Amounts owed to credit institutions	1,379.9	–	–	18.9	1,398.8
Amounts owed to other customers	216.7	–	–	–	216.7
Debt securities in issue	313.6	–	–	–	313.6
Derivative financial instruments	–	–	–	28.2	28.2
Subscribed capital	66.5	–	–	–	66.5
Total financial liabilities	**8,540.5**	**–**	**–**	**47.1**	**8,587.6**
Total non-financial liabilities					38.0
General reserve and other reserves					434.0
Total Group reserves and liabilities					**9,059.6**

31. Financial instruments (continued)

Carrying and fair values

The table below compares carrying values and fair values of the group's and the Society's financial instruments by category. It is accompanied by an explanation of the methods used to determine fair value.

	Note	2018 Carrying value £m	2018 Fair value £m	2017 Carrying value £m	2017 Fair value £m
Group assets					
Cash in hand and balances with Bank of England	i.	931.8	931.8	1,026.3	1,026.3
Loans and advances to credit institutions	ii.	147.8	147.8	168.8	168.8
Debt securities	iii.	32.9	32.9	124.9	124.9
Derivative financial instruments	iv.	24.8	24.8	29.6	29.6
Loans and advances to customers	v.	8,498.7	8,594.8	7,864.1	7,898.1
		9,636.0	**9,732.1**	**9,213.7**	**9,247.7**
Group liabilities					
Shares	vii.	6,989.8	6,999.4	6,563.8	6,574.8
Amounts owed to credit institutions	viii.	867.1	867.1	573.5	573.5
Amounts owed to other customers	viii.	141.4	141.4	216.7	216.7
Debt securities in issue	ix.	1,010.9	998.5	1,245.7	1,241.6
Derivative financial instruments	iv.	31.6	31.6	29.2	29.2
Subscribed capital	ix.	63.6	61.0	66.5	64.7
		9,104.4	**9,099.0**	**8,695.4**	**8,700.5**

	Note	2018 Carrying value £m	2018 Fair value £m	2017 Carrying value £m	2017 Fair value £m
Society assets					
Cash in hand and balances with Bank of England	i.	931.8	931.8	1,026.3	1,026.3
Loans and advances to credit institutions	ii.	67.6	67.6	61.4	61.4
Debt securities	iii.	32.9	32.9	124.9	124.9
Derivative financial instruments	iv.	21.2	21.2	27.8	27.8
Loans and advances to customers	v.	8,262.5	8,355.7	7,552.3	7,584.4
Loans and advances to subsidiaries	vi.	135.3	135.3	218.8	218.8
		9,451.3	**9,544.5**	**9,011.5**	**9,043.6**
Society liabilities					
Shares	vii.	6,989.8	6,999.5	6,563.8	6,574.8
Amounts owed to credit institutions	viii.	1,499.9	1,499.9	1,398.8	1,398.8
Amounts owed to other customers	viii.	141.4	141.4	216.7	216.7
Debt securities in issue	ix.	297.7	288.5	313.6	313.6
Derivative financial instruments	iv.	31.3	31.3	28.2	28.2
Subscribed capital	ix.	63.6	61.0	66.5	64.7
		9,023.7	**9,021.6**	**8,587.6**	**8,596.8**

Carrying and fair values

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following methods and assumptions have been applied in determining fair value:

i) The carrying amount of cash in hand and balances with the Bank of England are assumed to equate to fair value. Balances are held at amortised cost, and would be considered as a Level 2 item within the hierarchy for fair value.

ii) The carrying amount of loans and advances to credit institutions with a maturity of under 12 months is assumed to equate to their fair value. Balances would be considered as a Level 2 item within the hierarchy for fair value disclosures.

iii) Debt are measured at fair value by reference to market prices, with balances considered as a Level 1 item within the hierarchy for fair value disclosures.

iv) The fair value of interest rate swaps is calculated by utilising discounted cash flow valuation models. Balances are held as fair value through profit and loss, and a breakdown of the fair value hierarchies can be seen on page 167.

v) The fair value of loans and advances to customers represents the discounted amount of estimated future cash flows expected to be received after taking account of expected loss provisions, expected levels of early repayment and discounting at current market rates. Balances would be considered as a Level 3 item within the hierarchy for fair value disclosures.

vi) The fair value of loans and advances to subsidiaries at a variable rate is considered to be their carrying amounts with the use of transfer pricing mechanisms. Balances would be considered as a Level 3 item within the hierarchy for fair value disclosures.

vii) The fair value of customer accounts represents the discounted amount of estimated future cash flows expected to be paid, with reference to market-observable interest rates and would be considered as a Level 2 item.

viii) The fair values of amounts owed to credit institutions and amounts owed to other customers are considered to be the amount payable at the date of the statement of financial position. Balances are held at amortised cost, and would be considered as a Level 2 item within the hierarchy for fair value

ix) The fair values of debt securities in issue and subscribed capital are obtained from market prices. Balances are held at amortised cost, and would be considered as a Level 1 item within the hierarchy for fair value.

31. Financial instruments (continued)

	Group			
	2018 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	24.8	–	20.9	3.8
Financial assets at fair value through other comprehensive income:				
Debt securities	32.9	32.9	–	–
Total	**57.7**	**32.9**	**20.9**	**3.8**
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	4.3	–	4.3	–
Derivative financial instruments	31.6	–	27.7	3.8
Total	**35.9**	**-**	**32.0**	**3.8**

	Society			
	2018 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	21.2	–	20.9	0.3
Financial assets at fair value through other comprehensive income:				
Debt securities	32.9	32.9	–	–
Total	**54.1**	**32.9**	**20.9**	**0.3**
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	6.1	–	6.1	–
Derivative financial instruments	31.2	–	27.7	3.5
Total	**37.3**	**-**	**33.8**	**3.5**

	Group			
	2017 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	29.6	-	26.7	2.8
Available-for-sale financial assets:				
Debt securities	124.9	124.9	-	-
Total	**154.5**	**124.9**	**26.7**	**2.8**
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	18.9	-	18.9	-
Derivative financial instruments	29.2	-	26.4	2.8
Total	**48.1**	**-**	**45.3**	**2.8**

	Society			
	2017 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	27.8	-	26.7	1.1
Available-for-sale financial assets:				
Debt securities	124.9	124.9	-	-
Total	**152.7**	**124.9**	**26.7**	**1.1**
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	18.9	-	18.9	-
Derivative financial instruments	28.2	-	26.4	1.8
Total	**47.1**	**-**	**45.3**	**1.8**

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

Level	**Description**
1.	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
2.	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices).
3.	Inputs for the asset or liability that are not based solely on observable market data.

31. Financial instruments (continued)

The items included within Level 3 are interest rate swaps, the notional amounts for which track the amortisation profile of the mortgage assets within the RMBS structures. The valuations are provided by the counterparties using present value calculations based on market interest rate curves and projected mortgage prepayment amounts. The unobservable inputs relate to the projection of the notional amounts of the swaps, which change over time to match the balance of the underlying mortgage portfolio. There have been no additions or maturities within this category during the year therefore total movements throughout 2018 are due to changes in market rates.

The costs to replace derivatives contracts in the event that a counterparty was unable to honour their contractual obligation are materially equal to the fair value of derivatives disclosed above.

32. Credit risk

The credit risk to which the group is exposed is described in the Risk Management Report on pages 59-61. Credit risk in relation to loans and advances to customers including first and second charge retail credit risk and commercial lending credit risk, is described in section a) below. Credit risk in relation to treasury financial instruments, is described in section b).

a) Loans and advances to customers

The group's exposure to credit risk relating to loans and advances to customers can be broken down by security as follows:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
In respect of loans and advances to customers:				
Secured by a first charge on residential property	7,979.3	7,254.5	7,979.3	7,254.5
Secured by a first charge on land	282.7	291.9	282.7	291.9
Secured by a second charge on residential property	237.4	313.7	–	–
	8,499.4	7,860.1	8,262.0	7,546.4
Provision for impairment losses	(30.5)	(30.3)	(21.6)	(20.5)
Effective Interest Rate adjustments	22.2	21.4	14.5	13.5
Fair value adjustments	7.6	12.9	7.6	12.9
	8,498.7	**7,864.1**	**8,262.5**	**7,552.3**

The group's exposure to credit risk relating to loans and advances to customers can be broken down by business segment as follows:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
Retail financial services	7,494.3	6,775.5	7,494.3	6,775.5
Commercial lending	760.6	763.9	760.6	763.9
Secured personal lending	236.2	311.8	–	–
Fair value adjustments	7.6	12.9	7.6	12.9
	8,498.7	**7,864.1**	**8,262.5**	**7,552.3**

i) Retail financial services and secured personal lending credit risk

Risk concentrations

The group provides loans secured on residential property across England, Scotland and Wales and the Society, as a regional building society, has a geographical concentration in Wales.

The geographical concentration of first and second charge retail loans by account and value is shown below:

	Group by account		Group by value	
	2018 %	2017 %	2018 %	2017 %
In Wales	33.4	32.4	30.7	29.8
Outside Wales	66.6	67.6	69.3	70.2
	100.0	**100.0**	**100.0**	**100.0**

The group holds a high quality buy-to-let portfolio of £1,929.4m (2017: £1,696.6m). At the end of the year, 74% of buy-to-let mortgages were on interest only products, 25% repayable by capital and interest repayments and 1% a combination of interest only and capital and interest.

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property. The average index linked LTV in respect of the group's loans secured on residential property including mortgages under offer is estimated to be 58.2% (2017: 57.0%). Index-linked LTV banding is shown below:

	Group		Society	
	2018 %	2017 %	2018 %	2017 %
Less than 70%	68.3	71.1	68.3	71.2
More than 70% but less than 80%	14.1	13.4	14.1	13.3
More than 80% but less than 90%	10.8	10.2	10.8	10.4
More than 90% but less than 100%	4.7	3.6	4.7	3.5
More than 100%	2.1	1.7	2.1	1.6
	100.0	**100.0**	**100.0**	**100.0**

Performance

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than three months is 0.49% (2017: 0.53%) which compares favourably with the industry average of 0.78% (UK Finance and possession data at 30 September 2018). Residential lending cases fully secured by a first charge which were six months or more in arrears had arrears balances of £0.8m (31 December 2017: £0.8m) with 174 cases (31 December 2017: 179).

The percentage of secured personal loans currently in arrears of two months or more by number is 4.76% (2017: 4.63%), which by value is 5.67% (2017: 5.66%).

32. Credit risk (continued)

The table below provides further information on the first and second charge retail loans secured on residential property by payment due status:

	Group			
	2018		2017	
	£m	%	£m	%
Current	7,648.2	98.9	6,997.5	98.8
Past due up to 3 months	46.8	0.7	50.3	0.7
Past due 3 months up to 6 months	17.7	0.2	21.1	0.3
Past due 6 months up to 12 months	10.9	0.1	10.5	0.1
Past due over 12 months	5.3	0.1	7.2	0.1
Possessions	1.6	-	0.8	-
	7,730.5	**100.0**	**7,087.4**	**100.0**

	Society			
	2018		2017	
	£m	%	£m	%
Current	7,430.4	99.1	6,709.1	99.0
Past due up to 3 months	34.5	0.5	35.5	0.5
Past due 3 months up to 6 months	15.4	0.2	17.3	0.3
Past due 6 months up to 12 months	8.8	0.1	8.3	0.1
Past due over 12 months	3.6	0.1	4.5	0.1
Possessions	1.6	-	0.8	-
	7,494.3	**100.00**	**6,775.5**	**100.00**

Collateral values are updated at the date of each statement of financial position based on the best information publicly available. Land Registry data is used in the Retail Financial Services sector with Nationwide and Hometrack indices being used in the Secured Personal Lending business. Both indices take account of the geographical location of the collateral.

Based on indexed valuations the total collateral held in relation to lending secured against residential property is estimated to be £18,093.1m (2017: £17,224.4m).

The group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £2.3m (2017: £2.5m) of collateral is held against possession cases. Repossessed properties are made available-for-sale in accordance with statutory guidelines with proceeds used to reduce or repay the outstanding loan. The group has a statutory duty to obtain the best reasonable price and to sell as soon as it reasonably can. Any collateral surplus on the sale of repossessed properties, after a deduction for costs incurred in relation to the sale, would be returned to the borrower.

Impairment provisions are held against loans and advances to customers in line with the accounting policies which are outlined in note 1. Provisions on retail loans and mortgages by business segment are broken down as follows:

	2018 £m	2017 £m
Retail financial services	9.2	5.5
Secured personal loans	8.9	9.8
	18.1	**15.3**

Forbearance

The group uses a range of forbearance options which are considered based on the borrower's financial circumstances, agreed subject to set criteria and reviewed on a case-by-case basis. Forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. Repossession of a property will only take place once all alternatives have been reviewed and there are no other solutions available. 36 properties were taken into possession during 2018 (2017: 53) with balances of £3.0m (2017: £3.2m).

The table below sets out the mortgage balances which have had some form of forbearance over the last 12 months. Where accounts have had more than one form of forbearance the balance has been categorised based on the first instance of forbearance.

2018	Revised payment schedule £m	Transfer to interest-only £m	Term extensions £m	Other £m	Total £m
Current	12.2	11.0	-	3.0	26.2
Past due up to 3 months	9.7	0.6	-	0.4	10.7
Past due 3 months up to 6 months	4.1	-	-	0.3	4.4
Past due 6 months up to 12 months	1.5	0.2	-	0.5	2.2
Past due over 12 months	0.3	-	-	0.8	1.1
	27.8	**11.8**	**-**	**5.0**	**44.6**

2017	Revised payment schedule £m	Transfer to interest-only £m	Term extensions £m	Other £m	Total £m
Current	14.9	13.6	0.4	2.1	31.0
Past due up to 3 months	10.4	0.3	-	1.1	11.8
Past due 3 months up to 6 months	4.3	0.2	-	0.4	4.9
Past due 6 months up to 12 months	2.2	-	-	0.8	3.0
Past due over 12 months	0.7	0.1	-	2.1	2.9
	32.5	**14.2**	**0.4**	**6.5**	**53.6**

The underlying performance of previous forbearance activities are reflected in the provisioning methodology and are not individually or collectively material.

32. Credit risk (continued)

ii) 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 property.

Further detail of the group's risk management strategy in relation to commercial lending is described in the Risk Management Report on page 60.

The commercial loan portfolio is managed by a relationship team with many years' experience in the commercial property lending business. All lending is subject to a rigorous underwriting process, operating within a well-defined and conservative lending policy.

Risk concentrations

The group's commercial loan portfolio, excluding impairment provisions and fair value adjustments, comprises the following:

	Group and Society			
	2018		2017	
	£m	%	£m	%
Loans to Registered Social Landlords secured on residential property	145.9	18.8	153.8	19.7
Other loans secured on residential property	352.8	45.5	342.0	43.7
Loans secured on commercial property	277.4	35.7	286.2	36.6
	776.1	**100.0**	**782.0**	**100.0**

Loans secured on commercial property are well diversified by industry type and counterparty. An analysis of commercial property loans by industry is provided below:

	Group and Society			
	2018		2017	
	£m	%	£m	%
Office	98.0	35.3	96.4	33.7
Retail	103.3	37.3	104.7	36.6
Industrial	51.1	18.4	50.3	17.6
Leisure	6.0	2.2	11.8	4.1
Land	2.0	0.7	2.6	0.9
Other	17.0	6.1	20.4	7.1
	277.4	**100.0**	**286.2**	**100.0**

The group provides loans secured on commercial property across England and Wales and the Society, as a regional building society, has a geographical concentration in Wales. An analysis of commercial property loans by geographical location is provided below:

Region	Group and Society			
	2018		2017	
	£m	%	£m	%
Wales	365.6	47.2	379.2	48.5
Greater London	251.8	32.4	228.8	29.3
South East/East of England	41.3	5.3	46.6	6.0
Midlands	27.4	3.5	28.7	3.7
South West/South of England	39.6	5.1	38.6	4.9
North West/North of England	22.6	2.9	30.8	3.9
Mixed/other	27.8	3.6	29.3	3.7
	776.1	**100.0**	**782.0**	**100.0**

The average loan to value (LTV) in respect of the group's commercial loans is estimated to be 52.8% (2017: 56.8%). LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/tenant as well as geographical location.

£7.0m of exposures have an LTV of greater than 100% (2017: £17.7m). Of these, £6.2m are already classified as impaired and a further £0.8m are on the watch-list.

The largest exposure to one counterparty is £29.6m (2017: £29.6m) or 3.8% (2017: 3.8%) of gross balances.

Performance

The commercial lending risk procedure for loans and advances to customers is described in the Risk Management Report on page 60.

Using the commercial credit risk grading system the commercial loan portfolio is distributed as follows (the figures exclude provision for loan impairment and fair value adjustments):

	Group and Society			
	2018		2017	
	£m	%	£m	%
Exposures not classified as higher risk	765.4	98.6	753.1	96.3
Watch-list	0.8	0.1	11.8	1.5
Impaired or past due up to 3 months	9.9	1.3	17.1	2.2
	776.1	**100.0**	**782.0**	**100.0**

32. Credit risk (continued)

Under the IRB supervisory slotting approach for specialised lending, which includes commercial property lending (Income Producing Real Estate – "IPRE"), the book is categorised as follows:

Slot	Standardised £m	Strong £m	Good £m	Satisfactory £m	Weak £m	Default £m	Total £m	%
Registered Social Landlords	146.0	–	–	–	–	–	146.0	18.8
Commercial Investment (including Owner Occupier)	–	11.3	199.7	54.3	3.8	5.0	274.1	35.3
Residential Investment	–	2.4	271.2	22.5	–	4.9	301.0	38.8
Commercial Development	–	–	3.2	–	–	–	3.2	0.4
Residential Development	–	–	44.9	6.9	–	–	51.8	6.7
	146.0	**13.7**	**519.0**	**83.7**	**3.8**	**9.9**	**776.1**	**100.0**

Watch-list exposures are categorised in line with the perceived severity of the risk to identify cases having the greatest potential cause for concern and to facilitate timely risk mitigation activity. Accounts on the watch-list are typically those which have had a material covenant breach, have persistent arrears (but are not presently >30 days past due) or where there are other concerns about the likelihood of eventual repayment. Defaulted accounts are described as impaired.

The table below provides further information on commercial loans and advances by defaulted and delinquency status:

	Group and Society			
	2018		2017	
	£m	%	£m	%
Unimpaired				
Current	766.2	98.7	764.9	97.8
Past due 1 to 3 months	–	–	–	–
Impaired				
Past due 3 to 6 months	0.6	0.1	–	–
Past due 6 to 12 months	–	–	–	–
Past due over 12 months	–	–	–	–
Defaulted but not past due	9.3	1.2	17.1	2.2
Law of Property Act (LPA) Receivers appointed	–	–	–	–
	776.1	**100.0**	**782.0**	**100.0**

There are 2 commercial cases (2017: nil) three months or more in arrears (fixed charge receiver appointed). Total arrears of one month or more are £0.6m (2017: £nil).

The total collateral held against commercial loans is estimated to be £1,608m (2017: £1,546m). Lending is classified by sector according to the property type held as collateral. The current value of collateral is estimated based on the latest professional valuation adjusted for subsequent commercial property price movements. Where considered necessary, new professional valuations are commissioned.

Provisions are held against impaired loans as follows:

	Group and Society 2018		
	Stage 1 £m	Stage 2 £m	Stage 3 £m
Commercial lending provisions	2.4	5.3	4.7
Total provisions	**2.4**	**5.3**	**4.7**

From 1 January 2018, provisions are now held under IFRS 9. Total provisions at 31 December 2018 are £12.4m.

	Group and Society 2017 £m
Collective provisions	9.0
Specific provisions	6.0
Total provisions	**15.0**

Forbearance

In some cases of default, or in order to avoid a default, action plans are implemented which may require the granting of a concession involving amendments to the contractual terms of a loan, such as an extension of a maturity, reduction in interest rate or non-enforcement of covenants, recognising that providing such forbearance can often be the best way to avoid default and minimise losses, giving the customer time to take action to improve their situation. Such forbearance activity is always carefully considered with the aim of maximising the benefit and optimising the outcome for both the group and the borrower. In 2018, 3 (2017: 1) accounts with balances totalling £4.5m (2017: £1.9m) in value were granted forbearance concessions. The total exposure in forbearance at December 2018 stands at balances of £10.3m and 12 accounts (2017: £28.3m, 21 accounts). The potential for losses on these accounts is assessed and considered in the level of overall provisions held against the Commercial Lending portfolio. Additionally, their status in terms of whether deemed impaired or placed on the watch-list is also considered on a regular basis.

b) Treasury financial instruments

The treasury credit risk strategy is described in the risk report on page 61.

The classes of financial instruments to which the group is most exposed to Treasury credit risk are loans and advances to credit institutions, debt securities and financial derivatives. For financial assets recognised in the statement of financial position, the exposure to credit risk equals their carrying amount. For loan commitments and guarantees, the exposure to credit risk is the full amount committed. The following table shows the group's estimated maximum exposure to credit risk without taking into account any collateral held or other credit enhancements.

32. Credit risk (continued)

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
UK government securities	–	85.9	–	85.9
UK financial institutions	156.9	237.4	76.7	128.2
	156.9	**323.3**	**76.7**	**214.1**

None of these exposures was either past due or impaired and there are no assets that would otherwise be past due or impaired whose terms have been renegotiated.

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £0.3m (2017: £6.3m) is held over derivative financial instruments.

The following table shows the exposures broken down by Fitch ratings:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
AAA to AA-	92.5	248.2	48.8	173.7
A+ to A-	61.5	60.3	25.0	27.4
BBB+ to BBB-	2.9	14.8	2.9	13.0
	156.9	**323.3**	**76.7**	**214.1**

The geographical distribution of these exposures is as follows:

	Group		Society	
	2018 £m	2017 £m	2018 £m	2017 £m
UK	156.9	323.3	76.7	214.1
	156.9	**323.3**	**76.7**	**214.1**

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.

33. Liquidity risk

The following tables analyse the gross contractual principal cash flows payable under financial liabilities. These balances will not agree directly to the balances in the consolidated statement of financial position as the table incorporates only principal amounts and does not reflect accrued interest or fair value adjustments.

2018	Undefined maturity £m	Less than 3 months £m	Between 3 months and 1 year £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Group						
Non-derivative liabilities						
Shares	-	3,990.1	1,143.7	1,805.3	-	6,939.1
Amounts owed to credit institutions	0.3	177.9	10.5	675.0	-	863.7
Other customers	-	75.5	65.4	-	-	140.9
Debt securities in issue	-	37.8	114.7	857.3	-	1,009.8
Subscribed capital	-	-	-	60.0	-	60.0
	0.3	**4,281.3**	**1,334.3**	**3,397.6**	**-**	**9,013.5**
Society						
Non-derivative liabilities						
Shares	-	3,990.1	1,143.7	1,805.3	-	6,939.1
Amounts owed to credit institutions	0.3	213.2	112.4	1,170.7	-	1,496.6
Other customers	-	75.5	65.4	-	-	140.9
Debt securities in issue	-	-	-	298.7	-	298.7
Subscribed capital	-	-	-	60.0	-	60.0
	0.3	**4,278.8**	**1,321.5**	**3,334.7**	**-**	**8,935.3**
Group						
Derivative liabilities						
Interest rate swaps	-	0.1	1.9	20.3	9.3	31.6
	-	**0.1**	**1.9**	**20.3**	**9.3**	**31.6**
Society						
Derivative liabilities						
Interest rate swaps	-	0.1	1.9	20.0	9.3	31.3
	-	**0.1**	**1.9**	**20.0**	**9.3**	**31.3**

2017	Undefined maturity £m	Less than 3 months £m	Between 3 months and 1 year £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Group						
Non-derivative liabilities						
Shares	–	3,926.7	759.9	1,831.2	–	6,517.8
Amounts owed to credit institutions	6.3	40.2	17.7	506.4	–	570.6
Other customers	–	88.3	127.9	–	–	216.2
Debt securities in issue	–	47.2	153.1	743.8	298.4	1,242.5
Subordinated liabilities	–	–	–	–	–	–
Subscribed capital	–	–	–	60.0	–	60.0
	6.3	**4,102.4**	**1,058.6**	**3,141.4**	**298.4**	**8,607.1**
Society						
Non-derivative liabilities						
Shares	–	3,926.7	759.9	1,831.2	–	6,517.8
Amounts owed to credit institutions	6.3	56.1	129.1	1,204.4	–	1,395.9
Other customers	–	88.3	127.9	–	–	216.2
Debt securities in issue	–	0.5	13.0	–	298.4	311.9
Subordinated liabilities	–	–	–	–	–	–
Subscribed capital	–	–	–	60.0	–	60.0
	6.3	**4,071.6**	**1,029.9**	**3,095.6**	**298.4**	**8,501.8**
Group						
Derivative liabilities						
Interest rate swaps	–	0.1	1.9	15.0	12.2	29.2
	-	**0.1**	**1.9**	**15.0**	**12.2**	**29.2**
Society						
Derivative liabilities						
Interest rate swaps	–	0.1	1.9	14.0	12.2	28.2
	-	**0.1**	**1.9**	**14.0**	**12.2**	**28.2**

Further information on the Society's approach to managing capital risk is described within the Risk Management report on pages 68-70.

34. Market risk

Market risk can be sub-divided into interest rate risk and currency risk.

Interest rate risk

Interest rate risk is the risk that the value of, or income arising from, the group's assets and liabilities changes as a result of movements in market rates. The group reviews the potential impact that six interest rate scenarios (a range of parallel and non-parallel market rate shifts) could have on the market value of its financial assets and liabilities, on a discounted cashflow basis. Account is also taken of those assets and liabilities with embedded optionality, such as pipeline and prepayment risk on fixed rate mortgages. The group monitors its position continuously and operates within parameters set by Board Risk Committee. As at 31 December 2018, the economic value of the group's balance sheet would have reduced by £0.4m in the case of a 2% parallel shift upwards.

Because market risk can manifest itself as both an impact on the group's economic value and/or the group's earnings (or Net Interest Income), both metrics are considered when assessing the level of interest rate risk in the banking book and are monitored via Finance Committee and Board Risk Committee.

Currency risk

The group has no material exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates.

35. Related party transactions

The remuneration of the Directors (including Non-Executive Directors), who are the key management personnel of the group, is set out in the Report of the Remuneration Committee on pages 78-87.

Loans to and shares held by Directors

There was an aggregate of £0.2m (2017: £0.2m) outstanding at the end of the financial year in respect of secured advances made prior to or during the year to Directors.

In so far as it is required under Section 68(1) and Section 68(3) of the Building Societies Act 1986, details of such loans are maintained in a register kept at Principality Buildings, Queen Street, Cardiff, and a statement containing requisite particulars will be available for inspection by Members at the same address for the period of 15 days prior to the Annual General Meeting to be held on 27 April 2019.

As required by the Society's Rules, each Director has a share account. The Society's duty of confidentiality to its Members precludes individual disclosure of these details; the aggregate total of deposits held by Directors was £0.1m (2017: £0.1m).

Directors' transactions

There were no other transactions with Directors during the year.

Transactions with group companies

The Society undertook the following transactions with group companies during the year:

2018	Interest paid to Society £m	Fees paid to Society £m
Year ended 31 December 2018		
Nemo Personal Finance Limited	7.1	1.3
	7.1	**1.3**
Year ended 31 December 2017		
Nemo Personal Finance Limited	9.0	0.6
	9.0	**0.6**

At the year-end the following balances were outstanding:

2018	Loans owed to Society 2018 £m	Loans owed to Society 2017 £m
Nemo Personal Finance Limited	135.2	218.7
	135.2	**218.7**

Annual business statement

for the year ended 31 December 2018

1. Statutory percentages

	At 31 December 2018 %	At 31 December 2017 %	Statutory limit %
The lending limit	3.4	4.2	25.0
The funding limit	22.5	23.7	50.0

The percentages are calculated in accordance with, and the statutory limits are those prescribed by, Sections 6 and 7 of the Building Societies Act 1986 (as substituted by the Building Societies Act 1997) and are based on the consolidated statement of financial position.

2. Other percentages

As a percentage of shares and borrowings:	2018 %	2017 %
Gross capital	6.8	6.8
Free capital	6.4	6.7
Liquid assets	12.4	15.4
As a percentage of mean total assets:		
Profit for the year as a percentage of statutory mean total assets	0.35	0.50
Management expenses as a percentage of statutory mean total assets	0.86	1.02

Gross capital is the aggregate of general reserve, available-for-sale reserve, subscribed capital and subordinated liabilities.

Free capital is gross capital plus collective impairment provisions less intangible assets and property, plant and equipment.

Liquid assets represent the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.

Annual Business Statement (continued)

Mean total assets represent the average of the total assets in the consolidated statement of financial position at the beginning and end of the year.

Management expenses represent the aggregate of administrative expenses, depreciation and amortisation.

Directors

Details of Directors are contained on pages 36-40.

Details of Directors' service contracts are included in the Report of the Remuneration Committee on page 87.

Documents may be served on any of the Directors c/o Eversheds Sutherland, Reference RP, 1 Callaghan Square, Cardiff CF10 5BT.

No Director or other officer, including connected persons, has any right to subscribe for share capital in, or debentures of, any connected undertaking of the Society.

Subsidiary companies

Nemo Personal Finance Limited
Chief Executive:
Iain Mansfield

Glossary

Additional Tier 1 capital	A component of regulatory capital comprising permanent interest-bearing shares (PIBS) and other qualifying instruments after regulatory adjustments.
Administered Rate	A rate which is set by the Society, such as SVR, and that is at the Society's discretion to change, subject to the terms and conditions of the product.
Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan payment is overdue. Such a customer can also be said to be in a state of delinquency.
Basel III	In December 2010, the Basel Committee on Banking Supervision issued the Basel III rules text, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity.
Brand Consideration	Brand Consideration measures whether a respondent would actively consider Principality as a potential provider when approaching a new purchase.
Buffer eligible liquid assets	Includes high quality debt securities issued by a government or central bank, securities issued by a designated multilateral development bank or reserves in the form of sight deposits with a central bank in an EEA State or Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.
Business assets	The total assets of the Society and its subsidiary undertakings as shown in the statement of financial position plus provision for loan impairment, less fixed assets and liquid assets.
Capital Requirements Directive (CRD IV)	European legislation to implement Basel III, which includes the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD).
Commercial lending	Secured loans to a commercial borrower.
Commercial property	Includes office buildings, industrial property, medical centres, hotels, retail stores, shopping centres, multifamily housing buildings, warehouses, garages and industrial properties.
Contractual maturity	The final payment date of a loan or other financial instrument, at which point the entire remaining outstanding principal and interest is due to be repaid.

Common Equity Tier 1 capital	The highest quality form of capital as defined in the Capital Requirements Directive IV, comprising accumulated reserves and qualifying instruments after regulatory deductions.
Common Equity Tier 1 capital ratio	Common Equity Tier 1 capital as a proportion of risk-weighted assets.
Cost income ratio	A ratio that represents the proportion of management expenses (i.e. administrative expenses, depreciation and amortisation) to total income.
Covered bonds	A type of wholesale funding backed by cash flows from mortgages.
Credit risk	The risk of financial loss arising from a failure of a customer or counterparty to settle their financial and contractual obligations as they fall due.
Credit Valuation Adjustment (CVA)	An adjustment that represents an estimate of the change to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures.
Debt securities in issue	Transferable certificates of indebtedness including certificates of deposits, and fixed and floating rate notes.
Defined benefit pension scheme	A scheme that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary.
Defined contribution pension scheme	A scheme into which the group and the employee pay fixed contributions without any obligation to pay further contributions.
Delinquency	See Arrears.
Effective Interest Rate method (EIR)	The group uses the EIR method to recognise income for certain financial instruments held at amortised cost. To calculate the appropriate EIR, the group makes assumptions of the expected lives of financial instruments and the anticipated level of early redemption charges.
Euro Medium Term Note (EMTN)	Medium term flexible debt instrument.

Glossary (continued)

Expected Loss (EL)	A regulatory capital calculation to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.
Exposure	The maximum loss that a financial institution might suffer if a borrower or counterparty fails to meet its obligations to the group.
Exposure At Default (EAD)	A regulatory capital parameter used to estimate the amount outstanding at the time of default.
Financial Conduct Authority (FCA)	The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from 1 April 2013. The FCA also has responsibility for protecting consumers and promoting healthy competition.
Financial Services Compensation Scheme (FSCS)	A protection fund for depositors of failed institutions. This is funded by the financial services industry and each firm, including the Society, is obliged to pay an annual levy.
Forbearance strategies	Strategies to assist borrowers in financial difficulty, such as extending loan terms, temporarily converting loans to an interest-only basis and agreeing a temporary reduction in payments. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.
Funding limit	The proportion of shares and borrowings not in the form of customer accounts held by individuals.
Individual Liquidity Adequacy Assessment Process (ILAAP)	The group's internal assessment of the levels of liquidity that need to be held by the Society to meet its regulatory liquidity requirements.
Impaired loans	Loans where there is evidence to suggest a measurable decrease in the present value of expected cash flows that has occurred after initial recognition of the asset, but before the statement of financial position date.
Individually/collectively assessed impairment allowances	Impairment is measured individually for assets and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available. Collective assessment also covers losses that have occurred but are not yet individually identified on loans subject to individual assessment.
Individual Liquidity Guidance (ILG)	Guidance from the PRA on the required quantity of a firm's liquidity resources and the firm's funding profile.
Internal Capital Adequacy Assessment Process (ICAAP)	The group's internal assessment of the levels of capital that need to be held by the Society to meet its regulatory capital requirements.

International Swaps and Derivatives Association (ISDA) master agreement	A standardised contract developed by ISDA and used to enter into bilateral derivatives transactions. The contracts grant legal rights of set-off for derivative transactions with the same counterparty. This reduces the credit risk of the derivatives to the extent that negative values offset positive values.
Internal Ratings Based (IRB)	An approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk sensitive than the standardised approach and may be Foundation or Advanced. IRB approaches may only be used with PRA permission.
Lending limit	The proportion of business assets not in the form of loans fully secured on residential property.
Leverage ratio	A Basel III ratio which measures Tier 1 capital against total on and off balance sheet assets.
LIBOR	London Inter Bank Offered Rate.
Liquid assets	Cash or other assets that can be readily converted to cash without loss of value.
Liquidity Coverage Ratio (LCR)	A liquidity metric which aims to ensure that a firm maintains an adequate level of liquidity to meet its needs for a 30 calendar day time horizon under a severe stress scenario.
Liquidity and funding risk	The risk that the group does not hold sufficient liquidity, in terms of quantity and quality, to meet its liabilities as they fall due.
Loan To Value ratio (LTV)	A ratio showing outstanding loan balance as a percentage of the value of the security.
Loss Given Default (LGD)	The difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.
Management Expense Ratio	A ratio that measures cost as a proportion of mean assets.
Member	A person who has a share investment or a mortgage loan with the Society.
Net interest income	The difference between the interest received on assets and the interest paid on liabilities.

Glossary (continued)

Net interest margin	This ratio calculates the net interest income as a percentage of mean total assets.
Net Stable Funding Ratio (NSFR)	A liquidity ratio, currently proposed under Basel III, to calculate the proportion of long-term assets that are funded by stable, long-term funding sources (customer deposits and long-term wholesale funding).
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
Overnight Indexed Swap rate (OIS)	A rate reflecting the overnight interest typically earned or paid in respect of collateral exchanged. OIS is used in valuing collateralised interest rate derivatives.
Permanent Interest-Bearing Shares (PIBS)	Unsecured, Sterling denominated Additional Common Equity Tier 1 capital instruments repayable at the option of the Society.
Plevin	In November 2014, the Supreme Court ruled in Plevin v Paragon Personal Finance Ltd (Plevin) that a failure to disclose a commission payment on a PPI policy made the relationship between a lender and the borrower unfair under the Consumer Credit Act.
Prudential Regulation Authority (PRA)	The UK prudential regulator, which is a part of the Bank of England and alongside the FCA has responsibility for the oversight of building societies, banks and insurers. The PRA's objective is to promote the safety and soundness of regulated firms.
Probability of Default (PD)	A regulatory capital parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.
Recovery and Resolution Plans	The recovery plan outlines the steps the Society can take to prevent failure. The resolution plan includes the data required by the Bank of England to establish an orderly resolution of the Society's affairs, in the event that recovery cannot be achieved.
Regulatory capital	Capital allowable under regulatory rules, less certain required regulatory adjustments and deductions.

Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)	A repurchase agreement (repo) is a transaction in which the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the counterparty to the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo.
Residential Mortgage Backed Securities (RMBS)	A category of asset backed security that represents interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).
Retail loans	Loans to individuals rather than institutions, including residential mortgage lending.
Risk appetite	The articulation of the level of risk that the group is willing to take (or not take) in order to safeguard the interests of the Society's Members whilst achieving business objectives.
Risk-Weighted Assets (RWA)	A regulatory measure that adjusts the value of assets to reflect their level of risk when calculating capital requirements.
Securitisation	A process by which a group of assets, usually loans, is aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) which then issues securities backed by the assets. The group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.
Senior unsecured debt funding	Bonds issued by corporate bodies and financial institutions, which are not secured by any collateral and are not subordinated to any other liabilities of the Society.
Shares	Money deposited by Members in a retail savings account with the Society and held as a liability in the statement of financial position.
Shares and borrowings	The total of shares, deposits from banks, other deposits, amounts due to customers and debt securities in issue.
Solvency ratio	A component of regulatory capital measuring of the group's total regulatory capital as a proportion of the group's risk weighted assets.

Special Purpose Entities (SPEs)	Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The group uses an SPE set up under securitisation programme. Where the group has control of these entities or retains the risks and rewards relating to them they are consolidated within the group's results. This term is used interchangeably with SPV (special purpose vehicle).
Standardised approach	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.
Stress testing	Various techniques that are used by the group to gauge the potential vulnerability to exceptional but plausible events.
Subscribed capital	See permanent interest-bearing shares (PIBS).
Subordinated debt/liabilities	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 (PIBS).
Tier 1 capital ratio	Tier 1 capital as a proportion of risk-weighted assets.
Tier 2 capital	A further component of regulatory capital comprising subordinated debt less certain regulatory deductions.
Value at Risk (VAR)	A technique that estimates the potential loss that could occur on risk positions as a result of future movements in market rates and prices over a specified time horizon and to a given level of statistical confidence.

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