HALF YEAR FINANCIAL STATEMENTS

2018

Building your future

Principality
Building Society
Cymdeithas Adeiladu

Where home matters
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Forward Looking Statements

This interim report contains certain forward-looking statements. These statements are made by the directors in good faith based on the information available to them up to the time of their approval of this report, and such statements should be treated with caution due to the inherent uncertainties, including both economic and business risk factors, underlying any such forward-looking information.

Therefore, actual results may differ materially from those expressed or implied by these forward-looking statements.

The directors undertake no obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

Underlying Profit

Profit before tax on both an underlying and statutory basis is shown on page 5. Statutory profit before tax of £24.9m has been adjusted for fair value gains and losses from derivatives and hedge accounting and Financial Services Compensation Scheme levies resulting from historic failures of deposit taking institutions, to derive an underlying profit before tax of £27.4m. The purpose of this measure is to reflect management’s view of the group's underlying performance, to aid comparability across reporting periods.

Chief Executive's review

I am pleased to announce another good half-year performance from Principality Building Society. Despite continued competition in the mortgage market, our net residential mortgage lending increased by £340.3m in the first six months of this year (June 2017: £357.5m), bringing our total assets to £9.6bn (December 2017: £9.3bn). This growth has been delivered against a backdrop of uncertainty over UK base rate increases, geo-political restlessness and Brexit negotiations, which have all undoubtedly had an impact on consumer confidence and market volatility.

In order to support the growth in our lending we attracted an additional £309.3m in savings, with competitively priced products that have maintained our position as one of the best on the High Street. The savings rates we can offer are impacted by the interest we earn on mortgages, and to ensure our business continues in an affordable and sustainable way we have to balance our commitment to support savers with the need to offer competitive mortgage pricing. With that in mind, we have still delivered an average rate to savers of 1.06%, compared with a market average over the same period of 0.68%[1].

We take a long-term view in our approach to running the business in the best interests of our Members and, as anticipated and previously communicated, this has resulted in underlying profits falling year on year from £29.5m to £27.4m. 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 ensure we are relevant for the future;
- higher interest payable as a consequence of securing long-term wholesale funding and continuing to pay great savings rates to our Members; and
- the run-off of Nemo, our second charge loans business, as we redeploy capital into residential mortgage lending.

Statutory pre-tax profit was £24.9m (June 2017: £31.8m) which has been impacted by the above factors together with fair value movements in derivatives as set out in the Business Review.

I am immensely proud of our performance and the delivery of my colleagues in the first six months, in an increasingly challenging market. Our service to our Members continues to be stand-out and our Members tell us it sets us apart from the competition.

Our strong performance and profitability in recent years has helped to support the significant investment in our technology, our branches and our people. Our capital and liquidity remain strong and our arrears levels low. It is vital to our business that we continue to provide safety and security for our Members, but at the same time we need to adapt to secure our organisation for existing and future generations.

Digital technology is evolving at a rapid pace and our Members have told us they want flexibility and the opportunity to do business with us through their channel of choice – be that through branches, online, by phone, or other mobile devices. We have already made a number of improvements to our online service to complement our great branch network, and more are planned in the second half of the year.

Over the last 12 months we have fully reviewed our mortgage end-to-end journey, updating many of our internal processes and systems to make it much easier for customers and brokers to do business with us. We have significantly improved our mortgage speed to offer and our broker satisfaction results are at a record high. We have also enhanced our approach to maturing savings, both by offering tailored maturity products and by simplifying the process, resulting in increased savings retention.

1 Source: CACI data as at 19 July 2018. Weighted UK average interest rates for fixed and variable rate stock and new business to April 2018.

Chief Executive's review (continued)

While major banks are disappearing from local communities across Wales, we remain committed to the High Street. Our branch refurbishment programme has continued and we are seeing an increase in customer transactions in branches compared with the same period in 2017. The prosperity of our Members and communities in which we operate is core to why we exist and delivering great customer service is the bedrock of our building society. We are making life easier for our Members and becoming more efficient in how we serve them. We have invested in cyber, data and privacy protection, proof that we are delivering on our promises to make our Society even better and protecting the interests of our Members.

Good performance in the first half of the year

The building society has delivered a good trading performance in the first half of the year, with the following key highlights:

- Total assets £9.6bn (31 December 2017: £9.3bn)
- Savings balances have increased by £309.3m (30 June 2017: £366.9m)
- Net residential mortgage balances of £7,115.8m (31 December 2017: £6,775.5m)
- Gross residential mortgage lending for the first six months of the year of £912.9m (30 June 2017: £814.8m)
- Underlying pre-tax profits of £27.4m (30 June 2017: £29.5m)
- Statutory pre-tax profits of £24.9m (30 June 2017: £31.8m)
- 84.1% of mortgages funded by savers (31 December 2017: 83.5%)
- Strong capital with a Common Equity Tier 1 ratio of 25.2%[1] (30 June 2017: 23.4%)
- Arrears levels remain consistently low, with the percentage of first charge cases greater than three months in arrears currently standing at 0.52% (31 December 2017: 0.53%)
- Customer Service Net Promoter Score performed strongly at 79.2%[2] (31 December 2017: 74.8%)
- Net interest margin of 1.29% (30 June 2017: 1.45%)

1. Excluding unaudited interim profits. The equivalent ratio including interim profits at 30 June 2018 would be 26.2%.
2. Source: Based on internal survey data for the 6 months ended 30 July.

Society Businesses

Our Commercial lending division together with Nemo, our second charge loans business, are important in delivering financial dividends to our Members. Principality Commercial has been performing strongly in recent years signing a number of high profile deals across Wales and the South East of England, and has recorded a half year pre-tax profit of £8.2m (June 2017: £8.5m), originating £69.2m of new deals in the first six months of this year with a loan book size of £775.6m. Nemo has again made a meaningful contribution to the overall results with a pre-tax profit of £7.2m (June 2017: £8.4m).

Members, Communities and Colleagues

Supporting our local communities and helping them prosper is what we do as a mutual building society. In the first half of the year, our colleagues have yet again put in considerable effort to raise more than £86,000 for our three chosen charity partners (Llamau, School of Hard Knocks and Cancer Research Wales), taking the total amount raised to well over £300,000 in the two and half years we have been supporting them. Colleagues have also volunteered almost 600 hours to help us achieve our Corporate Social Responsibility objectives of helping people to stay in a home for longer, health & wellbeing and financial education. The Society has invested £44,000 to support more than 50 community groups and school projects across Wales.

We've helped more than 1,200 pupils helped through our school activities, including financial education workshops. This includes sponsoring more than 200 pupils to complete the London Institute of Banking & Finance L2 qualifications, which are the equivalent to a GCSE.

Chief Executive’s review (continued)

Members, Communities and Colleagues (continued)

Our culture is renowned for being friendly, open and inclusive where we actively encourage everyone to be themselves at work. Our people are our most important asset and make us stand out in the finance sector. They are the driving force behind our success and I am proud that our efforts to create a diverse and inclusive working environment have received recognition by being named as a UK Best Workplace™ at the Great Place to Work® awards.

We received an excellent Net Promoter Score of 79 per cent from our Members, which is market leading and double the average in the financial sector. This score is based on people being prepared to recommend us as a provider to other people, and is an excellent endorsement of the work we do for our Members.

Our colleagues’ efforts have also been recognised with the following national awards in the first half of the year:

- What Mortgage Best Building Society Customer Service
- Moneyfacts ISA Provider of the Year
- Best Small Contact Centre of the Year awarded for outstanding customer service
- Education Award at the Wales Responsible Business Awards 2018 for our financial education work across schools in Wales

Outlook

Our business will continue to grow in the next six months but we expect market conditions to remain challenging and cause continued pressure on margin. Scale and growth are important to the Society’s strategy and we will grow in a safe and sustainable way but headline profitability will fall as we reshape and invest in our business for the long-term. While political and economic uncertainty will undoubtedly affect the financial landscape, our balance sheet is strong and we have the resilience to withstand economic headwinds. Our single minded focus is on transforming our core mortgage and savings business through investment in technology, customer service and our colleagues, to meet the future needs of our Members. We will drive efficiency in the way we do things to ensure we provide value to our Members and protect their interests for the long-term.

Stephen Hughes
Chief Executive
31 July 2018

Business review
for the six months ended 30 June 2018

Key Financial Performance Indicators

The business monitors a number of key financial performance indicators (KPIs) to measure progress towards its strategic objectives.

	30 June 2018	30 June 2017	31 December 2017
Purpose Led Organisation			
Net Mortgage Growth	£313.5m	£291.7m	£816.7m
Brand Consideration[1]	20.5%	17.9%	18.4%
Cost Income Ratio	63.4%	57.6%	65.0%
Brilliant People			
Employee Engagement Score[2]	78.0%	-	78.0%
Stand-Out Experience			
Net Promoter Score[3]	79.2%	74.0%	74.8%
Underlying Profit Before Tax	£27.4m	£29.5m	£53.8m
Statutory Profit Before Tax	£24.9m	£31.8m	£57.6m
Net Interest Margin	1.29%	1.45%	1.44%
Common Equity Tier 1 Ratio[4]	25.2%	23.4%	26.1%

1. The brand consideration metric is now provided by an alternative third-party. Comparative figures have been restated.
2. The employee engagement survey is performed annually in the second half of the year.
3. Source: Based on internal survey data for the 6 months ended 30 June 2018.
4. Excluding unaudited interim profits. The equivalent ratio including unaudited interim profits at 30 June 2018 would be 26.2% for CET1.

The above key performance indicators, apart from statutory profit before tax, are alternative performance measures (APMs) which are internally used to inform with key management decisions. Further information on these APMs can be found within the 2017 Annual Report and Accounts within the strategic report and glossary sections.

Financial Performance

Income Statement

Underlying pre-tax profit was £27.4m (30 June 2017: £29.5m). Statutory pre-tax profit was £24.9m (30 June 2017: £31.8m). Both measures reflect the ongoing performance of the business, and support the ability to invest for the longer term.

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

	30 June 2018 £m	30 June 2017 (restated) £m	31 December 2017 (restated) £m
Statutory profit before tax	24.9	31.8	57.6
Adjusted for:			
Losses/(gains) from derivatives and hedge accounting	2.2	(2.4)	(4.3)
FSCS levies	0.3	0.1	0.1
Underlying profit	27.4	29.5	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. Comparative periods have been restated accordingly.

Business review (continued)

for the six months ended 30 June 2018

Net Interest Margin

Net interest margin for the period was 1.29% (31 December 2017: 1.44%). The change in net interest margin is down to multiple factors, but is primarily driven by the reduction to £273.3m (31 December 2017: £311.8m) in the total assets held in Nemo, as the interest being earned on these loans has historically been higher than retail loans due to the nature of the business. Further factors include the very competitive residential mortgage market and impact of interest costs of senior unsecured debt issued in the prior year.

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 will reverse as the asset or liability approaches maturity. During the period the group recognised a loss of £2.2m in the income statement (30 June 2017: £2.4m gain) in relation to these movements in fair value.

Operating Expenses

Operating expenses reduced in the period to £38.8m (30 June 2017: £39.6m). The cost of investment in strategic programmes to transform our core mortgages and savings business has been offset through efficiencies gained from an ongoing focus on cost management and the lower cost of servicing the secured personal lending portfolio.

Total operating expenses are set out in the table below:

	30 June 2018 £m	30 June 2017 £m	31 December 2017 £m
Retail financial services	35.5	35.0	80.5
Commercial lending	1.8	1.8	3.6
Secured personal lending	1.5	2.8	5.5
Total operating expenses	38.8	39.6	89.6
Management expense ratio	0.83%	0.92%	1.02%
Cost/Income ratio	63.4%	57.6%	65.0%

Impairment

Impairment provisions for loans and advances to customers was a release of £2.9m (30 June 2017: £2.8m release). This was driven by a continued focus on the resolution of the remaining low credit quality loans in the commercial division. Provisioning levels reflect the prudent approach taken to lending and robust affordability, credit quality and underwriting standards. These standards mean the business is well positioned to deal with any potential future volatility associated with the current uncertain political and economic environment.

Arrears performance continues to remain strong across all portfolios, with arrears of more than three months of 0.52% in the retail mortgage portfolio (31 December 2017: 0.53%).

Business review (continued)
for the six months ended 30 June 2018

Impairment (continued)

Total impairment provisions held are as follows:

	IFRS 9	IAS 39	IAS 39
	30 June 2018 £m	30 June 2017 £m	31 December 2017 £m
Retail mortgages	7.0	6.0	5.5
Secured personal lending	9.4	13.6	9.8
Commercial lending	11.2	22.6	15.0
Total	27.6	42.2	30.3

Impairment provisions at 30 June 2018 are now calculated in accordance with IFRS 9, where provisions for comparative periods were calculated under IAS 39. Further information can be found in note 1.

Statement of Financial Position

Loans and advances to customers
Total assets have increased to £9,590.9m (31 December 2017: £9,262.6m), driven by growth in residential mortgage lending. The residential mortgage portfolio increased to £7,115.8m (31 December 2017: £6,775.5m), and the quality of the loans remains strong with an average indexed loan to value of 58.3% (31 December 2017: 57.0%). The Commercial lending portfolio increased to £775.6m (31 December 2017: £763.9m), and the Nemo portfolio has decreased to £273.3m (31 December 2017: £311.8m).

Funding
Retail savings increased to £6,873.1m (31 December 2017: £6,563.8m), reflecting the continued focus on providing competitive products to Members in the continuing low interest rate environment.

Capital and Liquidity
The capital position remains robust, with a CET1 ratio of 25.2% (31 December 2017: 26.1%), and a leverage ratio of 5.3% (31 December 2017: 5.3%), both well above the minimum regulatory requirements. The equivalent ratios including interim profits at 30 June 2018 would be 26.2% for CET1 and a leverage ratio of 5.5%.

The business continues to hold a prudent buffer of high quality liquid assets, with a liquidity ratio of 14.9% (31 December 2017: 14.6%). The Liquidity Coverage Ratio (LCR) is 186.2% as 30 June 2018 (31 December 2017: 203.0%), which remains well above the current regulatory minimum of 100%.

Principal Risks and Uncertainties
The principal risks and uncertainties affecting the group were set out on pages 49 to 57 of the Annual Report and Accounts for the year ended 31 December 2017. These risks are categorised as: credit, market, liquidity and funding, conduct, operational, business, solvency and legal and regulatory risk, which are common to most financial services firms in the UK. These risks continue to affect the business at 30 June 2018 and there have been no material changes to the approach to risk management during the first half of the year.

The outlook for the UK economy remains uncertain. This uncertainty is driven by various factors such as: the ongoing Brexit negotiations, macro-economic factors, the possibility of a UK rate rise and the ongoing difficulties faced by the high street.

Business review (continued)
for the six months ended 30 June 2018

Principal Risks and Uncertainties (continued)

The business is well placed to meet these challenges and the continuing surrounding uncertainty, with a diversified and flexible funding base, and strong levels of both capital and liquidity.

Tom Denman
Chief Financial Officer
31 July 2018

Condensed consolidated income statement

Group interim results for six months to 30 June 2018

	Notes	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Interest receivable and similar income	3	110.0	105.8	214.2
Interest payable and similar charges	4	(49.7)	(43.7)	(88.3)
Net interest income		60.3	62.1	125.9
Fees and commission receivable	5	3.2	3.9	7.1
Fees and commission payable		(0.8)	(0.4)	(1.0)
Net fee and commission income		2.4	3.5	6.1
Other operating income		0.6	0.7	1.4
Other fair value (losses)/gains	6	(2.2)	2.4	4.3
Net operating income		61.1	68.7	137.7
Administrative expenses	7	(35.9)	(36.4)	(76.4)
Depreciation and amortisation		(2.9)	(3.2)	(13.2)
Operating expenses		(38.8)	(39.6)	(89.6)
Impairment credit for losses on loans and advances		2.9	2.8	10.0
Provisions for liabilities and charges	11	(0.3)	(0.1)	(0.5)
Operating profit and profit before taxation		24.9	31.8	57.6
Taxation expense	9	(4.2)	(7.2)	(14.1)
Profit for the period/year		20.7	24.6	43.5

Condensed consolidated statement of other comprehensive income

Group interim results for six months to 30 June 2018

	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Profit for the period/year	20.7	24.6	43.5
Items that will not be reclassified subsequently to profit and loss:			
Actuarial gain on retirement benefit obligations	4.2	1.3	-
Tax on retirement benefit obligations	(0.8)	(0.8)	-
Items that may be reclassified subsequently to profit and loss:			
Gain on fair value through other comprehensive income	(0.5)	-	-
Tax on fair value through other comprehensive income	0.1	-	-
Loss on available for sale assets	-	(1.3)	(1.9)
Tax on available for sale assets	-	0.2	0.4
Total comprehensive income for the period/year	23.7	24.0	42.0

Condensed consolidated statement of financial position

Group interim results as at 30 June 2018

	Notes	30 June 2018 £m (Unaudited)	30 June 2017 £m (Unaudited)	31 December 2017 £m (Audited)
Assets				
Liquid assets:				
Cash in hand and balances with the Bank of England		1,022.2	1,173.4	1,026.3
Loans and advances to credit institutions		191.1	157.6	168.8
Debt securities		118.7	244.3	124.9
		1,332.0	1,575.3	1,320.0
Derivative financial instruments		30.8	29.7	29.6
Loans and advances to customers:				
Loans fully secured on residential property		7,888.6	7,052.5	7,582.4
Other loans		281.0	296.2	281.7
	10	8,169.6	7,348.7	7,864.1
Intangible fixed assets		2.6	1.0	0.8
Property, plant and equipment		35.2	43.2	32.7
Non current assets classified as held-for-sale		4.0	-	4.2
Deferred tax assets		2.6	3.3	3.5
Other assets		4.2	1.6	1.6
Prepayments and accrued income		9.9	8.9	6.1
Total Assets		9,590.9	9,011.7	9,262.6
Liabilities				
Shares		6,873.1	6,532.1	6,563.8
Deposits and debt securities:				
Amounts owed to credit institutions		749.4	605.3	573.5
Amounts owed to other customers		171.9	198.0	216.7
Debt securities in issue		1,123.5	1,018.8	1,245.7
		2,044.8	1,822.1	2,035.9
Derivative financial instruments		30.5	33.9	29.2
Current tax liabilities		2.8	6.3	7.0
Other liabilities		8.5	6.3	6.9
Provisions for liabilities	11	6.0	6.8	6.1
Accruals and deferred income		16.0	19.8	17.5
Deferred tax liabilities		1.0	0.2	0.4
Retirement benefit obligations	8	2.4	14.0	8.9
Subscribed capital		65.0	67.8	66.5
Total liabilities		9,050.1	8,509.3	8,742.2
General reserve		540.1	501.0	519.3
Other reserves		0.7	1.4	1.1
Total equity and liabilities		9,590.9	9,011.7	9,262.6

Condensed consolidated statement of changes in members' interests

Group interim results for six months to 30 June 2018

	Six months to 30 June 2018 (Unaudited)		
	General Reserve £m	Fair Value through OCI reserve £m	Total Equity Attributable to Members £m
Group			
Balance at 1 January 2018	519.3	1.1	520.4
Changes on initial application of IFRS 9*	(4.0)	0.1	(3.9)
Tax effect of IFRS 9 implementation	0.8	-	0.8
Changes on initial application of IFRS 15*	0.3	-	0.3
Restated balance at 1 January 2018	516.4	1.2	517.6
Comprehensive income for the period/year	23.7	(0.5)	23.2
At 30 June	540.1	0.7	540.8

* see note 1

	Six months to 30 June 2017 (Unaudited)		
	General Reserve £m	Available for Sale Reserve £m	Total Equity Attributable to Members £m
Group			
At 1 January	476.0	2.4	478.4
Comprehensive income for the period/year	25.0	(1.0)	24.0
At 30 June	501.0	1.4	502.4

	Year ended 31 December 2017 (Audited)		
	General Reserve £m	Available for Sale Reserve £m	Total Equity Attributable to Members £m
Group			
At 1 January	476.0	2.4	478.4
Comprehensive income for the year	43.3	(1.3)	42.0
At 31 December	519.3	1.1	520.4

Following the adoption of IFRS 9 on 1 January 2018, the available for sale reserve has been replaced by the fair value through other comprehensive income (FVOCI) reserve.

All items dealt with in arriving at the profit before tax and the profit for the period, and the preceding financial periods, relate to continuing operations. The accounting policies and notes on pages 13 to 30 form part of these accounts.

Condensed consolidated statement of cash flows

Group interim results for six months to 30 June 2018

	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Net cash inflow from operating activities (see below)	19.5	461.4	210.1
Cash flows from investing activities			
Purchase of intangible assets and property, plant and equipment	(7.0)	(1.7)	(5.0)
Purchase of investment securities	-	(6.0)	(16.0)
Proceeds from sale and maturity of investment securities	5.7	150.1	278.8
Increase in cash and cash equivalents	18.2	603.8	467.9
Cash and cash equivalents at beginning of period/year	1,195.1	727.2	727.2
Cash and cash equivalents at end of period/year	1,213.3	1,331.0	1,195.1
Represented by:			
Cash and balances with the Bank of England	1,022.2	1,173.4	1,026.3
Loans and advances to credit institutions repayable on demand	191.1	157.6	168.8
	1,213.3	1,331.0	1,195.1
Operating activities			
Profit before taxation	24.9	31.8	57.6
Adjusted for:			
Depreciation and amortisation	2.9	3.2	13.2
Charge on defined benefit scheme	-	0.3	0.3
Impairment charge/(credit) for loans and advances to customers	2.9	(2.8)	(10.0)
Change in fair values	2.3	3.2	11.1
Equity adjustment for accounting policy changes	(3.7)	-	-
Changes in net-operating assets			
Increase in loans and advances to customers	(316.4)	(289.0)	(806.8)
(Increase)/decrease in other assets	(2.6)	0.1	0.1
(Increase)/decrease in prepayments and accrued income	(3.9)	(0.7)	2.1
Change in derivative financial instruments	0.1	(11.1)	(15.7)
Increase in shares	310.9	373.9	409.5
Increase in deposits and debt securities	11.6	358.4	568.8
Increase/(decrease) in other liabilities	1.4	(0.5)	0.1
Decrease in provisions for liabilities	(0.1)	(0.3)	(0.9)
(Decrease)/increase in accruals and deferred income	(1.5)	1.0	(1.3)
Contributions paid into defined benefit scheme	(2.4)	(0.8)	(6.7)
Movement in subscribed capital	0.1	-	0.1
Taxation paid	(7.0)	(5.3)	(11.4)
Net cash inflow from Operating activities	19.5	461.4	210.1

Notes to the accounts
for the six months ended 30 June 2018

1. Basis of preparation

The condensed consolidated set of financial statements of the group for the half-year ended 30 June 2018 have been prepared in accordance with the Disclosure and Transparency Rules of the Financial Conduct Authority and with International Accounting Standard (IAS) 34 Interim Financial Reporting, as adopted by the European Union. The annual financial statements of the group are prepared in accordance with IFRSs as adopted by the European Union.

Going concern

The factors considered in determining the long term viability of the group are set out in the 2017 Annual Report and Accounts in the Directors' Report on page 70. The directors are satisfied, based on the latest review undertaken in July 2018, 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.

Accounting policies

The accounting policies adopted are consistent with those of the previous financial year and corresponding interim reporting period, except for the adoption of new and amended standards as set out below.

New and amended standards adopted by the group

A number of new or amended standards became applicable for the current reporting period. The group has changed its accounting policies and made retrospective adjustments as a result of adopting the following new standards:

- IFRS 9 Financial Instruments, and
- IFRS 15 Revenue from Contracts with Customers.

The impact of the adoption of these standards and the new accounting policies are disclosed in note 2. (b) below. The amendments to existing standards did not have any impact on the group's accounting policies and did not require retrospective adjustments.

Changes in accounting policies

This note explains the impact of the adoption of IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers, on the group's financial statements and also discloses the new accounting policies that have been applied from 1 January 2018, where they are different to those applied in prior periods.

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.

Notes to the accounts
for the six months ended 30 June 2018

1. Accounting policies (continued)

IFRS 9 Financial Instruments - Impact of adoption

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 group's financial assets:

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	237.4	237.2
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 groups 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 and measurement of financial liabilities.

Impairment of financial assets
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:

Measurement category	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

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for the six months ended 30 June 2018

1. Accounting policies (continued)

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.

The critical accounting judgements 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 will be reviewed on an ongoing basis as part of the group's IFRS 9 model governance process.

Significant Increase in Credit Risk

Retail Financial Services & 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; and
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 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 %	30 June 2018 %
1	92	92
2	7	7
3	1	1

1. Accounting policies (continued)

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

Staging reason	On transition on 1 January 2018 %	30 June 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 moment; and
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 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 %	30 June 2018 %
1	92	95
2	6	3
3	2	2

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

Staging reason	On transition on 1 January 2018 %	30 June 2018 %
Risk grade deterioration	92	97
30-60 days past due	8	3

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for the six months ended 30 June 2018

1. Accounting policies (continued)

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.

Sensitivity Analysis

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	0.2	0.2	0.5
Stage 2 to stage 1	(0.4)	(0.4)	(0.1)

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

Retail financial services £m	Secured personal lending £m	Commercial lending £m
0.5	0.5	0.4

Notes to the accounts
for the six months ended 30 June 2018

1. Accounting policies (continued)

Forward-looking information in the ECL models

The assessment of SICR and the calculation of ECL both incorporate forward looking information. The group 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. Five different economic scenarios have been selected which take account of a range of possible economic outcomes.

The five scenarios consist of the following:

Scenario	Weighting %
Base	44.7
Stronger near term growth	10.7
Mild recession	26.8
Protracted slump	7.1
Stagflation	10.7

The IFRS 9 models calculate expected credit losses for each of the 5 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 scenarios. The table below shows the range of ECL impact between the most optimistic scenario and the most severe scenario. The ECL range is the difference between applying a 100% weighting to the most severe downturn scenario (protracted slump) and the most optimistic scenario (stronger near term growth).

Portfolio	ECL Range £m
Retail financial services	10.7
Secured personal lending	9.5
Commercial lending	0.5

1. Accounting policies (continued)

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 PDs 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 credit default swap (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.

Significant judgements included within the debt securities expected credit loss model include the 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.

(b) IFRS 9 Financial Instruments - Accounting policies applied from 1 January 2018

(i) Financial assets

Classification and measurement

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; or
- those to be measured subsequently at fair value through profit or loss.

The classification depends on the entity's business model for managing the financial assets and the contractual terms of the cash flows.

Notes to the accounts
for the six months ended 30 June 2018

1. Accounting policies (continued)

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 separate line item in the income statement.
- 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.

Impairment

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 above.

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 prior periods this commission 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

IFRS 16 Leases

IFRS 16 was issued in January 2016. It will result in almost all leases being recognised on the balance sheet, as the distinction between operating and finance leases is removed. Under the new standard, an asset (the right to use the leased item) and a financial liability to pay rentals are recognised. The accounting for lessors will not significantly change.

The standard will primarily affect the accounting for the group's operating leases. Work is ongoing to determine the extent to which these commitments will result in the recognition of an asset and a liability for future payments and how this will affect the group's profit and classification of cash flows.

Notes to the accounts
for the six months ended 30 June 2018

Judgements in applying accounting policies and critical accounting estimates

The areas of significant judgement and estimates remain consistent with those disclosed in the 2017 Annual Report and Accounts.

The nature of judgements and estimates made in respect of calculating the impairment provision on loans and advances have changed following the adoption of IFRS 9 on 1 January 2018. These are set out in the Adoption of IFRS 9 Financial Instruments section above.

2. Business segments

The group operates three main business segments: retail financial services, commercial lending and secured personal lending.

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

	Six months to 30 June 2018 (Unaudited)			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	45.3	7.2	7.8	60.3
Other income and charges	0.1	0.6	0.1	0.8
Net operating income	45.4	7.8	7.9	61.1
Operating expenses	(35.5)	(1.8)	(1.5)	(38.8)
Impairment provision for losses on loans and advances	(0.1)	2.2	0.8	2.9
Provision for other liabilities and charges	(0.3)	-	-	(0.3)
Operating profit and profit before taxation	9.5	8.2	7.2	24.9
Taxation expense				(4.2)
Profit after taxation				20.7

	Six months to 30 June 2017 (Unaudited)			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	45.0	7.4	9.7	62.1
Other income and charges	5.6	0.9	0.1	6.6
Net operating income	50.6	8.3	9.8	68.7
Operating expenses	(35.0)	(1.8)	(2.8)	(39.6)
Impairment provision for losses on loans and advances	(0.6)	2.0	1.4	2.8
Provision for other liabilities and charges	(0.1)	-	-	(0.1)
Operating profit and profit before taxation	14.9	8.5	8.4	31.8
Taxation expense				(7.2)
Profit after taxation				24.6

2. Business segments (continued)

	Year ended 31 December 2017 (Audited)			
	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.

	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Total assets by business segments			
Retail financial services	8,527.1	7,883.5	8,169.1
Secured personal lending	273.6	350.9	312.4
Commercial lending	790.2	777.3	781.1
Total assets	9,590.9	9,011.7	9,262.6
Total liabilities and equity by business segment			
Retail financial services and Commercial lending	9,317.3	8,660.8	8,950.2
Secured personal lending	273.6	350.9	312.4
Total liabilities and equity	9,590.9	9,011.7	9,262.6

3. Interest receivable and similar income

	Group		
	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
On loans fully secured on residential property	107.1	106.8	216.7
On other loans	5.7	7.3	12.2
On debt securities	0.7	1.4	2.3
On other liquid assets	3.1	1.0	2.7
On derivative financial instruments	(6.6)	(10.7)	(19.7)
	110.0	105.8	214.2

Notes to the accounts
for the six months ended 30 June 2018

4. Interest payable and similar charges

	Group		
	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
On shares held by individuals	39.7	39.8	78.5
On deposits and debt securities	11.5	6.6	14.2
On subscribed capital	2.1	2.1	4.2
On derivative financial instruments	(3.6)	(4.8)	(8.6)
	49.7	43.7	88.3

5. Fees and commission receivable

	Group		
	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Insurance and related financial service products	0.9	1.8	2.6
Mortgage related fees	2.2	2.0	4.2
Other fees and commission	0.1	0.1	0.3
	3.2	3.9	7.1

6. Other fair value gains and losses

	Group		
	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Gains on derivatives	5.4	8.4	15.4
Losses on hedged items attributable to the hedged risk	(7.6)	(6.0)	(11.1)
	(2.2)	2.4	4.3

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.

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for the six months ended 30 June 2018

7. Administrative expenses

	Group		
	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Wages and salaries	19.5	19.9	39.8
Social security costs	1.9	2.0	3.9
Other pension costs	1.1	1.0	2.1
	22.5	22.9	45.8
Other administrative expenses	13.4	13.5	30.6
	35.9	36.4	76.4

8. Retirement benefit obligations

	Group		
	30 June 2018 £m (Unaudited)	30 June 2017 £m (Unaudited)	31 December 2017 £m (Audited)
Fair value of plan assets	63.5	57.3	63.4
Present value of funded and unfunded obligations	(65.9)	(71.3)	(72.3)
Pension scheme deficit	(2.4)	(14.0)	(8.9)

The deficit has decreased primarily as a result of contributions paid by the Society and an increase in the discount rate used to measure the scheme liabilities due to a rise in corporate bond yields over the period.

9. Taxation

Taxation for the group for the 6 months to 30 June 2018 is charged at 16.9% (30 June 2017: 22.6%), representing the best estimate of the annual effective tax rate expected for the full year, applied to the forecast pre-tax income for the year and pro-rated for the six-month period.

The statutory rate of corporation tax has remained at 19.0% since December 2017. This results in an effective statutory rate of 19.0% for the year ending December 2018. The statutory rate of corporation tax will be reduced to 17% from 1 April 2020.

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9. Taxation (continued)

The actual tax charge for the period differs from that calculated using the standard rate of corporation tax in the UK as follows:

	Group		
	6 months to 30 June 2018 £m (Unaudited)	6 months to 30 June 2017 £m (Unaudited)	Year ended 31 December 2017 £m (Audited)
Profit before tax	24.9	31.8	57.6
Profit multiplied by the standard rate of Corporation Tax at 19.00% (2017: 19.25%)	4.7	6.1	11.1
Effects of:			
Impact of banking surcharge	-	0.6	1.4
Expenses not deductible for tax purposes	-	0.1	1.3
Adjustments in respect of prior periods	-	-	0.2
Other	(0.5)	0.4	0.1
Tax charge	4.2	7.2	14.1

10. Loans and advances to customers

	Group		
	30 June 2018 £m (Unaudited)	30 June 2017 £m (Unaudited)	31 December 2017 £m (Audited)
Fully secured on residential property	7,878.9	7,046.3	7,568.2
Fully secured on land	290.0	311.9	291.9
	8,168.9	7,358.2	7,860.1
Provision for impairment losses	(27.6)	(42.2)	(30.3)
Unamortised loan origination fees	23.4	10.2	21.4
Fair value adjustment for hedged risk	4.9	22.5	12.9
	8,169.6	7,348.7	7,864.1

11. Provisions for liabilities

	Group		
	30 June 2018 £m (Unaudited)	30 June 2017 £m (Unaudited)	31 December 2017 £m (Audited)
At beginning of the period/year	6.1	7.1	7.1
Additions	0.3	0.1	0.5
Utilisation	(0.4)	(0.4)	(1.5)
At end of the period/year	6.0	6.8	6.1

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11. Provisions for liabilities (continued)

The provisions balance includes £0.8m for the FSCS levy. This balance is made up of the expected interest charges for scheme years April 2017 to March 2018 and April 2018 to March 2019.

Provision levels are broadly consistent in comparison to the amounts held at 31 December 2017. The group continues to hold provisions in respect of claims in relation to previous sales of Payment Protection Insurance (PPI) and various other customer claims. Further details are set out in note 19 of the 2017 Annual Report and Accounts.

12. Related party transactions

The group had no related party transactions outside the normal course of the business during the half-year to 30 June 2018. Transactions for this period are similar to those for the year to 31 December 2017, details of which can be found in note 35 of the 2017 Annual Report and Accounts.

13. Financial instruments

Carrying values and fair values

The table below compares carrying values and fair values of the group's financial instruments by category.

	30 June 2018		31 December 2017	
	Carrying Value £m (Unaudited)	Fair Value £m (Unaudited)	Carrying Value £m (Audited)	Fair Value £m (Audited)
Total assets				
Cash in hand and balances with Bank of England	1,022.2	1,022.2	1,026.3	1,026.3
Loans and advances to credit institutions	191.1	191.1	168.8	168.8
Debt securities	118.7	118.7	124.9	124.9
Derivative financial instruments	30.8	30.8	29.6	29.6
Loans and advances to customers	8,169.6	8,260.8	7,864.1	7,898.1
	9,532.4	9,623.6	9,213.7	9,247.7
Total liabilities				
Shares	6,873.1	6,886.0	6,563.8	6,574.8
Amounts owed to credit institutions	749.4	749.4	573.5	573.5
Amounts owed to other customers	171.9	171.9	216.7	216.7
Debt securities in issue	1,123.5	1,118.2	1,245.7	1,241.6
Derivative financial instruments	30.5	30.5	29.2	29.2
Subscribed capital	65.0	62.4	66.5	64.7
	9,013.4	9,018.4	8,695.4	8,700.5

Further details on the methods and assumptions which have been applied in determining fair value are set out in note 31 of the 2017 Annual Report and Accounts.

13. Financial instruments (continued)

Assets measured at fair value

On transition to IFRS 9, financial assets have been reclassified and re-measured as outlined in the accounting policies on page 13.

	30 June 2018 (Unaudited)			
		Level 1	Level 2	Level 3
	£m	£m	£m	£m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	30.8	-	26.3	4.5
Financial assets at fair value through other comprehensive income:				
Debt securities	118.7	118.7	-	-
Total	149.5	118.7	26.3	4.5
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	15.0	-	15.0	-
Derivative financial instruments	30.5	-	26.0	4.5
Total	45.5	-	41.0	4.5

	30 June 2017 (Unaudited)			
		Level 1	Level 2	Level 3
	£m	£m	£m	£m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	29.7	-	27.2	2.5
Available for sale financial assets:				
Debt securities	244.3	244.3	-	-
Total	274.0	244.3	27.2	2.5
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	22.0	-	22.0	-
Derivative financial instruments	33.9	-	31.4	2.5
Total	55.9	-	53.4	2.5

	31 December 2017 (Audited)			
		Level 1	Level 2	Level 3
	£m	£m	£m	£m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	29.6	-	26.8	2.8
Available for sale financial assets:				
Debt securities	124.9	124.9	-	-
Total	154.5	124.9	26.8	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

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. This is detailed on the following page.

13. Financial instruments (continued)

Hierarchy for fair value disclosures

Level	
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 on observable market data.

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 Retail Mortgage Backed Securities (RMBS) structures. The valuations are calculated 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.

14. Credit risk

The table below shows the group’s estimated maximum exposure to credit risk for all financial assets.

i) 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		
	30 June 2018 £m (Unaudited)	30 June 2017 £m (Unaudited)	31 December 2017 £m (Audited)
In respect of loans and advances to customers:			
Secured by a first charge on residential property	7,605.6	6,680.6	7,254.5
Secured by a first charge on land	290.0	311.9	291.9
Secured by a second charge on residential property	273.3	365.7	313.7
	8,168.9	7,358.2	7,860.1
Provisions for impairment losses	(27.6)	(42.2)	(30.3)
Effective interest rate adjustments	23.4	10.2	21.4
Fair value adjustments	4.9	22.5	12.9
	8,169.6	7,348.7	7,864.1

The group’s loan balances split by stage in accordance with IFRS 9 broken down by business segment is as follows:

	Retail Financial Services		Commercial Lending		Secured Personal Lending	
Stage	Opening balance as at 1 January 2018 £m (Unaudited)	30 June 2018 £m (Unaudited)	Opening balance as at 1 January 2018 £m (Unaudited)	30 June 2018 £m (Unaudited)	Opening balance as at 1 January 2018 £m (Unaudited)	30 June 2018 £m (Unaudited)
1	6,258.9	6,567.0	724.2	749.6	243.7	211.2
2	464.8	499.8	33.8	24.7	53.0	47.6
3	40.7	38.6	24.0	15.9	17.0	14.5
	6,764.4	7,105.4	782.0	790.2	313.7	273.3

Notes to the accounts
for the six months ended 30 June 2018

14. Credit risk (continued)

The group's exposure to credit risk relating to loans and advances to customers can be broken down by business segments as follows:

	Group		
	30 June 2018 £m (Unaudited)	30 June 2017 £m (Unaudited)	31 December 2017 £m (Audited)
Retail financial services	7,115.8	6,215.8	6,775.5
Commercial lending	775.6	760.3	763.9
Secured personal lending	273.3	350.1	311.8
Fair value adjustments	4.9	22.5	12.9
	8,169.6	7,348.7	7,864.1

The group provides loans secured on residential property across England and Wales and the Society, as a regional building society, has a geographical concentration in Wales.

The group's expected credit losses split by stage in accordance with IFRS 9 and by business segment is as follows:

	Retail Financial Services		Commercial Lending		Secured Personal Lending	
Stage	Opening balance as at 1 January 2018 £m (Unaudited)	30 June 2018 £m (Unaudited)	Opening balance as at 1 January 2018 £m (Unaudited)	30 June 2018 £m (Unaudited)	Opening balance as at 1 January 2018 £m (Unaudited)	30 June 2018 £m (Unaudited)
1	0.5	0.5	2.5	2.1	0.4	0.3
2	4.1	4.3	2.9	1.8	5.4	5.1
3	2.4	2.2	10.8	7.3	4.5	4.0
	7.0	7.0	16.2	11.2	10.3	9.4

As IFRS 9 is applicable for accounting periods commencing after 1 January 2018 comparative balances are not presented for the 6 months to 30 June 2017.

The average index-linked loan to value (LTV) in respect of the group's loans secured by a first or second charge on residential property is 58.3% (31 December 2017: 57.0%).

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than three months is 0.52% (31 December 2017: 0.53%) which compares favourably with the industry average of 0.81% (UK Finance arrears and possession data as at March 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 173 (31 December 2017: 179) cases.

The percentage of secured personal loans currently in arrears by two months or more by number is 4.53% (31 December 2017: 4.63%), which by value is 5.44% (31 December 2017: 5.66%).

14. Credit risk (continued)

ii) Commercial

Loans secured on commercial property are diversified by industry type with the largest exposure to one counterparty amounting to £29.6m (31 December 2017: £29.6m) or 3.7% (31 December 2017: 3.8%) of gross balances.

Asset quality remains strong with impaired balances of £7.5m (31 December 2017: £17.1m), or 0.9% of gross balances (31 December 2017: 2.2%).

iii) Treasury

The treasury risk function monitors exposure concentrations against a variety of criteria including counterparty and country limits, and all exposures are well spread across this risk assessment framework.

An assessment has been made of the group's key counterparties which concluded that no impairment provisions were required.

Responsibility statement

We confirm that to the best of our knowledge:

(a) the condensed set of financial statements has been prepared in accordance with IAS 34 Interim Financial Reporting as adopted by the EU;

(b) the interim management report includes a fair review of the information required by DTR 4.2.7 (indication of important events during the first six months and the description of principal risks and uncertainties for the remaining six months of the year); and

(c) the interim management report includes information required by DTR 4.2.8 (indication of any related party transactions that have taken place or any changes in the related party transactions described in the last annual report).

By order of the Board,

Stephen Hughes
Chief Executive Officer
31 July 2018

Independent review report
to Principality Building Society

We have been engaged by the Society to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2018 which comprises the condensed consolidated income statement, the condensed consolidated statement of other comprehensive income, the condensed consolidated statement of financial position, the condensed consolidated statement of changes in Members' interests, the condensed consolidated statement of cash flows and related notes 1 to 14. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Society in accordance with International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Financial Reporting Council. Our work has been undertaken so that we might state to the company those matters we are required to state to it in an independent review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company, for our review work, for this report, or for the conclusions we have formed.

Directors' responsibilities

The half-yearly financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-yearly financial report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

As disclosed in note 1, the annual financial statements of the group are prepared in accordance with IFRSs as adopted by the European Union. The condensed set of financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34 "Interim Financial Reporting" as adopted by the European Union.

Our responsibility

Our responsibility is to express to the Society a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Financial Reporting Council for use in the United Kingdom. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2018 is not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Conduct Authority.

Deloitte LLP
Statutory Auditor
Cardiff, United Kingdom
31 July 2018

Other information

The information for the period ended 30 June 2018 is unaudited and does not constitute accounts within the meaning of section 73 of the Building Societies Act 1986. The financial information for the year ended 31 December 2017 has been extracted from the Annual Report and Accounts for that year. The annual accounts for the year ended 31 December 2017 have been filed with the Financial Conduct Authority.

The auditor's report on the 2017 Annual Report and Accounts was not qualified and did not include a reference to any matters to which the auditor drew attention by way of emphasis without qualifying the report.

A copy of the Interim Financial Report is placed on Principality Building Society's website. The directors are responsible for the maintenance and integrity of the information on the website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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Principality Building Society is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, reference number 155998. Principality Building Society, Principality Buildings, Queen Street, Cardiff, CF10 1UA. principality.co.uk

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