ANNUAL REPORT
AND ACCOUNTS

2019




Building your future

Principality
Building Society
Cymdeithas Adeiladu

Where home matters
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Chairman's Review of the Year

2019 has been an eventful year for the UK with Brexit uncertainty dominating the political and economic landscape. The December general election result has now removed much of that uncertainty as we prepare to leave the EU. I am pleased to report we posted a strong set of results in 2019, continuing to provide a secure home for Members' savings and helping them get the home they want.

Performance

Our assets have increased to more than £10bn for the first time 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. The Board and I are proud that we helped over 4,900 first-time buyers on to the property ladder in the past year.

A particular focus this year has been improving our technology. We have made steady progress in the technological changes required to give Principality the ability to continue to grow and attract a new generation of Members and customers. Our technology will not change the core of who we are or what we do - but already the changes made have helped us provide a faster, more efficient mortgage service to brokers and Members. In time, we will be able to offer more savings products for Members who prefer to access them online. That will not deter us from maintaining our branch presence on the high streets across Wales and the Borders.

Pictured: Laurence Philip Adams, Chairman

Risk

The nature and pace of technological change represents a risk to the continued resilience of the financial services sector. Our ability to maintain and further develop operational resilience and operational risk management capabilities is vital to ensure we can continue to provide Members with a secure, stable and competitive service.

The Board and Board Risk Committee maintain regular oversight of programme delivery and the ongoing effectiveness of business level operational risk management capability and associated controls.

We are also aware of the potential long-term risks which climate change represents to our business model and to the wider economy. Our stress testing framework includes the assessment of financial risks emanating from climate change and takes into account current relevant risks in addition to those which may plausibly arise in the future. We will take a strategic approach to managing the financial risks arising from climate change based on the outcome of assessments undertaken.

Supporting our communities and Members

Our work in financial education has once again been outstanding as we have helped educate more than 11,000 young people about managing their finances. A recent survey of the members of the Welsh Youth Parliament highlighted that schools should teach more life skills to help young people before they leave.

Our colleagues from all over our branch network have done so much to educate more than 2,000 primary school children in the past year and we will continue to intensify our efforts to equip our young people with important life skills.

The Board is also immensely proud of the work our colleagues have put in over the year to help vulnerable groups of people across Wales. Our colleagues have received some very high profile national awards, such as the Mortgage Finance Gazette Best Regional Building Society, for providing great customer service to our Members, as well as for supporting our communities.

Our colleagues have also raised £156,000 for our two charity partners, Alzheimer's Society Cymru and Teenage Cancer Trust Cymru, during the first year of our three-year partnership. We are always pleased as a Board to see colleagues making a difference to people who need our help the most.

Governance

Principality is a member owned organisation. We particularly welcome therefore, feedback from all of our Members whether it is via our branches, by telephone, email, letter, member forum meetings, or at the AGM. We are very focused on making sure we have insight into key aspects of our business with the highest standards of governance that reflect the interests of all stakeholders.

There have been some changes to the Board this year. We say goodbye to Steve Hughes who resigned as Chief Executive Officer in December to take up a job opportunity elsewhere. Our Chief Risk Officer, Mike Jones, was unanimously appointed by the Board as Interim Chief Executive Officer in his place. Mike has more than 40 years' experience in financial services and has been with Principality for more than 20 years. He has also been a Board Member for the past six years.

While I am sorry to see Steve Hughes leave, I am also grateful for all that he has contributed to our organisation. In particular, he leaves a strong Executive team in place who will continue the excellent work of the last few years.

We are always looking to strengthen our capabilities as a Board to deal with the challenges ahead and, with that in mind, we welcomed Dr Debra Evans-Williams as a Non-Executive Director in the summer. Debra has more than 16 years' experience at board level, and will be advising the Society as we continue our digital transformation. Her knowledge and wealth of fintech experience will be of great value as we seek to improve the products and services we offer to our Members.

I am delighted that our Chief Operating Officer Iain Mansfield has also joined our Board. We strongly believe in growing and developing our colleagues at all levels. Iain is a valuable member of our Executive team with great experience across the business, most notably his leadership in delivering technology and change related aspects of the Society's business. His work will help to provide better customer service for our Members in the long-term.

Thank you

On behalf of the Board, I want to thank our wonderful colleagues for their continued contribution to another successful year. I am fortunate as the Chair to meet so many of our committed, professional and enthusiastic people and I know from these meetings that the Society is in excellent hands. Our Society would not be successful without our dedicated colleagues in our branches, agencies and head office who have a tremendous connection with their communities.

Finally, we would not be successful without the support of you, our loyal Members. I would like to thank each of you for continuing to choose Principality.

Laurence Philip Adams
Chairman
5 February 2020

Pictured:
The season of giving - Principality donates hundreds of presents to our charity partners

Chief Executive's Review of the Year

for the year ended 31 December 2019

Principality Building Society has delivered a strong performance in 2019. We have maintained our growth strategy despite a tough marketplace, and at the same time have invested in upgrading services for our Members. Once again we have helped people across Wales and the Borders to prosper.

Performance

I am very proud of our performance and the excellent service we continue to deliver to our Members. Our net retail mortgage lending was £499m in the year (2018: £719m), helping to take our total assets to above £10bn for the first time in our history at £10.7bn (2018: £9.7bn). This is a fantastic achievement and is testament to our colleagues' hard work over many years.

To support the growth in our lending we attracted an extra £596m in savings. Our competitive products have maintained our position as one of the best on the high street. We delivered an average rate to savers of 1.18% compared to the market average of 0.74%[1] over the same period. We also raised wholesale funding with two residential mortgage-backed security issuances.

Balancing the needs of savers whilst remaining competitive in the mortgage market is a constant focus. The savings rates we can offer to Members depend upon the interest we earn on mortgages. Economic and political uncertainty has resulted in reduced activity in the housing market. Alongside intense competition in the market, it has led to downward pressure on margins.

Pictured: R. Michael Jones, Interim CEO

As a building society owned by our Members, we are not under pressure to meet the short-term needs of shareholders. Our aim is not to maximise profit but to focus on the long-term future of the Society. Underlying profit before tax was in line with our expectations at £39.8m (£43.8m in 2018). Statutory profit before tax was £39.6m (2018: £40.7m).

[1] *Source: CACI's CSDB, weighted UK average interest rates for fixed and variable rate stock, January – October 2019 (latest data available).*

Pictured: Principality Commercial finances a coastal housing development in Pembrokeshire

Our strong capital base, supported by our low risk business model, allows us to take a long-term view when investing in the business. We are a safe and secure home for our Members' savings. This is crucial to our ongoing success, and we will continue to build scale, to provide strength and protection for the future.

Our Commercial Team has once again made an outstanding contribution to our communities. This has included making £50m available in loans to help smaller housing developers build homes across Wales. They also provided £75m for housing associations to support the creation of affordable homes. Their efforts have helped to support the Welsh Housing Agenda.

Changes for the future

We have an ambitious growth strategy with a clear focus on transforming our mortgage and savings business. We are partway through improvements that will help provide current and future Members with flexible ways to manage their needs. Our strong performance and profitability supports this significant investment in our technology, branches and our people. We have made our mortgage journey simpler for brokers, customers and colleagues. It means faster offer times and a much better service experience. Our plans to deliver a new savings platform are well advanced and will improve our online service.

This is a challenging but exciting period in Principality's history. Our focus is to secure the future of the business for our next generation of savers and borrowers. We remain committed to the high street. As bank branches on the high street in Wales continue to close, our presence is strong with 70 branches and agencies across Wales and the Borders. We continue to invest in our branches while others are shutting theirs.

Members, communities and colleagues

As a purpose led business, we will continue to work hard to help our communities deal with the many challenges they face. We will support them in developing the confidence and knowledge to become a nation of savers.

A key focus of our efforts is to educate young people across Wales by giving them the financial skills to prepare them for adult life. In the past year we have provided financial education to 11,000 children.

We have invested £110,000, partnering with secondary schools in West Wales and Cardiff. It has helped thousands of school children to earn the equivalent of a GCSE in financial education. Our work saw us receive the Business in the Community Cymru Volunteering Impact Award. We also created savings products such as Learner Earner to encourage savings habits amongst families.

STRATEGIC REPORT

It was wonderful to once again be named as one of the best places to work in the UK by Great Place to Work®. Our colleagues continue to help us stand out and are renowned for their warmth, empathy and personal approach. In 2019, the Society's Net Promoter Score[2], which measures the likelihood of customers and brokers to recommend Principality to other people, improved to 81.5% (2018: 78.6%).

In 2019, we received independent recognition for our customer service. Which? named us Recommended Provider for Mortgages, for the second year running.

We are delighted to be working with two new charity partners, Teenage Cancer Trust Cymru and Alzheimer's Society Cymru. Our partnership with these two outstanding charities got off to a great start. Our colleagues raised £156,000 for these causes last year.

Outlook

Looking ahead, we expect the economic environment to remain challenging. Fierce competition in the mortgage market is continuing to squeeze interest margins. Nevertheless, we are in a strong position to withstand an economic downturn, while ensuring we protect our Members' interests.

Our financial performance in recent years has provided us with the opportunity to build strong foundations for future growth and our investment programme will transform the technology supporting our core mortgage and savings operations. While this will impact short-term profitability, we have the strength and resilience to continue to grow the Society's business in a safe and secure way. Our plans will help us attract a new generation of customers, while providing a level of service that matches the expectations of you, our loyal Members.

R. Michael Jones
Interim Chief Executive Officer
5 February 2020

[2] *We continually survey our customers and brokers who have had a recent interaction with our colleagues across Retail, Connect, Regulated Sales and Customer Services. In 2019, we received over 18,000 completed surveys, in which we ask our customers and brokers to rate on a scale of zero to ten how likely they are to recommend us to their friends or family, and from this we are able to create a Net Promoter Score, which is a measure of their satisfaction and relationship with Principality.*

The Net Promoter Score is calculated by taking the proportion of respondents classed as Detractors (those rating 0 to 6) from the proportion of respondents classed as Promoters (those rating 9 or 10). In 2019, there were 84.8% of respondents who were classed as Promoters with just 3.3% of respondents being classed as Detractors.

Pictured: Staff member delivering financial education to primary school pupils

Business Model and Strategy

for the year ended 31 December 2019

Our purpose and vision

Principality Building Society was founded 159 years ago 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 was then.

Our purpose today is to help our Members prosper in their homes. They tell us that home is the heart of life, where their plans, decisions and memories are made and it is where we can help change our Members lives for the better. Our purpose underpins everything that we do, but it is not just about the products and services we offer – it is about the value we add to people's lives at every stage.

Our purpose and commitment to our Members also informs our strategic thinking and has helped us to develop our vision to deliver products and solutions that meet their current and future needs, allowing Members to do business with us through any channel that they want to – seamlessly. Achieving our vision will ensure we remain relevant, providing solutions that Members need and improving access to our range of products and services.

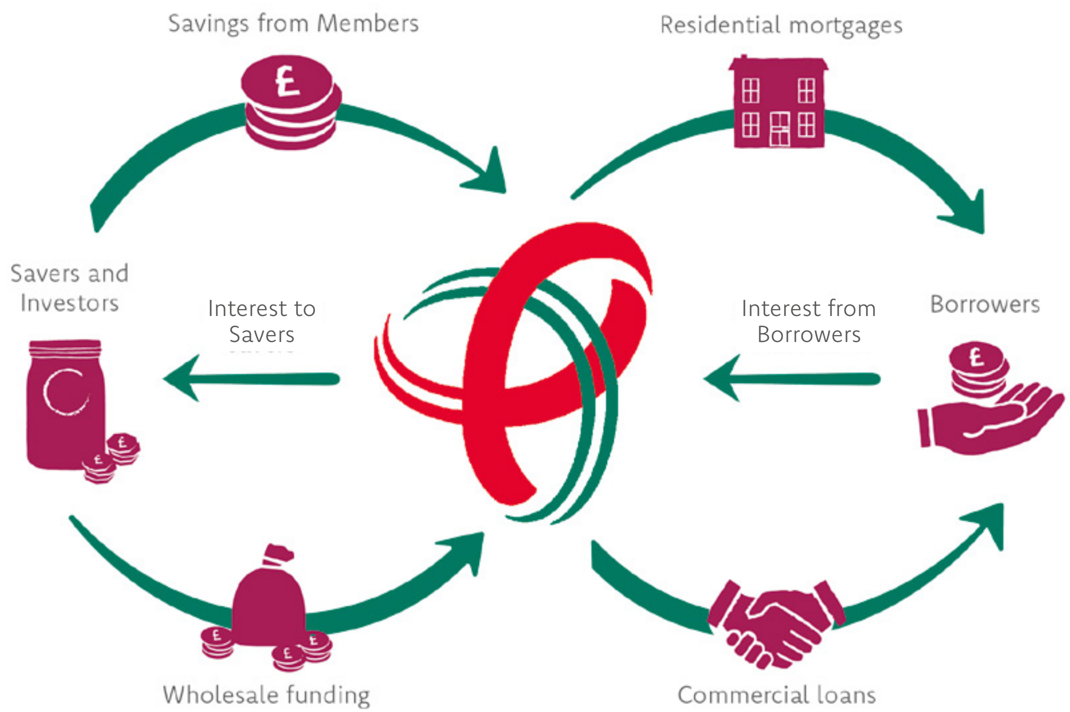
Pictured: Prestatyn School using Principality's board game, Sheep and Ladders, as a financial education tool

Our business model

Our business model primarily operates across two lines of business: retail financial services and commercial lending, and our distribution channels allow us to reach customers through our branches, our broker network, over the phone and digitally. Our secured personal lending business, Nemo, stopped offering new customer loans in 2016 but continues to focus on delivering excellent customer service and delivering a meaningful contribution to the group results. Additional contribution also comes from our range of complementary products of life insurance, home insurance and funeral plans, all with the goal of protecting Members over the longer term.

As a mutual building society we are owned by and run for the benefit of our 500,000 plus Members – our savers and borrowers. Our business model raises over 80% of our funds 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.

This is used for a number of purposes including enhancing our offering to ensure we are helping Members to prosper in their homes, covering operational expenses, reinvesting in the business and technology to future proof our position and supporting community and charity projects through our branch and agency network. We do this to ensure we achieve our vision and deliver on our purpose, all whilst holding capital to safeguard the Society for future generations.



Our strategy

Our strategy helps us achieve our vision and deliver on our purpose. It clearly sets out our focus on our core mortgage and savings business, driving sustainable growth through customer focused propositions tailored to member need, a commitment to service excellence, and the development of internal expertise all delivered through continuously improving processes and capable, empowered colleagues. This strategy drives our key activities and progress towards achieving our vision and is continually measured through a clear set of Key Performance Indicators aligned to our strategic pillars.

Strategic Pillars	Key Activity	Performance Indicators
"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 Net Savings Growth Brand Consideration Cost Income Ratio
"We'll inspire **Brilliant People** across the Society with a customer focused culture"	We'll be an employer of choice, continuing to attract and retain talented and passionate people. We'll inspire a strong inclusive customer focused 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
"We'll provide our Members with a **Stand-Out Experience** focused 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 compliments 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 five years, we have focused on delivering our strategy, investing in a number of areas to improve the organisation. A summary of progress against our strategic aims is below:

Purpose Led Organisation

Investment in technology to support the transformation and growth of our core mortgage and savings products, allowing us to be more agile as an organisation and develop a pipeline of differentiated products and services aligned to Member needs.

Commercial lending focus on supporting communities to prosper through funding of projects including care home facilities, residential developments, student accommodation and regenerational commercial development.

Continued growth of brand awareness through leveraging the sponsorship of Principality Stadium and the exposure generated by our involvement with the WRU.

Commitment to our charity partnerships, with involvement across three key pillars of Financial Education, Getting and Staying in a Home and Health and Wellbeing.

Which? Recommended Mortgage Provider 2019.

11,000 children engaged through 2019 in our Financial Education Programme.

Brilliant People

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

Enhanced focus on equality and diversity.

Investment in the working environment for our Brilliant People, including redevelopment of Principality House and Friary House and refurbishment of the branch network as part of our branch of the future project.

Recognised as a Great Place to Work®.

Stand-Out Experience

Improved efficiency of processes, including programmes to review and improve both our mortgage and savings customer journeys.

Investment in our digital capability, allowing more Members than ever to interact with us online.

Ongoing monitoring of customer feedback and insight to inform decision-making, ensuring we continue to deliver service excellence.

Named What Mortgage Best Customer Service for second year running.

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 the stand-out experience our Members receive from colleagues 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 recommend the Society to others, based on internally designed instant feedback surveys. 2019 has seen our score increase from 78.6% to 81.5%, which is testament to our ongoing commitment to providing a stand-out experience.

Transforming our Society

The world we live in continues to change at a fast pace, with technology having a significant impact on the way many people interact with financial services organisations and the expectations placed upon us. We remain committed to the high street but also recognise that we need to adapt to remain relevant and improve accessibility to our business, and for this, investment in technology is vital to ensuring our ongoing success. We have continued our transformation journey throughout 2019 and are now excitedly entering the delivery phase but as we do, Member experience will remain at the heart of our decision-making. As we improve our digital capability, we remain dedicated to delivering the same stand-out experience that Members currently receive, ensuring a consistent experience as we take steps to improve their interactions with us across all 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.

	2019	2018
Purpose Led Organisation		
Net Retail Mortgage Growth	£499.3m	£718.7m
Net Savings Growth	£598.7m	£426.0m
Brand Consideration[1]	16.4%	15.5%
Cost Income Ratio	69.4%	66.4%
Brilliant People		
Employee Engagement Score	77.0%	76.0%
Stand-Out Experience		
Net Promoter Score[2]	81.5%	78.6%
Underlying Profit Before Tax[3]	£39.8m	£43.8m
Profit Before Tax	£39.6m	£40.7m
Net Interest Margin	1.09%	1.26%
Common Equity Tier 1 Ratio	26.20%	27.06%

1. The 2018 comparative figure for brand consideration has been restated in line with a change in methodology from our provider, YouGov.
2. Source: Based on internal survey data for the 12 months ended 31 December 2019.
3. Reconciliation can be found on p19.

The above Key Performance Indicators, apart from Profit Before Tax, are alternative performance measures (APMs) which are used internally 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. 2019 has seen our score further increase from 78.6% to 81.5% 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.

Pictured: Principality colleague chatting to a Member at last year's AGM

STRATEGIC REPORT

Financial Review

for the year ended 31 December 2019

Income statement overview:

Continuing Operations	2015 £m	2016 £m	2017 £m	2018 £m	2019 £m
Net interest income	134.1	124.9	125.9	119.6	111.4
Other income	6.8	9.7	7.5	5.6	4.4
Fair value gains/(losses)	0.9	1.6	4.3	(2.4)	(0.2)
Operating expenses	(83.7)	(82.1)	(89.6)	(81.5)	(80.1)
Impairment provisions (charge)/release	(4.8)	2.7	10.0	(0.6)	4.1
Other provisions	(4.3)	(6.5)	(0.5)	-	-
Profit before tax	**49.0**	**50.3**	**57.6**	**40.7**	**39.6**

Statutory pre-tax profit for 2019 was broadly in line with the prior year at £39.6m (2018: £40.7m). The main movement was a reduction in net interest income, which has been impacted by higher interest costs on both retail savings and wholesale funding. This has been partially offset by releases in impairment provisions and a reduction in fair value losses.

Underlying pre-tax profit, which primarily excludes fair value movements and reflects the true trading performance of the business was £39.8m (2018: £43.8m).

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

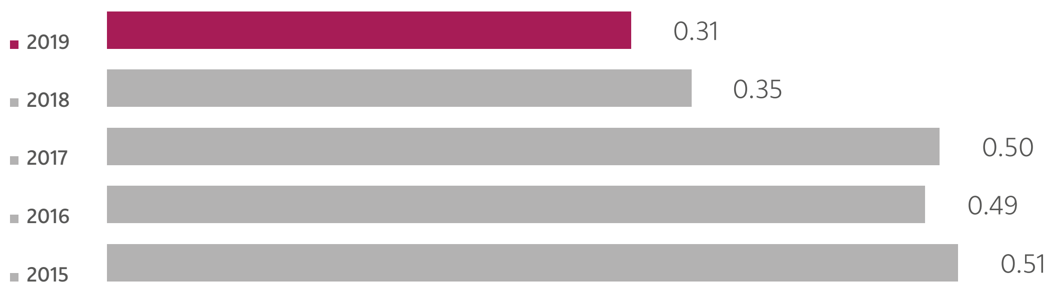
	2019 £m	2018 £m
Statutory profit before tax	39.6	40.7
Adjusted for:		
Fair value losses	0.2	2.4
Additional pension charge for GMP equalisation	-	0.7
Underlying profit	**39.8**	**43.8**

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 principle difference between statutory and underlying profit is fair value movements, which 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.

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 (%)



STRATEGIC REPORT
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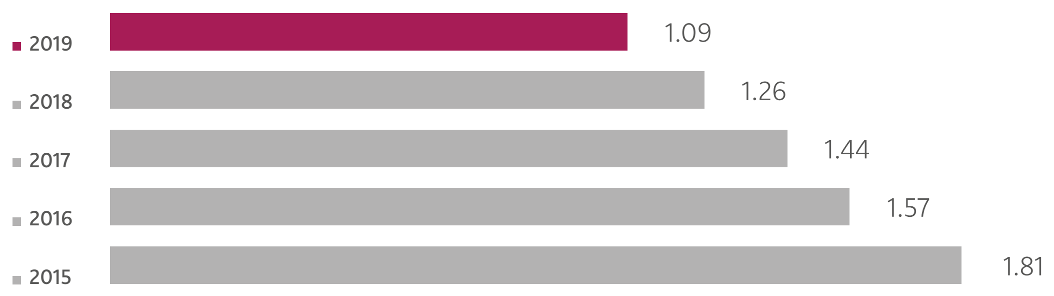
Net interest Margin

Our net interest margin for the year was 1.09% (2018: 1.26%). 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 UK prime residential mortgage market, driving the continued replacement of older, higher margin loans with newer, lower margin lending.

Our lending continues to be primarily funded by Members' retail savings, with 84.0% (2018: 82.2%) 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. During 2019, we have seen competition increase in the savings market which represents some better news for savers and we have continued to offer better than average savings rates to our Members, but this has resulted in further downward pressure on interest margins.

In addition to the funding provided by retail savings, we aim to maintain a diverse range of funding sources, and have raised £665m of wholesale funding in the year through two Residential Mortgage Backed Securities (RMBS) issuances. 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.

NET INTEREST MARGIN (%)



Other income

Other income at £4.4m (2018: £5.6m) has decreased from the prior year, driven primarily by lower levels of commission earned from our general insurance partnerships.

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 £80.1m (2018: £81.5m), despite further spending on our strategic transformation programme. A significant proportion of expenditure on software development has been capitalised as an intangible asset on the group's balance sheet; however, not all costs meet the criteria for capitalisation and have therefore been expensed in the period.

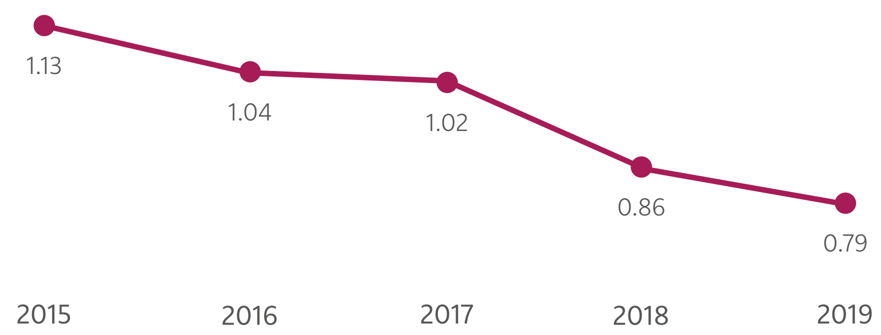
The overall reduction in operating expenses has been driven by a continued focus on managing the core cost base of the business, including the lower costs of servicing the secured personal lending portfolio.

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

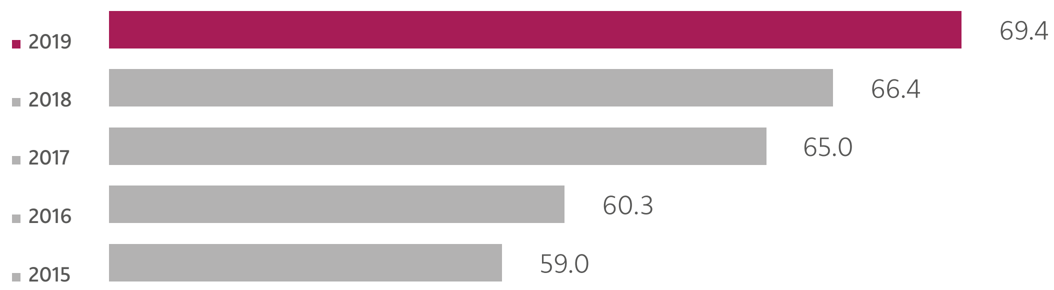
	2019 £m	2018 £m
Retail financial services	75.2	75.4
Commercial lending	3.6	3.7
Secured personal lending	1.3	2.4
Total operating expenses	**80.1**	**81.5**
Management expense ratio	0.79%	0.86%
Cost income ratio	69.4%	66.4%

The reduction in costs is reflected in a continued reduction in the management expense ratio, which compares costs as a proportion of the assets of the business. The cost income ratio has increased over the same period. 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 2020 and beyond.

MANAGEMENT EXPENSE RATIO (%)



COST INCOME RATIO (%)



Impairment provisions for losses on loans and advances

	2019 £m	2018 £m
Retail mortgage lending	2.1	2.4
Commercial lending	(2.7)	(0.5)
Secured personal lending	(3.7)	(1.3)
Treasury assets	0.2	-
Total (release)/charge	**(4.1)**	**0.6**

Impairment releases totalled £4.1m in 2019 compared with a £0.6m charge in 2018. This is primarily due to releases of provisions for closed loans together with a £1.3m recovery from the sale of a portfolio of unsecured loans to a third party during the year.

The group continues to have a low overall level of arrears, reflecting our prudent affordability, credit quality and underwriting standards. However, although the conclusive outcome to the General Election in December 2019 gave certainty to the UK leaving the EU, significant uncertainty remains as to the outcome of the trade negotiations and the type of trade relationship that will exist between the UK and EU in the future, and the impact this may have on house price growth, levels of employment and ultimately arrears levels over the next few years. These considerations, together with uncertainties arising at a global level from economic, political and environmental factors, 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 total loan loss impairment provisions held on the statement of financial position were as follows:

	2019 £m	2018 £m
Retail mortgage lending	11.0	9.2
Commercial lending	8.0	12.4
Secured personal lending	6.5	8.9
Total	**25.5**	**30.5**

Provisions for liabilities

Regulatory provisions have been made in respect of various customer claims. At 31 December 2019, the group held a provision of £4.4m (2018: £5.1m). This reflects management's best estimate of the costs required to settle its remaining obligations and takes account of expected customer behaviour, costs expected to be incurred, and an assessment of the exposure population.

The provision is monitored on an ongoing basis with customer trends and behaviour analysed to ensure the level of provision held is appropriate. Further information on the level of provisions and the uncertainties therein can be found in notes 2, 19 and 29.

Taxation

The effective tax rate for the group was 19.0% (2018: 19.2%) which aligns to the statutory rate of 19.0% (2018: 19.0%).

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

Statement of financial position

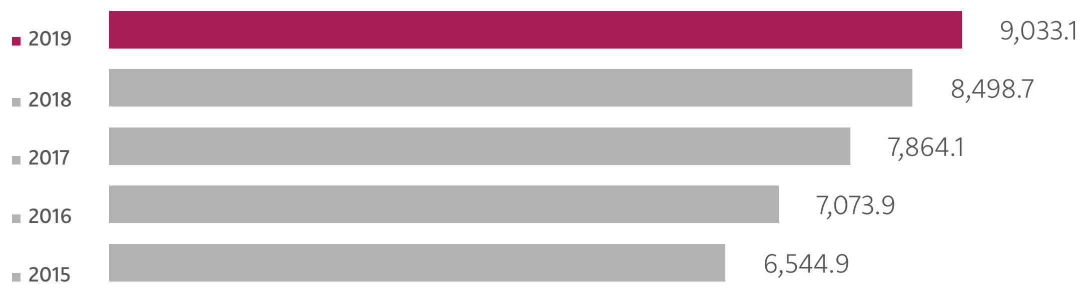
Total assets increased by £1,008.4m to £10,695.8m, taking total assets above £10bn for the first time in the Society's history.

	2015 £m	2016 £m	2017 £m	2018 £m	2019 £m
Liquid assets	962.0	1,116.8	1,320.0	1,112.5	1,569.6
Loans and advances to customers	6,544.9	7,073.9	7,864.1	8,498.7	9,033.1
Other assets	77.5	90.5	78.5	76.2	93.1
Total assets	**7,584.4**	**8,281.2**	**9,262.6**	**9,687.4**	**10,695.8**
Retail savings	5,621.8	6,165.2	6,563.8	6,989.8	7,588.5
Wholesale funding	1,287.5	1,468.8	2,035.9	2,019.4	2,378.1
Other liabilities	226.1	168.8	142.5	127.5	145.8
Total liabilities	**7,135.4**	**7,802.8**	**8,742.2**	**9,136.7**	**10,112.4**
Reserves	449.0	478.4	520.4	550.7	583.4
Total liabilities and equity	**7,584.4**	**8,281.2**	**9,262.6**	**9,687.4**	**10,695.8**

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 a net increase in loans and advances to customers of £534.4m (2018: £634.6m) to £9,033.1m (2018: £8,498.7m). We have achieved this profitably and in line with our risk appetite. Net retail mortgage lending in the year was £499.3m (2018: £718.7m). Gross retail mortgage lending was £1,599.9m (2018: £1,869.2m).

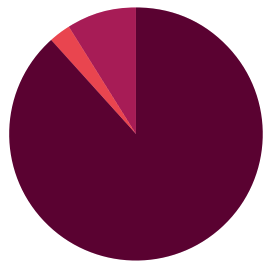
LOAN & ADVANCES TO CUSTOMERS (£M)



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 £7,993.5m (2018: £7,494.3m). This includes both lending to homeowners and a high quality buy-to-let portfolio of £2,151.2m (2018: £1,929.4m). 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 £179.3m (2018: £236.2m), secured against residential property by a second charge. This business is in run-off with balances reducing by £56.9m (2018: £75.6m reduction) in the year.

LOANS & ADVANCES TO CUSTOMERS BY PORTFOLIO (£M)*



*Figures exclude fair value adjustments.

Our retail mortgage and secured personal lending portfolios reflect the prudent nature of our lending policies, with 68% (2018: 68%) of exposures having a loan to indexed valuation of less than 70% and 83% (2018: 82%) 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 31.1% of lending (2018: 30.7%) in the retail mortgage and secured personal lending portfolios.

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 0.42% (2018: 0.49%) which compares favourably with the industry average of 0.79%*. The number of properties taken into possession during the year was 35 (2018: 36).

The percentage of secured personal loans currently in arrears of two months or more by number is 4.72% (2018: 4.76%), which by value is 5.92% (2018: 5.67%).

The commercial lending portfolio is made up of commercial property exposures representing 36.1% (2018: 35.7%) of balances, and lending against residential property and to registered social landlords of 63.9% (2018: 64.3%). The Society provides loans secured on commercial property across England and Wales, with 47.3% (2018: 47.1%) of lending situated in Wales.

The commercial lending portfolio had three exposures greater than three months in arrears at the year-end (2018: two) with a balance of £0.7m (2018: £0.6m). 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 2019.*

Defined benefit pension scheme

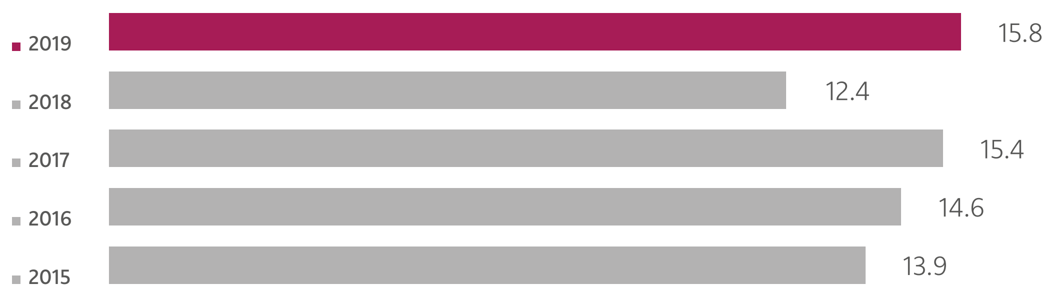
The Society operates a defined benefit pension scheme, which is closed to new entrants and to further accrual. During the year, the pension scheme deficit (the difference between the scheme assets and scheme liabilities on an accounting basis) was reduced to nil (2018: £3.9m), due largely to contributions made by the Society in the year of £3.7m (2018: £4.6m).

The scheme is subject to a triennial valuation by the scheme's independent actuary, with the most recent valuation underway with a reference date of 30 September 2019. This process will be completed prior to the 31 December 2020 year-end and 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 15.8% (2018: 12.4%) as a proportion of shares, deposits and loans (SDL). Liquidity levels at the end of the year were increased by a £350m RMBS issuance in November 2019. There were no similar issuances in 2018.

LIQUIDITY RATIO (%)



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 86.6% (2018: 86.3%). Of the total liquid assets, none (2018: none) 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 223.1% at the year-end (2018: 155.8%), 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:

	2019 £m	2018 £m
Cash and balances with the Bank of England	1,201.9	931.8
Securities issued by the UK Government and Multilateral Development Banks	141.3	–
Total Buffer Eligible Assets	**1,343.2**	**931.8**
Loans and advances to credit institutions and other debt securities	226.4	180.7
Total	**1,569.6**	**1,112.5**

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 £7,588.5m (2018: £6,989.8m) represent 84.0% (2018: 82.2%) of all mortgage and loan balances. Retail savings balances have increased by £598.7m in the year (2018: £426.0m), reflecting the continued focus on offering attractive products to Members.

In 2019, we completed our fifth and sixth RMBS issuances, raising £665m of funding. These issuances supported our strategic objective of maintaining a diverse and balanced funding base. The total value of RMBS notes outstanding at the end of the year was £805.3m (2018: £713.2m).

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, 23.3% (2018: 22.9%) of the group's assets were encumbered, representing £2,288.2m (2018: £2,072.1m) of residential mortgage assets and £198.9m (2018: £145.0m) 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.

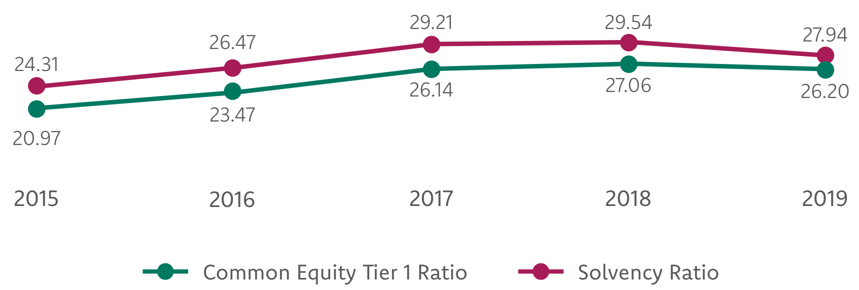
Capital is held in both of the regulatory tiers. The group's general reserve qualifies as Common Equity Tier 1 capital, the very highest quality of capital. Under Basel III transitional rules, the PIBS qualify as Additional Tier 1 capital, but amortise on a straight line basis over eight years from 2014. 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 reduced to 26.20% in the year (2018: 27.06%). This reduction has been driven by a marginal increase in the level of risk attributed to certain loan assets in the current economic climate, including impacts of movements in house prices, rather than a reduction in capital levels held. The ratio remains strong and our profitability during the year means that we are continuing to generate sufficient capital through our financial performance to facilitate the increase in lending to households and businesses.

Due to these factors, our Solvency ratio, the ratio of total capital to risk weighted assets, has also reduced to 27.94% (2018: 29.54%).

CAPITAL RATIOS (%)



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 5.21% (2018: 5.60%).

Member, Colleague and Community

for the year ended 31 December 2019

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 been busy raising money for our two new charity partners, Teenage Cancer Trust Cymru and Alzheimer's Society Cymru.

This is the first year of a three year partnership with these brilliant charities and highlights include £156,000 raised during 2019, split evenly between each charity, and helped by the Home Advantage Bond which generated £50,000 based on five wins by Wales during the Guinness Six Nations 2019.

£156,000 raised and split evenly between Teenage Cancer Trust Cymru and Alzheimer's Society Cymru which includes **£50,000** generated by the Home Advantage Bond based on five wins by Wales during the Guinness Six Nations 2019

Financial education

We have continued to grow our financial education (Fin-Ed) activity across Wales, with Business Class secondary school partnerships (working with Careers Wales), workshops in primary schools, support of Talk Money Week, Fin-Ed qualification sponsorships with the London Institute of Banking and Finance (LIBF) and a number of collaborative projects including Savings Challenge events (with GCSE pupils coming up with new product ideas) and a Savings School pilot with Techniquest in North Wales. Highlights include:

3 of our Business Class Schools are Young Money Financial Education Centres	3 of our Business Class Schools are, or are working towards becoming, Young Money Financial Education Centres of Excellence.
We helped over **11,000** pupils	2019 was a record breaking year of pupil engagement – we helped over 11,000 pupils learn more about money and develop their careers based skills.
1,104 pupils have gained Fin-Ed qualifications	We have been working with our Business Class partner schools for a number of years and for the period between 2017 and 2019, 1,104 pupils have gained recognised Fin-Ed qualifications, 921 of which are equivalent to a GCSE (Level 2 Certificate in Financial Capability and Careers Development), and 589 at A* or A grades.
£110,000 of funding to help pupils	We have also launched Fin-Ed qualification projects across Carmarthenshire and Cardiff – providing £110,000 of funding to help pupils across 14 schools.
Over **150** took part in our Savimngs Challenge events	Over 150 pupils across 5 schools took part in our Savings Challenge events – with winning groups from each school due to take part in a final at the Principality Stadium in early 2020. This has helped bring the world of work and financial services a little closer to pupils.

Volunteering

- The vast majority of our colleague volunteering takes place in schools as part of our commitment to Fin-Ed. In 2019, we invested 1,100 hours of volunteering into local schools and community projects.
- We always look forward to Talk Money Week each year and again in 2019 colleagues swapped their branches for the classroom, delivering workshops in primary schools. Over 2,000 pupils were helped during Talk Money Week in 2019.
- We also helped develop some green spaces for the community, going back to the Orchard at Llandough Hospital and the garden at St John's Day Centre in Swansea.
- We were very proud to be recognised at the Business In The Community (BITC) Wales Responsible Business Awards 2019 with a Volunteering Impact Award, Mortgage Finance Gazette Awards 2019 for Corporate Social Responsibility and for the second straight year Principality was named as a finalist in the Financial Innovation Awards 2019 for Financial Inclusion.

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 Principality Stadium benefitting the local economy and grassroots rugby across Wales.

Close to **1000**

Tickets to Principality Stadium events given away through our Member Rewards competitions.

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

40

Consecutive years of sponsorship of the National Eisteddfod event which celebrates Welsh culture.

25

More than 25 years sponsoring the Royal Welsh Show.

STRATEGIC REPORT

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.

The Member Forum is made up of volunteer members who act as a collective voice for all Principality Members. They attend meetings on a quarterly basis to share their views and tell us what they think of our products, 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.

Principality also engages with its Members in a number of other 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.

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

The aim of our people strategy is to deliver continuous 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 focused 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.

As one of our greatest assets, we are incredibly proud of our colleagues. Through our People Pact, we are committed to helping our colleagues prosper at every stage of their working lives. 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 UK's Best Workplaces 2019 - Super Large Category, we are committed to building on what our colleagues tell us they enjoy about working in our organisation and we work hard to address 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 encouraging our colleagues to live and demonstrate 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. 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. Encouraging diversity throughout our business remains a priority and we have been pleased to see a positive take-up amongst our colleagues for a number of diversity-focused 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.

Over the past year, we have worked closely with Stonewall to ensure we can do everything possible to help all colleagues feel comfortable, safe and to be able to be themselves at work. We have also worked extensively on our recruitment process, introducing gender de-coding, blind shortlisting, and gender balanced interview panels and ensuring that protected characteristics are championed throughout.

Recognising that no two colleagues are the same, we also offer a flexible benefits package allowing our colleagues to select the benefits that are most meaningful to them. The range includes private medical cover, dental cover, holiday buy and sell, will writing, travel accounts and much more.

We encourage expertise: investing in our talent to 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 through our People Pact around 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. New for 2018/19, our Accelerated Development Programme focuses on our leaders – building their skills and experience so they can lead and support our workforce with increased knowledge and expertise.

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 our PBS Manager training for all people managers, our skills exchange and a mentoring scheme. More recently we have 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 2019, 91% 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 2019 survey showed that engagement remains strong at 77% (2018: 76%). 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 well-being approach that aims to promote both mental and physical health amongst our colleagues. With a wide ranging wellbeing-focused 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.

In July 2019, we were delighted to be awarded with the Corporate Health Standard, part of the Welsh Government's 'Healthy Working Wales' programme with a purpose of encouraging and enabling the development of good practice in the promotion of health and wellbeing in the workplace. In addition, in November 2019, we were recognised as a Centre of Excellence in Wellbeing by Great Place to Work®.

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 Society's successes, 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.

Managing and reducing environmental impacts

At Principality, we are passionate about our communities and our Corporate Social Responsibility efforts have won awards for our 'Responsible Business' practices, but we want to up the ante on our environmental focus and that starts in the workplace.

We know that as we grow, the resources we use increase, with a potentially greater environmental impact. As protecting our environment becomes ever more important to our Members and colleagues, we are continuing to work on becoming more efficient in the amount of energy we consume as a business, increasing the effectiveness of recycling programmes and improving colleague awareness of environmentally responsible behaviour such as reducing paper, energy and personal car use. Our flexible working policy has enabled more colleagues to work from home where appropriate, reducing the need for unnecessary travel.

We know from our carbon footprint that heating, lighting and general electrical use are the main contributors to our energy usage, so we are working hard to reduce their usage across our property estate. An important part of this work involves identifying any anomalies or areas of high-usage and raising awareness about the best way to use existing systems to reduce energy consumption.

Energy efficient working environments

As part of the refurbishment of our head office (Principality House, Cardiff), we introduced a number of energy saving initiatives to reduce our energy consumption and create a sustainable workplace:

- All lighting has been replaced with energy efficient lighting with motion sensors.
- All kitchen spaces have efficient zip taps for cold and hot water to encourage reusable water bottles and reduce usage of kettles.
- All windows have been coated with a film to reduce sun glare and reduce overheating.
- We invested in our heating, ventilation and air conditioning systems, making them more energy efficient.
- Our in-house colleague café uses only recyclable or biodegradable packaging.

We have introduced a number of energy saving initiatives across our branch network too, including LED lighting and updated technology systems and we are continuously working with colleagues across all 53 branches to share best practice and reduce energy consumption.

All of our offices are situated in environmentally considerate locations with good transport links. We promote the use of public transport and where possible, we provide facilities to encourage cycling to work, including showers and secure bike storage. We participate in the Cycle to Work scheme and offer discounts on season tickets for train and bus commuting.

Case Study: Redevelopment of The Friary

Focus on environmental efficiency

When Principality House opened in 1992, Cardiff County Council took on a lease on the 25,000 square feet, five storey building attached to the back of Principality House known as 'The Friary Centre'. In September 2018, Principality took back occupation of The Friary Centre and began an extensive renovation programme to bring the space up to standard, incorporating many environmental considerations into the work undertaken.

Environmental considerations

The Society already possess solid social and environmental credentials through its membership of ESOS (Energy Saving Opportunity Scheme). During the redevelopment of the building, we installed a number of electrical and mechanical systems to ensure compliance with our requirement to conserve energy and to target zero ozone depletion.

New internal and external lighting has been installed, based on presence detection and daylight control. The heating and ventilation systems utilised in the building incorporate the latest technologies for maximum efficiency and water provisions are also closely monitored to ensure minimal wastage.

Reducing waste and recycling effectively

Managing waste effectively is an important area of focus for us. All of our colleagues have access to recycling points and we are proud that Principality's recycling figure is exceeding the target set by Welsh Government, with 74.7% of our waste recycled and 23.4% of our waste being converted to energy. In 2019, we introduced food waste recycling points in addition to our dry mixed recycling and paper/confidential waste bins.

Energy-efficient technology

We regularly review our technology and IT usage to identify where we can reduce energy consumption. Desktop PC's and laptops continue to be replaced with more energy efficient equipment when required and old equipment is recycled either through donation or through an appropriate recycling unit. In 2018, we introduced video conferencing technology which is used by colleagues and customers alike to reduce transport and optimise time that would usually be spent travelling to appointments/meetings.

External support

We continue to consult with a number of external companies and schemes to identify cost-effective energy saving measures. We have continued to engage with both our third party relationships and specialist organisations for advice and guidance on areas for improvement. We also are members of 'Cynnal Cymru/Sustain Wales' and sponsor an initiative called 'Size of Wales' that is helping tackle climate change.

2019 Highlights:

'Go Green Day'

Like many organisations across Wales the Society supported the 'Go Green Day' in June organised by the Size of Wales charity. On this day, we encouraged colleagues to:

Travel Green

- Consider walking or cycling to work, taking public transport or car sharing.

Ditch the single-use plastics and packaging

- Bring a reusable water bottle or coffee cup, and bring lunch in a reusable container rather than buying lunch.

Eat in

- Consider eating in to reduce unnecessary takeaway packaging.

Recycle properly

- Ensure waste is recycled in the correct bins to reduce contamination.

Reusable bags

- Bring a reusable shopping bag rather than buying a plastic single-use carrier.

Colleagues were encouraged to make a 'green pledge', committing a promise to adopt a new habit or change one thing to reduce their individual impact on the environment.

Environmental Champions

We now have a group of 15 Environment Champions from across all areas of our business, who are all passionate about making Principality a greener workplace. The role of our Environmental Champions is to:

- Raise awareness of what Principality is doing to reduce its environmental impact.
- Help empower colleagues with the knowledge they need to reduce their own impact on the environment whilst at work.
- Highlight key initiatives, awareness days, and share general tips and advice on how to be greener at work.
- Represent colleagues on our Colleague Forum to ensure the topic of environment stays at the forefront of key decision-makers and influencers at Principality.
- Communicate ideas about initiatives that the Society can adopt to reduce its impact on the environment through identified channels to reach all levels within the Society.

One key initiative for the Environment Champions for 2020 will be an Environmental Awareness week in which the ambassadors will share tips and guidance on how to adopt greener habits for colleagues. Throughout the rest of the year, the network will work to improve our recycling rates and encourage colleagues to produce less waste and consume less energy whilst at work.

The Energy Savings Opportunity Scheme (ESOS 2)

The Energy Savings Opportunity Scheme (ESOS) was established to implement Article 8 4-6 of the European Union Energy Efficiency Directive (2012/27/EU). The ESOS Regulations 2014 gave effect to them. Since 2015 when the scheme was implemented and our assessment was completed, the Society has invested to become more efficient using the recommendations as guidance. In line with our obligations under the regulations we were re-assessed against ESOS 2 in April of this year and we will continue to look into efficiencies within the business to support our environmental aims.

Environment priorities for 2020

We have devised an energy saving plan that identifies a number of areas in which we believe we can make significant savings in transport, energy and materials across all sites within our business. We will continue to challenge ourselves to identify and combat our impact on the environment, and produce immediate, short and long-term initiatives and actions for all colleagues and departments across the business.

KPIs

To measure our progress we monitor the following KPIs:

	2017	2018	2019
Road Miles Travelled	455,177	413,171	353,479
Energy Usage (KwH)	4,408,616	4,116,543	3,947,920

Risk Overview

for the year ended 31 December 2019

As a business, we are exposed to a diverse range of risks in the execution of our strategy and in undertaking our day-to-day activities. These risks are mitigated to an extent by the straightforward nature of our business model and the products we offer. Our culture and risk management philosophy reflects a strong awareness of the current and emerging risk landscape, which could affect the delivery of our strategy. We operate solely within the UK and take risks only where they can be fully understood, monitored and controlled.

We manage 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;
- Monitoring and managing risks within risk appetite as set by the Board; and
- Ensuring we maintain sufficient capital and liquidity, to enable the business to survive severe but plausible market and firm specific stresses.

Principal risks

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

Business risk	Credit risk	Liquidity and funding risk	Market 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, competitive, geographical, regulatory or other factors.	The risk that borrowers or counterparties do not meet their financial obligations as they fall due.	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.	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.
Operational risk	**Solvency risk**	**Conduct risk**	**Legal & regulatory risk**
The risk of loss arising from inadequate or failed internal processes, systems, human error or from external events.	The risk that the Society does not maintain sufficient capital resources in excess of minimum regulatory requirements.	The risk that the Society does not treat its customers fairly resulting in inappropriate or unfair outcomes.	The risk that the Society does not comply with legislation and regulation.

a) Business risk

We consider 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 Board Risk Committee whose remit encompasses all risk categories on a Society-wide basis.

(i) Market background and uncertainties

Competition in mortgage and savings markets from 'Challenger' and mainstream UK banks is increasing as they focus on service delivery and non-investment banking activities. We are focusing on efficiency and cost control through our continuous improvement programme, but cost pressures will continue to arise from the pace and complexity of regulatory change, required levels of investment in technology and organic growth.

(ii) 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 the Board and senior risk committees whose remit encompasses the oversight of all risk categories.

b) Credit risk
Credit risk arises primarily from loans to retail and commercial customers and from the investments held by the Society's Treasury function.

(i) Market background and uncertainties
The current global political and economic outlook remains uncertain. Despite a measure of certainty gained from the outcome of the recent general election, Brexit trade negotiations are likely to continue to impact consumer sentiment. This has already started to manifest itself in lower demand for housing and falling property values, particularly in the South East of England. Relatively low wage growth continues to put pressure on real incomes, restricting those wishing to purchase their first home. These factors pose a threat to longer-term prosperity in the UK. For that reason, our forecasts and plans continue to take account of scenarios that model stresses on the ability of customers and counterparties to meet their financial obligations. These stress factors include movements in interest rates, decreases in house prices, impacts on commercial property market values, the ability to re-finance at maturity, a sustained deterioration in the macroeconomic environment and consequential increases in unemployment.

(ii) Risk mitigation
The quality of individual lending decisions and subsequent management and control, together with the application of a credit policy that reflects our risk appetite, have a direct impact on the success of our strategy. Each business area; residential lending, commercial lending and treasury, has a Credit Risk Policy Statement setting out the Board's risk appetite including 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 to measure, mitigate and manage credit risk in a manner consistent with risk appetite. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

(iii) Retail credit risk
We continue 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 our risk appetite. Applicant quality is monitored closely, defined in terms of creditworthiness, loan to value (LTV) and loan to income (LTI) ratios, and affordability profile. We assess affordability using a stressed, higher interest rate to protect the borrower from entering into a mortgage commitment that could prove unsustainable in a higher interest rate environment. We no longer originate new lending in the second charge retail market.

Lending is secured against properties in the UK. This concentration in the UK market could be exacerbated by over exposure to one geographical location or reliance on particular product types within the portfolio.

STRATEGIC REPORT

We manage 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 is undertaken which seeks to establish the extent to which losses may emerge under a range of scenarios. These stress tests primarily consider the impact of economic events on rates of default and on house price movements.

Our 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 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.

(iv) 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. We remain cautious with regard to commercial lending which is undertaken on a prudent basis and continue 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. Commercial lending relationships are subject to regular reviews to ensure that facilities are 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. In particular the commercial lending division will engage in extensive dialogue with customers and advisors, and 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, Credit Risk Committee and Board Risk Committee.

(v) Treasury credit risk
Treasury credit risk arises from the investments held to meet liquidity requirements. The Treasury function is responsible for managing this aspect of credit risk within policy limits. Treasury counterparty lines of credit are reviewed on a weekly basis by the Finance Committee. Changes to lines and limits are approved by the Board Risk Committee within a framework prescribed by the Board.

STRATEGIC REPORT

c) Liquidity and funding risk

Determining the appropriate mix and amount of liquidity and funding to hold is a key decision for the Board, which recognises that we must remain a safe and attractive home for Members' retail deposits in addition to providing adequate levels of profitability.

(i) Market background and uncertainties

Uncertainties in the political and economic outlook globally and in the UK can impact the availability of funding. However, we have demonstrated a strong track record of being able to attract and retain retail funding, and our external credit ratings continue to support access to wholesale funding markets.

In August 2016, the Bank of England launched the Term Funding Scheme (TFS), which provided 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 received a total of £675m from the Scheme before it closed.

(ii) Risk mitigation

The day-to-day management of liquidity is the responsibility of the Treasury function. The Finance Committee exercises control over levels of 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 Internal Liquidity Adequacy Assessment Process (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 2019.

As at 31 December 2019, we held a Liquidity Coverage Ratio (LCR) ratio well in excess of 100%. Based on current interpretations of Net Stable Funding Ratio (NSFR) regulatory guidance, we held a NSFR ratio well in excess of the full 100% ratio requirement.

d) Market risk

The Treasury function is responsible for managing our 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, Finance Committee, Executive and Board Risk Committees.

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

(i) Interest rate risk

Interest rate risk principally arises 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.

We continue to ensure that we maintain a significant proportion of discretionary variable rate savings and mortgages on our balance sheet, which provides flexibility to manage a prolonged low interest rate environment, or the possible impacts of a change in Bank of England Base Rate.

We have 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 the balance sheet.

(ii) Market background and uncertainties

Market interest rates have remained volatile during 2019. Expectations are that interest rates will remain lower for a longer period than previously envisaged, however, this is dependent on the impact of Brexit trade negotiations. In the short-term, interest rates could decrease further from current levels and our plans take account of the need to mitigate the potential impact on margin.

Regulators plan to phase out the use of LIBOR (London Interbank Offered Rate) by 2021. LIBOR is a measure of the average rate at which banks are willing to lend funds. It is a major interest rate benchmark used across the industry. We are impacted due to our exposures to LIBOR assets and liabilities, particularly in the commercial lending portfolio and associated derivatives. The risks associated with this transition are fully understood and not expected to be material.

(iii) 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 and in accordance with the terms of the Building Societies Act 1986.

On a monthly basis, the Finance Committee considers the impact of a number of interest rate risk and basis risk stress tests on the balance sheet, using both earnings and value measures. In addition, our Executive and Board Risk Committees review options and strategies available to manage the impact of any potential future increases in interest rates. Our forecasts and plans take account of the risk of interest rate changes and are stressed accordingly.

(iv) Currency risk

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

STRATEGIC REPORT

e) Operational risk

We assess our exposure to and management of operational risks by reference to eight categories:

Risk Category	Brief Definition
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.

(i) 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. 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. We continue to strengthen our control environment to protect those who are most vulnerable to financial abuse, and work collaboratively with industry partners to further improve controls and enhance both staff and customer education.

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

(ii) Risk mitigation

We manage our 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 above. 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.

Our 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, and 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 considers an appropriate amount of capital to be held for operational failures.

f) 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 we are exposed and the need for capital to be available to support the growth of the business.

In 2013, we obtained permission to use the Internal Ratings Based (IRB) approach for calculating Pillar 1 capital requirements for our first charge retail and commercial lending portfolios. This approach allows us to calculate regulatory capital requirements using internally developed models that reflect the credit quality of our mortgage book and detailed understanding of our customer base and credit risk profile.

For other exposures and risk areas, we follow the standardised approach that uses capital risk weighting percentages set by the PRA. Capital Requirements Directive IV set enhanced minimum capital requirements for firms and we expect at all times to meet these requirements.

In addition to Pillar 1 capital requirements, we hold capital within Pillar 2 for those risks not captured adequately in Pillar 1 and additionally retain capital buffers which may be drawn down in periods of stress, CRD IV requires firms to hold supplementary capital buffers. Our strategic plans envisage an accretive capital position, thereby ensuring Pillar 1 and 2 capital requirements are comfortably met at all times. Additionally, the Board is confident that we will maintain a strong leverage ratio throughout the existing business plan and would continue to do so across a range of stressed conditions.

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 bailouts in the UK. These rules require certain firms to hold capital over and above that discussed above. Our resolution strategy has been set as the modified insolvency process. This reflects the low perceived risk we pose to the UK Financial system; we are not required to hold capital additional to Pillars 1 and 2 noted above.

To meet Basel III Pillar 3 requirements, we publish further information about our exposures and risk management procedures and policies. This will be published on our website (www.principality.co.uk) in April 2020.

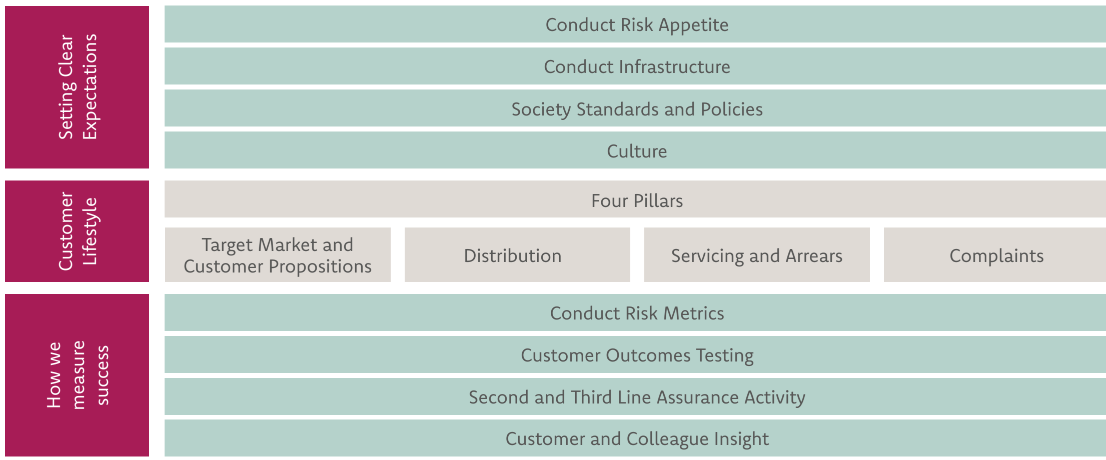
g) Conduct risk

(i) Market background and uncertainties

The sustainability of our business model and achievement of our longer-term strategy are dependent upon the consistent and fair treatment of Members and customers. We have 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.

(ii) Risk mitigation

Our framework for managing conduct risk is outlined in the following diagram:



The Conduct Strategy sets out our strategy for managing conduct risk and also articulates the Board's risk appetite in relation to conduct risk. The Conduct Strategy is considered and approved on a triennial basis, unless earlier review is warranted by material changes in the external environment or in our strategy. The next scheduled review date by the Board is in April 2020.

Our 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 Compliance and Conduct Policy sets out high level expectations in relation to the management of conduct risk 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 our 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 we achieve our aim of consistently delivering fair outcomes for Members and customers. Regular feedback from Members and customers is also obtained.

h) Legal and Regulatory risk

(i) Market back ground and uncertainties

The following matters pose potential risks to the achievement of our 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 focused business operating in highly regulated markets, we are subject to complaints in the ordinary course of business. In addition, at a sector level, the incidence of regulatory reviews, challenges and investigations remains elevated. Regulatory expectations in respect of conduct standards increase the risk of future sanctions, fines or customer redress.

Our business model and strong Member focus ensures that we are well placed to meet current and emerging requirements.

(ii) Risk mitigation

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

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

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 our business model.

Emerging risks

Alongside the principal risks detailed previously, our exposure to current and emerging risks is closely monitored through a formal governance structure which includes measuring performance against key risk indicators.

Regular horizon scanning activity is undertaken to identify any new or emerging risks that could threaten the long-term viability of the business. We also consider the outputs of stress testing and conduct 'Black Swan' exercises which consider unlikely events which would have a material impact on its business model. The most significant emerging risks to our strategy are detailed in the table below, together with actions being taken to mitigate those risks:

Risk	Mitigating Actions
Macroeconomic and geopolitical environment The nature of our business means that we are 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.	We prepare medium-term financial plans on an annual basis which incorporate scenarios that 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 headwinds in the economy. In addition, we have 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.
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 continued competition in our 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 Banking technology.	Our transformation programme is primarily intended to ensure that our core offering remains appropriate and relevant to our target market. The successful delivery of these investment plans will help mitigate the risks arising as a consequence of increased competition. Focus at a Board level has increased in line with the perceived benefits and risks associated with delivery of the project. The markets in which we operate are constantly monitored, to ensure the business can respond to changes in customer requirements.

Risk	Mitigating Actions
Operational resilience The nature and pace of technological change represents a risk to the continued resilience of the financial services sector. Our ability to maintain and further develop operational resilience and operational risk management capabilities is vital to ensure we can continue to provide Members with a secure, stable and competitive service.	Our transformation programme incorporates appropriate levels of investment in systems capability and underlying resilience. The Board Risk Committee maintains regular oversight of programme delivery and in ensuring the ongoing effectiveness of business level operational risk management capability and associated controls.
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.	We continue to develop our cyber risk management capability alongside the investment in our core product offering. We continue to regularly review the availability of preventative and detective controls.

Approval of the Strategic Report

This Strategic Report (on pages 4 to 49) has been approved by the Board of Directors and is signed on behalf of the Board by:

Tom Denman
Chief Financial Officer
5 February 2020

Governance

Board of Directors

Committee Key: (in bold for Chair)

AC	Audit Committee	RC	Remuneration Committee	GNC	Governance and Nominations Committee
BRC	Board Risk Committee	TC	Technology Committee		

Laurence Philip Adams MA

Chairman, Non-Executive Director GNC RC

Joined the Board in August 2013, elected Chairman in April 2014

Skills and experience

I am a qualified solicitor with more than 25 years' experience in the banking industry, which helps advise and guide the Society through the increasingly demanding and complex regulatory environment in which it now operates. 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.

Contribution to the Society's long-term sustainable success

I am responsible for leading the work of the Board, ensuring the Board operates effectively in setting the strategy, overseeing the performance and setting the risk appetites of the Society. I am also responsible for ensuring robust succession plans are in place, that the Society maintains the highest standards of corporate governance and that we have an open and transparent culture.

Other roles

Director of Outside Insight Ltd and Non-Executive Director of London Clearing House Limited, part of the London Stock Exchange.

Nigel Charles Annett CBE, MSc, MA [Hons], DSc Econ

Independent Non-Executive Director TC BRC GNC

Joined the Board in October 2013

Skills and experience

I previously worked in investment banking, but after ten 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 Managing Director of Welsh Water until 2014. I believe strongly that mutual business models can do a great deal of good for the people and the communities that they serve.

Contribution to the Society's long-term sustainable success

I am responsible for ensuring effective oversight of the Society's ongoing transformation programme so that we continue to transform and modernise to benefit both current and future generations of Members.

Other roles

Board member of the Canal and River Trust and a Trustee of the Community Foundation in Wales.

Claire Hafner ACA, MA

Independent Non-Executive Director

AC RC GNC

Joined the Board in April 2018

Skills and experience

I am a qualified accountant (ACA) and have an MA in Languages and Economics. I trained and qualified at Ernst & Young in the Financial Services audit 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 a term of six years as a Non-Executive Director of the West Bromwich Building Society.

Contribution to the Society's long-term sustainable success

My experience across the different sectors of financial services, payments, professional services, multimedia and telecoms enables me to contribute to the Society's change programme and to the Society's continuing success.

Other roles

I sit as a member of the Society's Colleague Forum and it is my role to ensure that the voice of colleagues is heard directly in the Boardroom alongside that of Members.

Sally Jones-Evans FCIB, MBA, MSC

Independent Non-Executive Director

RC GNC AC TC

Joined the Board in February 2015

Skills and experience

I spent 30 years in retail banking and general insurance during which I gained wide ranging experience in leading people through change, mainly in areas directly serving customers. I believe that helps me to support the Executive Leadership team to shape the Society's ongoing change agenda.

Contribution to the Society's long-term sustainable success

I am responsible for ensuring that the Society's remuneration and reward strategy, policy and procedures support the strategy approved by the Board reflecting the best interests of Members. This enables the Society to attract and retain the best people to ensure the Society is run safely and successfully.

Other roles

I sit on the Boards of Hafren Dyfrydwy Ltd (a subsidiary of Severn Trent PLC) and Saga Services Ltd, the insurance broking arm of Saga Group PLC. I have a special interest in tackling poverty and injustice and serve as a Trustee of Tearfund, the humanitarian and overseas development charity and am a Non-Executive Director for the Board of the Department for International Development.

Derek Anthony Howell BSc [Hons], FCA

Independent Non-Executive Director

AC BRC GNC

Joined the Board in April 2014

Skills and experience

I hold a degree in mathematics and qualified as a Chartered Accountant with Price Waterhouse – subsequently Pricewaterhouse Coopers (PwC) where I initially worked in audit and eventually specialised in corporate recovery and insolvency work, becoming a partner in 1988. Following my retirement from the partnership, I continue to act as a consultant for PwC solely in connection with the ongoing administration of Lehman Brothers.

Contribution to the Society's long-term sustainable success

As Senior Independent Director, I act as a sounding board for the Chairman, serve as an intermediary for other directors, and am responsible for leading the annual review of the Chairman's performance. As the Board appointed Whistleblowing Champion, I am also available to Members if they have concerns which they have not been able to resolve through the normal channels, or for which such contact is inappropriate.

I am responsible for helping the Board fulfil its oversight responsibilities in respect of matters relating to the integrity of financial and narrative statements; systems of risk management and internal control.

Other roles

Treasurer of St John Cymru Wales, Consultant for PwC and a trustee of both the National Botanic Garden of Wales and Artes Mundi.

Debra Evans-Williams

Independent Non-Executive Director

GNC TC

Joined the Board in September 2019

Skills and experience

During my career, I have held a range of Executive and Non-Executive Director positions and have also worked in a consultancy role with companies in the UK, Europe and the US. My previous experience includes five years spent at the Britannia Building Society, as well as senior roles at Tesco Compare and Confused.com.

Contribution to the Society's long-term sustainable success

My experience in the fintech/e-commerce arenas will enable me to make a positive contribution to the Society's ongoing digital transformation which will support the continued delivery of stand-out experience for our Members.

Other roles

Chair of Local Democracy and Boundary Commission for Wales, Non-Executive Chair of Careers Wales, Non-Executive Director of the Milford Haven Port Authority and Trustee of the Alacrity Foundation. I am also a proud ambassador for Tŷ Hafan.

David James Rigney ACMA, MBA, MA

Independent Non-Executive Director

BRC AC GNC TC

Joined the Board in March 2015

Skills and experience

I am a Chartered Management Accountant and during my career have performed a broad range of roles across multiple sectors including a Board Director at Nationwide Building Society. I believe this experience leaves me well placed to contribute to the Society's ongoing change programme and to contribute to the Society's continuing success.

Contribution to the Society's long-term sustainable success

I am responsible for making sure the Society actively manages the principal risks that arise from its activities, alongside ensuring awareness of the current and emerging risk environments which helps protect the Society so it can continue to be successful and sustainable for its Members.

Other roles

Non-Executive Director at LINK Scheme Holdings Ltd and Senior Independent Director of Elexon Limited.

Robert Michael Jones BA [Hons], MBA, ACIB

Interim Chief Executive Officer (CEO)

Joined the Board in February 2013

Skills and experience

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 Chief Risk Officer (CRO)) in 2009. In December 2019, I was appointed Interim CEO by the Board. I have spent over 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.

Contribution to the Society's long-term sustainable success

In my role as Interim CEO, I am responsible for leading the Executive team to ensure we continue to deliver the Society's strategy for the long-term interests of our Members in addition to maintaining the smooth running of the Society's day-to-day operations. As Chief Risk Officer, together with the Chief Finance Officer (CFO), I am responsible for ensuring the Society maintains a strong capital base which will enable it to continue to grow and compete successfully over the long-term. I also have responsibility for the Society's second line of defence to ensure risk management is embedded throughout and aligns to the Society's risk appetite, purpose and objectives.

Julie-Ann Haines MSc, BA [Hons]
Chief Customer Officer (CCO)
Joined the Board in May 2016

Skills and experience
I have been the Society's Customer Director since 2012. Prior to joining Principality, I had almost 20 years' experience leading retail businesses. I was senior manager in sales, marketing and technology for companies such as Sainsbury's and HBOS. Working closely with customers has always been a critical part of what I do.

Contribution to the Society's long-term sustainable success
In my role as CCO, I am responsible for strategy, marketing, distribution and leading the Society's transformation programme as Executive Business Sponsor. I have been a Board Member since May 2016, and am proud to be the first female Executive Director in the Society's history. I negotiated our decade long partnership with the Welsh Rugby Union, which led to the naming rights of Principality Stadium.

Other roles
Chair of UK Finance Cymru and an advisor of FinTech Wales, a new organisation to champion fintech and financial services in Wales.

Iain Mansfield, LLB [Hons], FCA
Chief Operating Officer (COO)
Joined the Board in December 2019
(Board appointment subject to regulatory approval)

Skills and experience
I initially joined Principality's subsidiary business, Nemo Personal Finance, as Finance Director in January 2015. In October 2017, I was appointed Chief Operating Officer for the Society, in addition to retaining overall responsibility for Nemo. I am a qualified Chartered Accountant and, prior to joining Principality, built 15 years' experience in senior leadership roles across large banks, start-up businesses and private equity backed retail financial services businesses.

Contribution to the Society's long-term sustainable success
My role is to ensure we provide excellent service to our customers, maintain and transform our technology and deliver change effectively and efficiently while maintaining appropriate operational resilience to run our business in the interests of our Members and the sustainability of the Society.

Tom Denman, BSc Econ [Hons], ACA
Chief Financial Officer (CFO)
Joined the Board in August 2017

Skills and experience
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 five years with PwC in Cardiff and Sydney. I was appointed Deputy Finance Director in March 2016 with responsibility for all of finance, treasury operations, procurement and legal services, and was subsequently appointed CFO in June 2017.

Contribution to the Society's long-term sustainable success
My role is to ensure we plan and manage the Society's capital, liquidity and funding in the long-term interests of our Members and the sustainability of the Society.

Corporate Governance Report

for the year ended 31 December 2019

The Society's approach to corporate governance is based on the Principles and Provisions of the UK Corporate Governance Code ("UK Code"). A revised version of the UK Code was published by the Financial Reporting Council (FRC) in July 2018, which came into effect from January 2019. Although the UK Code is primarily aimed at listed companies, the Society's Board is committed to operating in line with best practice standards of corporate governance. For this reason, and to meet the expectations of the Society's Members and other stakeholders, the Board chooses to comply with the UK Code, in so far as possible and relevant to building societies.

Upon publication of the July 2018 version of the UK Code, the FRC stated that the revised UK Code sets higher standards of corporate governance to promote transparency and integrity in business by emphasising the importance of:

- relationships with Members and wider stakeholders;
- the need for a clear purpose and strategy to promote a healthy corporate culture;
- high quality Board composition, which promotes diversity; and
- remuneration which is proportionate and supports long-term success.

The implementation of the Society's approach to the revised UK Code has been monitored and overseen by the Society's Governance and Nominations, Audit and Remuneration Committees during the course of 2018 and 2019.

The Role of the Board
The Board is the governing body of the Society and its responsibilities fall under a number of broad functions, which include, setting the overall strategy and risk appetite, leading the development of the Society's culture, operational oversight and setting the corporate governance framework. One of its primary duties is to promote the long-term success of the Society, whilst acting in the best interests of both current and future Members. In doing so, the Board also has regard to its wider stakeholders.

Board Activity
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 agenda to ensure that the Board can address emerging matters in a timely manner. The following table provides a sample of some of the matters the Board has considered during the year:

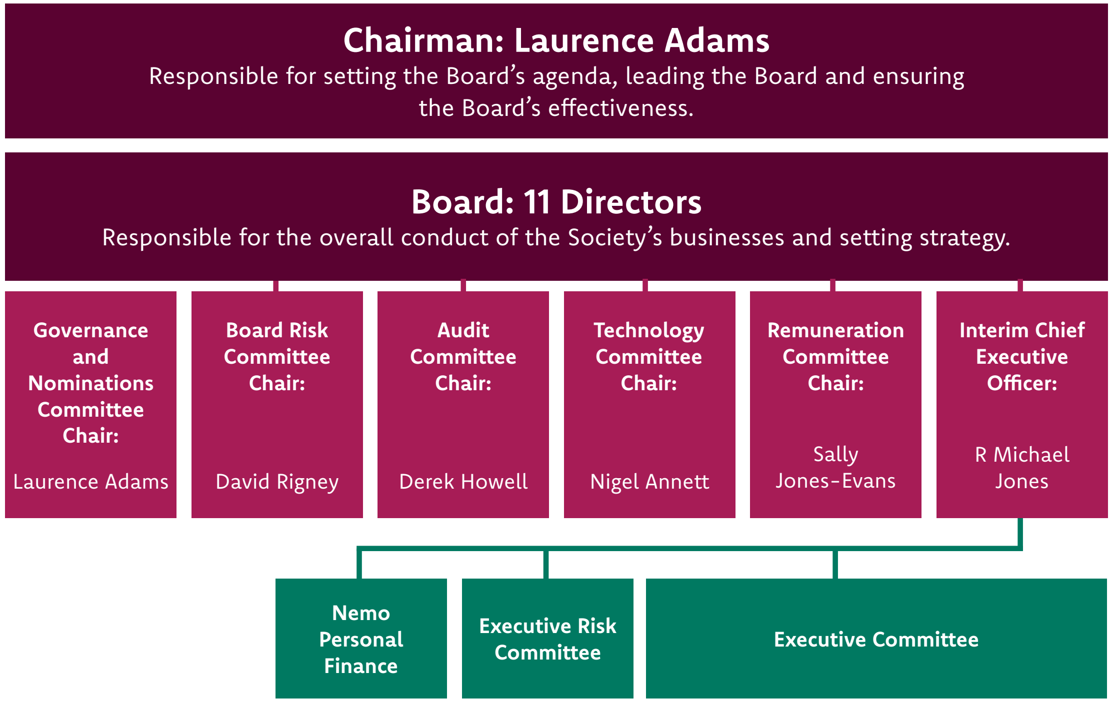
Responsibility	Key Activity
Standing Agenda Items	• Management information pack to facilitate the monitoring of Key Performance Indicators and key risk indicators. • Reports from the Chief Executive Officer, Chief Financial Officer and Chief Risk Officer on performance and risk matters, including non-financial information. • Reports from the Board Committee Chairs on key matters considered and decisions made at the last Committee meeting.
Strategy	• Medium Term Plan • Approval of 2019 Corporate Plan • Approval of Capital Expenditure 2019 Budget • Welsh Affordable Housing Strategy • Market Place Developments • Macroeconomic assumptions • Brexit Planning • Housing and Commercial Strategy • Marketing and Distribution Strategy Review • Information Security Strategy • Conduct Strategy • Transformation Programme & Change Programme update
Financial Reporting and Performance	• Long-term Viability Statement Review • 2018 Annual Report and Accounts and 2019 Interim Financial Statements • Letter of Representation to the Auditors • Summary Financial Statement • Quarterly Performance Review • Cost Management update • Capital Expenditure Budget • 2019 Budget & Quarterly Reforecasts

Responsibility	Key Activity
People, Culture and Remuneration	• People Strategy • Annual Colleague Survey (Great Place to Work Survey) • Culture including People Programme and Diversity and Inclusion • Member and Stakeholder Engagement (including Corporate Social Responsibility) • Member Talkback & Colleague Forum updates • Remuneration Policy
Risk Management	• 2018 ILAAP and ICAAP • Regulatory Matters • Climate Change Risks • 2018 Recovery and Resolution Plan • Approval of Risk Appetite • Information Security and Cyber Resilience • Operational Resilience • Senior Manager Certification Regime – Responsibilities Map • Approval of Treasury Policy Statement • Wholesale Funding Decisions • Lending Policies
Governance	• Adoption of Part II to schedule 10 of the Building Societies Act 1986 and Section 68 & 69 of the Statements and Elections • Approval of Board Committee Terms of Reference • Schedule of Matters Reserved to the Board • 2018 Board Effectiveness Review (including Action Plan) • Election of Chairman • 2020 Annual General Meeting Notice and Proxy Form • Approval of Modern Slavery and Human Trafficking Statement • Changes to the UK Corporate Governance Code • Common Seal Policy • Whistleblowing Policy - Oversight of the Society's Whistleblowing arrangements is a responsibility which has been transferred from the Audit Committee, in accordance with the revised UK Code. • Whistleblowing Champion's Report • Directors Independence

Delegation of Authority

The Board recognises that ensuring a system of effective corporate governance is integral to the successful delivery of the Society's goals. In order to allow the Board to spend sufficient time on items of the most strategic importance, the Board delegates a number of oversight responsibilities to its Committees. The delegation of a Board responsibility to a Committee is made on the basis that membership of each of the Committees comprises Non-Executive Directors with the most relevant skills, knowledge and experience required for that subject area. The responsibilities of each Committee of the Board are outlined within their respective Terms of Reference, which are subject to annual review by the Board and can be viewed on the Society's website: https://www.principality.co.uk. In addition, the Board also maintains a schedule of matters which are reserved for its decision, which is also subject to annual review, and is available on the website.

The Board oversees the work of each of the Committees by receiving regular reports from each Committee Chair on the key matters considered following each Committee meeting. In addition, each Committee carries out a review of its own effectiveness and reports on the outcome of this to the Board.



Board Composition

Under the Society's Rules, the Board must comprise no more than 14 and no less than 7 Directors and, under the UK Code, at least half of the Board should comprise Non-Executive Directors. At 31 December 2019, the Society's Board comprised the Chairman, six independent Non-Executive Directors 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.

During the year, the Board Composition Policy was reviewed and the Board concluded that it remains satisfied that this policy continues to appropriately reflect the importance of building an inclusive culture in which the whole organisation works together and where diversity is valued. More information on this topic is provided within the Governance and Nominations Committee report on page 66.

Non-Executive Directors

The Non-Executive Directors are expected to have a broad range of skills, knowledge and experience to exercise independent judgement on strategy, performance, risk management and corporate governance. In addition, the purpose of the Non-Executive role is to:

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

Time Commitment

One of the key criteria which is taken into account when appointing a Non-Executive Director is whether they are able to commit sufficient time to the role with the Society. Time commitment of the Non-Executive Directors is reviewed by the Chairman upon appointment and is monitored carefully by the Governance and Nominations Committee. Any additional roles that a Non-Executive Director wishes to take up following appointment requires the prior approval of the Board.

Board and Committee membership and attendance

	Board	Audit	Technology	Board Risk	Governance and Nominations	Remuneration
Laurence Adams	12/12	–	–	–	5/5	5/5
Nigel Annett	12/12	–	8/8	6/6	5/5	5/5
Derek Howell	12/12	7/7	–	6/6	5/5	–
Sally Jones-Evans	12/12	6/7	8/8	–	5/5	5/5
David Rigney	12/12	7/7	8/8	6/6	5/5	–
Claire Hafner	12/12	7/7	–	–	5/5	4/5
Debra Evans-Williams[1]	3/5	–	2/2	–	2/2	–
Stephen Hughes[2]	10/10	–	–	–	–	–
R Michael Jones	12/12	–	–	–	–	–
Julie-Ann Haines	12/12	–	–	–	–	
Tom Denman	12/12	–	–	–	–	–

[1] *Debra Evans-Williams joined the Board on 1 September 2019.*

[2] *Stephen Hughes resigned from the Board on 2 December 2019.*

Independence
The Board reviews the independence of its Non-Executive Directors annually. The UK Code outlines criteria for assessing the independence of a Non-Executive Director. A compromise of independence is presumed where Non-Executive Directors have been recent employees of the Society, held a material business relationship with the Society, received any additional fee other than their Director's fee, or have close family ties or significant links to the Society . In addition, the UK Code presumes that a Non-Executive Director who has served more than 9 years on the Board is no longer independent. In light of this, the Board has concluded that all six Non-Executive Directors continue to remain independent.

At the time of his appointment as Chairman, the Board was satisfied that Laurence Adams met the independence criteria as outlined within the UK Code. 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.

Senior Independent Director
Derek Howell is the Board appointed Senior Independent Director. This particular role 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.

Chairman and CEO
The offices of Chairman and Chief Executive Officer are separate and held by different individuals. The Chairman is not involved in the day-to-day management of the Society but is responsible for the following matters which are outlined within a role profile which is subject to review and approval by the Board:

- the leadership and operation of the Board, ensuring that it promotes high standards of corporate governance;
- leading the development of the Society's culture and standards;
- ensuring the effectiveness of the Board, its committees and individual directors is subject to annual evaluation;
- ensuring that the Society engages effectively with its key stakeholders;
- setting the agenda, style and tone of Board discussions;
- ensuring that Directors receive accurate, timely and clear information;
- developing the Board Succession Plan; and
- 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.

The Chief Executive Officer's primary responsibilities are the day-to-day management of the Society, the implementation of the Board approved strategies and policies, and chairing the Executive Committee. His full responsibilities are also outlined within a role profile which is reviewed and approved by the Board. The Chairman and the Chief Executive Officer maintain a close working relationship.

The Executive Committee oversees the day to day operations of the Society's business and formally meets twice a month. These meetings focus on topics relating to people, change, the market and performance, as well as reviewing matters which are due to be presented to the Board of Directors. The Executive Committee is composed of the Chief Executive Officer, three other Executive Directors and three members of the Senior Leadership Team.

Appointments to the Board
Debra Evans-Williams joined the Board as a new Non-Executive Director in September 2019 and now serves as a member of the Technology Committee and Governance and Nominations Committee. Further details about the Non-Executive recruitment process can be found in the Report of the Governance and Nominations Committee on page 66. Iain Mansfield, the Society's Chief Operating Officer, was appointed to the Board as an Executive Director on 31 December 2019.

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, where necessary, 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 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 2020 AGM.

Culture
The Board is responsible for leading the development of the Society's culture. The Board is committed to ensuring that a diverse and inclusive culture is in place which enables all colleagues to feel accepted and valued. Fostering an appropriate culture encourages colleagues from all backgrounds to feel confident in their ability and to achieve their best and are likely to stay longer with the Society as a result.

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 branches, offices and attending meetings of the Member Forum and Colleague Forum, Member Talkback sessions and the Annual General Meeting, 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.

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.

Independent Professional Advice
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 Training Programme
The Chairman is responsible for ensuring that each Non-Executive Director receives induction training, upon joining the Board, and subsequent ongoing training which is tailored to their individual needs and requirements.

The Society's induction programme for new Non-Executive Directors 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 Executives, 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 areas of the business.

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.

The Society's Secretary maintains an ongoing Board training and development programme and during 2019 the following areas were addressed:

- asset and liability risk management;
- legal and regulatory developments;
- corporate governance developments;
- economic environment;
- marketplace developments;
- cyber security; and
- operational resilience.

Individual Performance Evaluation

The Society has a framework in place to ensure that all Directors and 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 duration 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. The Senior Independent Director is responsible for leading the evaluation of the Chairman's performance, in conjunction with the other Non-Executive Directors, 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. Each of the relevant fit and proper assessments were carried out during the course of 2019 and the Chairman continues to be satisfied that each Non-Executive Director is fit and proper and has the requisite knowledge and skills to be able to discharge their responsibilities effectively.

Board Effectiveness Review

The collective effectiveness of the Board is subject to an external evaluation every three years. The last external 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 included (but was 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 contained a number of recommendations about ways in which the work of the Board could evolve, following which the Board developed an implementation plan. Having worked to address the findings over the course of 2019, the Board received an update in December which confirmed that all actions arising from the 2018 Board Effectiveness Review had been completed.

At the end of 2019, the Society's Secretary commenced the internal Board Effectiveness Review which was facilitated through the use of a structured questionnaire. Feedback within the questionnaire is due to be discussed by the Board at a collective roundtable discussion in the New Year, in order to form an action plan for 2020.

Member Engagement 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/or 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 2019 were duly elected or re-elected. All Directors will again stand for election or re-election at the 2020 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 any of the resolutions on the agenda at that meeting. A resolution on the Report on Directors' Remuneration is included on the agenda. 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.

In line with accepted good practice, the Society's Members will have the opportunity of voting directly on the Directors' Remuneration Policy at the Society's 2020 Annual General Meeting.

Laurence Philip Adams
Chairman
5 February 2020

Report of the Governance and Nominations Committee

for the year ended 31 December 2019

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.

The Society's Board is strongly committed to promoting diversity and making appointments on merit, against objective criteria. During the year the Committee appointed Goodson Thomas (who have no other relationships with the Society) to lead the recruitment process which resulted in the appointment of Debra Evans-Williams to the Board. Following a robust process, the Committee was satisfied with the selection process and endorsed the proposed appointment at its August 2019 meeting. Following her appointment to the Board a tailored induction programme has been arranged for Debra Evans-Williams. This appointment helps to extend the breath of skills available around the Board table addressing one of the main findings/recommendations arising from the 2018 Board Effectiveness Review. All appointments are subject to extensive external checks and where required regulatory approval. All new Non-Executive Directors undergo a tailored and comprehensive induction programme on appointment.

Committee membership

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 five occasions in 2019.

Activity during the year

Together with overseeing the appointment of Debra Evans-Williams as a Non-Executive Director, during the year the Committee has:

- Overseen the appointment of the Chief Operating Officer (Iain Mansfield) to the Board in December 2019.
- Reviewed the size and composition of the Board and its committees.
- Reviewed the mix of skills and experience on the Board.
- Reviewed the Board and Senior Management Succession Plans.
- Reviewed the time commitment of Non-Executive Directors.
- Received regular reports on the steps being taken to put in place arrangements which enable the Society to comply with the provisions contained in the new Corporate Governance Code, as far as the Code can reasonably be applied to a building society.
- Received regular reports on corporate governance related developments.

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.

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 33.3%. At 31 December 2019, 36% of Board members were female. The table below shows the ratio of women to men in senior management positions within the Society over the period from 1 January 2018 to 31 December 2019:

Diversity Target Ratio (September 2021)	Ratio as at 1 January 2018	Ratio as at 31 December 2018	Ratio as at 31 December 2019
33.3%	23%	28%	31%

Laurence Philip Adams
Chair of the Governance and Nominations Committee
5 February 2020

GOVERNANCE

Risk Management Report

for the year ended 31 December 2019

The Committee seeks to ensure the continued safety and security of the Society by ensuring all principal and significant emerging risks are identified, managed, monitored and mitigated as effectively as possible. The Committee recommends to the Board risk appetite measures in respect of these risks. Exposure against risk appetite is monitored at each meeting and is integral to the Society's business planning and forecasting.

The Committee is also responsible for ensuring the continued adequacy of the Society's financial resources and recovery plans. To this end the Committee reviews the output of stress testing and scenario analysis, using such assessments to inform its view of potential, albeit unlikely, adverse outcomes.

Committee membership

Throughout 2019, the Committee comprised three independent non-executive directors, David Rigney, Derek Howell and Nigel Annett. The Committee regularly invites the Chief Executive Officer, Chief Financial Officer and Chief Risk Officer to attend the meetings, together with other colleagues from across the business, where appropriate. The Committee met on six occasions during the year.

Management of risk

The Society has developed and implemented 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 tolerance and governance and control systems.

a) 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. A key element of the Society's risk culture is a genuine emphasis on putting Members' interests and needs first. This is reflected, for instance, in the absence of sales-related incentives for any colleagues.

b) Three lines of defence model

The ERMF employs a 'three lines of defence' model to ensure clear independence of responsibilities for risk control, oversight and governance. This is key to ensuring that risk management is embedded across the Society, encouraging colleagues to take ownership for identification and management of risk within their respective areas of operation.

Three lines of defence model:

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.

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.

a) Risk management

Primary responsibility for the identification, assessment, control, mitigation and monitoring of risk rests with the business; the first line of defence.

Oversight and governance are provided through specialist support functions including Risk, Finance and Compliance and Conduct. The role of these functions is to maintain and review policies, establish quantitative limits and qualitative standards which are consistent with the Society's risk appetite. These functions additionally monitor and report on compliance with those limits and standards and provide a holistic oversight role to the management of risk.

The Society's Internal Audit function provides independent assurance regarding the activities of the business and of the specialist functions across the Society and reports on the effectiveness of the control environment to the Audit Committee on a quarterly basis. The Committee monitors the arrangements for assessing risk inherent in the Society's activities on behalf of the Board.

d) Risk appetite and tolerance

The Board approves risk appetite statements identifying and defining the types and levels of risk it is willing to accept in the pursuit of its strategic goals. This provides the business with a framework within which decision making and planning can be undertaken.

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.

e) Planning and stress testing

The Society undertakes stress testing, scenario analysis and contingency planning to understand the impact of unlikely, but severe risk events and to better enable it to react should events of this severity occur. A range of multi-risk category stress tests, reverse stress tests and operational risk scenario analyses are undertaken with the results forming a central component of the firm's capital and liquidity adequacy assessments.

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 measurement. A qualitative approach is used to explore potential scenarios, which, if crystallised, could result in failure of the Society. This is supplemented by quantitative assessments which determine the potential impact to the firm's capital or liquidity arising as a consequence of the 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.

The Society is aware of the potential long term risks which climate change represents to the firm's business model and to the wider economy. The Society's stress testing framework includes the assessment of the financial risks emanating from climate change which takes into account current relevant risks in addition to those which may plausibly arise in the future. The Society will take a strategic approach to managing the financial risks arising from climate change based on the outcome of assessments undertaken. The Committee will review the output of these assessments and re-appraise the approach to the management and mitigation of the associated risks where necessary.

f) Recovery and resolution planning

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. The recovery plan outlines the steps the Society can take to prevent failure whilst the resolution plan includes information 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 manage firm-specific or market-wide stress and which can be incorporated into a credible and executable plan.

g) Governance and control

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 the following committees, which report to the Board Risk Committee and the Board.

Each committee includes appropriate representation drawn from the Executive (ExCo), divisional management and risk specialists:

- **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 assist in the quantification of impairment provisions required under IFRS 9.
- **Credit Risk Committee (CRC)** is chaired by the Head of Prudential 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 Enterprise Risk and is responsible for monitoring and reviewing exposure to operational and financial crime risks arising from the Society's day-to-day activities.
- **Compliance & Conduct Committee (CCC)** is chaired by the Head of Compliance and Conduct Risk and is responsible for monitoring and reviewing exposure to conduct 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 Technology Committee (TC), a separate Board committee, is responsible for providing oversight of the Society's technology transformation programme.

Activity during the year

The following outlines the Committee's activities and areas of focus during the year:

Topic	Activity
Strategy & risk appetite	• Review of Strategic Risk Appetite and Tolerance Statements • Development of Operational Resilience Framework • Review of Approach for Assessment of Climate Change Risks
Policy	• Annual Review and Approval of Enterprise Risk Management Framework & Policy • Annual Review and Approval of Treasury Policy Statement & Retail & Commercial Lending Policies • Annual Approval of Compliance & Conduct Risk Management Policy & Conduct Monitoring Plan • Approval of Cyber Risk penetration testing programme
Stress testing	• Annual Review and Recommendation of the ICAAP to the Board • Annual Review and recommendation of the ILAAP to the Board • Annual Review and recommendation of the Recovery & Resolution Plan to the Board • Co-ordination and implementation of scenario-based 'playbook' risk management exercise for Board
Risk management	• Review of Credit Risk profile of mortgage portfolios • Review of annual Money Laundering Reporting Officer's Report • Review of annual Data Protection Officer's report • Review of cyber risk management and results of penetration testing programme
Risk monitoring	• Review of risk exposure relative to appetite and tolerance measures • Review of CROs report and Key Risk heat map • Horizon scanning • Oversight of Executive Risk Committee and subsidiary risk management committees • Review of Conduct Risk monitoring activity and relevant Internal Audit reports

Following each meeting, the Chair of the Committee provides an oral update to the Board on matters considered by the Committee. In addition, minutes of Committee meetings are available to the Board, if further detail is required.

David Rigney
Chair of the Board Risk Committee
5 February 2020

Report of the Audit Committee

for the year ended 31 December 2019

The Audit Committee assists the Board in fulfilling its oversight responsibilities in respect of matters relating to financial reporting, systems of risk management and internal control, and internal and external audit. The Committee acts as Audit Committee for both the Society and its subsidiary business, Nemo Personal Finance Limited.

The Committee is responsible for ensuring that the key accounting policies and judgements supporting the Society's financial statements are appropriate.

Committee membership

The Audit Committee is a Board Committee and in 2019 comprised four independent non-executive directors, Derek Howell, Sally-Jones Evans, David Rigney and Claire Hafner. The Committee met on seven occasions during the year.

Each Committee member has recent and relevant financial experience in accordance with the UK Corporate Governance Code ("UK Code"). The Board continues to be satisfied that the Committee has the requisite levels of knowledge and understanding relevant to the markets in which the Society operates.

The Committee regularly invites the Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Chief Internal Auditor and representatives from the Society's external auditor, Deloitte LLP ('Deloitte'), to attend the meetings, along with other colleagues from across the business, where appropriate.

Activity during the year

Financial Reporting Judgements and Estimates

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 reviews included consideration of the narrative reports, together with the description of the business model, strategy and the risks inherent in the business model. Following its review, the Committee 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:

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 continued to consider the risk that leaving the EU could adversely affect the availability and cost of wholesale funding.

Impairment provisions on loans.

During the year the Committee has closely monitored the output from the IFRS 9 impairment provision models and the performance of the Society's loan books. The level of impairment suggested by the models and the assumptions which inform the models 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 (Probability of Default) and the severity of losses (Loss Given Default) against each loan book, in conjunction with the overall adequacy of the provisions held against those loan books. The Committee concluded that the assumptions that are 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 the assumptions made by management in connection with the scale of the provision recognised for this purpose. The level of provision is based on estimates of complaint volumes, customer behaviour, the rate at which these claims are upheld and the level of redress paid on each complaint. The Committee continues to be satisfied that the scale of the provision recognised for this purpose is appropriate.

Retirement benefit obligations.

The Committee has considered the key assumptions used by the Scheme Actuary to determine the asset or liability under IAS 19 in connection with the Society's Defined Benefit Retirement Scheme obligation. The Committee agreed that the assumptions used for this purpose were reasonable.

Capitalisation of Intangible Assets.

In the context of the Society's transformation programme, the Committee has considered the requirements of IAS 38 and the need to recognise intangible assets, provided the relevant criteria is satisfied. Having carefully considered the criteria, the Committee concluded that it was satisfied with the assumptions used to capitalise qualifying expenditure related to the programme and that there is no impairment of intangible assets in the course of construction at the year end.

In addition to these key judgements, the Committee considered the approach taken to comply with the new accounting standard for leases, IFRS 16, which became effective from 1 January 2019. In particular, the Committee was satisfied with the approach taken to identify the discount rate applied to calculate the right of use asset and lease liability on transition.

After reviewing reports by management and after consulting with the Society's external auditor, the Audit Committee was satisfied that the financial statements appropriately addressed the critical judgements and key estimates. The Committee is also satisfied that the significant assumptions used for determining the value of the group's 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 the Committee considered those reports 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 they were 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 safeguard assets and facilitate the effectiveness and efficiency of day to day operations. Management is responsible for establishing and maintaining the control environment, which is designed to evolve as the risks faced by the Society change over time. The Committee is responsible for monitoring and ensuring the effectiveness of those controls. This work is primarily driven through the work 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 including financial controls, internal control and risk management systems. 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, items of thematic interest which warrant the Committee's attention and progress with work to implement audit recommendations.

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 Officer 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 five 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 and has received a report on this from the Chief Internal Auditor and has reviewed the Internal Audit Charter.

During the year, the Committee also considered carefully the risks associated with management circumventing the control framework. Work undertaken by the Internal Audit team during the year and by Deloitte, as part of the annual audit cycle, 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 2019.

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 Audit Committee is responsible for considering on behalf of the Board whether 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. In justifying this statement, the Audit Committee has considered the robust process which operates in creating the Annual Report and Accounts, which includes the following:

- Changes 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 in to the accounts to verify accuracy and consistency, including review by senior management.
- A meeting of the Audit Committee to review and consider the draft Annual Report and Accounts in advance of the final sign-off. The Chairman of the Audit Committee reports the Committee's conclusions to the Board and final sign off is provided by the Board of Directors.

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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 and effectiveness

The Audit Committee is responsible for assessing the effectiveness of the annual audit process, monitoring the independence and objectivity of the external auditor and making recommendations to the Board in relation to the appointment, reappointment, remuneration and removal of the external auditor.

As part of its annual assessment of the effectiveness of the external audit process, the Committee conducts a formal review whereby members of the Committee and senior members of the Finance team consider the performance, qualifications, expertise, resources, independence and objectivity of the external auditor. The results of the review are discussed by the Committee without the external auditor being present and any actions or suggestions about the external process are subsequently discussed with the external auditor.

During the year, the Committee has also reviewed and approved the external auditor's overall work plan which further ensures that the process is effective. There is periodic rotation of the audit partner responsible for the audit engagement, and each year the external audit firm confirms to the Audit Committee that it considers itself to be independent as defined by the current rules of the Financial Reporting Council.

Following the completion of an open tender process, Deloitte were re-engaged as the Society's external auditors in December 2016. The Audit Committee has previously agreed that it will consider whether to undertake a new tender where the incumbent auditor has served a further term of five years.

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 services which can only be undertaken with appropriate authority from the Committee Chair or the Committee where non-audit fees will exceed pre-set thresholds. The external 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 £335k. Non-audit fees, mainly in relation to further assurance services, were £79k.

Other matters

Following each Committee meeting, the Chair of the Committee provides an oral update to the Board on matters considered. In addition, minutes of Committee meetings are available to the Board, if further detail is required.

Derek Howell
Chair of the Audit Committee
5 February 2020

Technology Committee Report

for the year ended 31 December 2019

The Technology Committee (formerly the Customer, Conduct and Transformation Committee) is responsible for providing oversight of the Society's technology transformation programme and for making recommendations to the Board in respect of any material changes to the programme.

Committee membership

The Technology Committee is a Board Committee and in 2019 comprised four independent Non-Executive Directors, Nigel Annett, Sally Jones-Evans, David Rigney and, from 1 September 2019, Debra Williams. The Committee met eight times during the year.

The Committee regularly invites the Chief Customer Officer and the Chief Operating Officer to attend its meetings, along with other colleagues from across the business, where appropriate. 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 were subject to Board decision.

Activity during the year

During the year, the Committee provided oversight and challenge on the following matters:

- Key Performance Indicators relating to cost, time, quality and programme outcomes which are measured against the Board agreed key milestones.
- Regular assurance reports from first, second and third line teams.
- The engagement of DMW Group to provide independent assurance services in respect of the Society's technology transformation programme. DMW Group's role is to provide independent assurance on whether the Society is delivering the technology transformation programme in a manner which is consistent with the Board agreed business case, clearly defined programme governance, the strategic direction of the Society and Member and regulatory requirements. DMW Group's role is also to provide assurance that changes, risks, issues, assumptions and dependencies are clear and managed and that the Society embodies a delivery-focused culture with appropriate resources.
- Activity to reach a contractual agreement with a third party software provider in respect of the Society's new mortgage platform.
- Regular updates from the HTP Executive Sponsor (Chief Customer Officer) on both the Mortgages and Savings work streams, which form the technology transformation programme.
- The governance relating to the design and build/integration of new systems to set a template for any future, largescale change.
- Regulatory change which could impact any of the individual components of the transformation programme.
- Resource requirements and ensuring that colleague capability had been enhanced.
- Internal and external readiness for the launch of the new systems, ensuring ongoing stakeholder engagement.
- The methodology which supports the capitalisation of expenditure incurred in respect of the transformation programme.

Following each Technology Committee meeting, the Chair of the Committee provides a verbal update to the Board on matters considered by the Committee. In addition, minutes of Committee meetings are available to the Board, if further detail is required.

Nigel Annett
Chair of the Technology Committee
5 February 2020

Report of the Remuneration Committee

for the year ended 31 December 2019

The role of the Committee is to ensure that all of our remuneration policies align with the Board-approved strategy and the Society's purpose and values. To ensure that this aspect of the business is run safely and successfully for our Members, the Committee's Terms of Reference are reviewed and updated annually.

Committee membership

Membership of the Remuneration Committee during 2019 remained consistent and comprised:

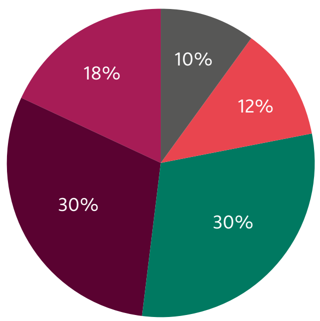
- Sally Jones-Evans – Chair of the Committee and Non-Executive Director
- Laurence Adams – Chairman of the Board
- Nigel Annett – Non-Executive Director
- Claire Hafner – Non-Executive Director

Activity during the year

A significant proportion of the Committee's time throughout 2019 has been dedicated to pay strategy and approach, including:

- A strong focus on the fair pay agenda for all colleagues, with the introduction of a new pay and grading framework and flexible benefits platform.
- Introduction of the newly designed variable pay scheme for executives and senior leaders, the Leading Excellence Award.
- Realignment of basic salary for two Executive Directors, following a robust and thorough external benchmarking exercise, including a review of the CEO basic salary.

PROPORTION OF TIME SPENT BY THE REMUNERATION COMMITTEE



Performance in 2019

As outlined in other sections of this annual report, the Society's performance has been positive despite a challenging, competitive and uncertain external environment. Savings and new lending have continued to grow successfully and profitability is good. As the long-term strength and safety of the Society are paramount to our strategy, initial risk gateways set are set for our variable pay schemes, which have been exceeded for 2019.

Customer and member feedback continues to be very positive, resulting in encouraging net promoter scores and external awards. This is coupled with steady progress being made in relation to our investment programme across our Society's IT platforms, which will allow us to remain competitive and relevant in the market.

Remuneration policy

We believe that our people are the Society's greatest asset; we strive to be an employer of choice so that we can continue to attract and retain talented and passionate people. Therefore, the remuneration policy is deliberately designed to:

- Ensure that the business is run safely and successfully for our Members.
- Support the delivery of "Brilliant People", the central pillar of the overall business strategy.
- Recognise the principles of the Remuneration Code and Corporate Governance Code.

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. This is done by positioning all aspects of pay 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 to be met before any variable pay award can be made and, for the Executive team and Senior Leadership Team, deferring an element of variable pay.
- Incentivise performance and share success by having a competitive variable pay scheme which rewards all colleagues for the achievement of challenging objectives, where performance is judged against a minimum of two critical measures, including a financial measure and a customer measure.

During the year the Committee continued to use PwC to provide independent advice on executive remuneration and benchmarking information. PwC are also appointed to provide the Society with advice on taxation matters.

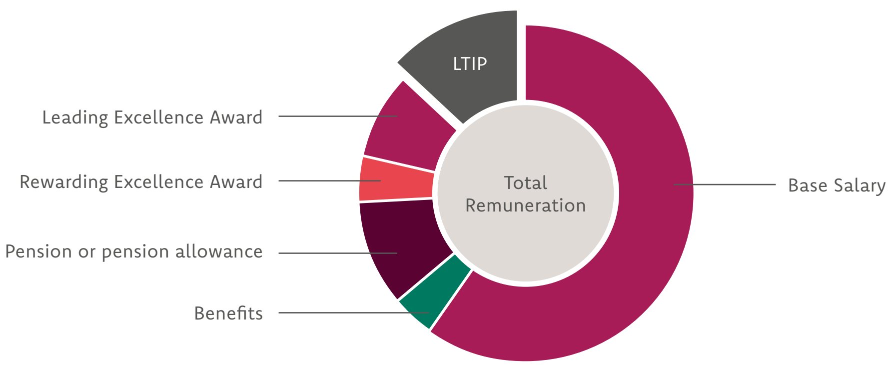
The Remuneration Committee is satisfied that the remuneration policy operated as intended throughout 2019.

How this policy is applied

The table below provides a summary of the different elements of remuneration for Executive Directors for 2019:

Component	Purpose
Base Salary	To attract and retain experienced executives of calibre through the payment of competitive rates. Base salaries are reviewed annually (or more frequently if required)
Benefits	To ensure the Society is acting as a responsible employer and to assist in the performance of the job. Includes car allowance, family private medical insurance, critical illness cover and life assurance.
Pension or pension allowance	To provide for longer-term savings to fund retirement. Pension contribution of 15% of base salary or equivalent cash allowance.
Rewarding Excellence Award	Designed to share the benefits of teamwork, financial discipline and customer service with all colleagues. Providing a maximum award payment of 12% of base salary, with annual targets based on risk gateways, profit before tax and customer service measures.
Leading Excellence Award	The leading Excellence Award replaced 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.
Long term incentive	The LTIP has been replaced moving forward by the LEA, however transitional arrangements mean that legacy LTIP awards will be paid in respect of 2019 and 2020.

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



Each of the elements outlined above are deliberately designed to align with our Remuneration Policy and the characteristics set out in the Corporate Governance Code in respect of clarity, simplicity, risk, predictability, proportionality and alignment to culture. Reports received by the Committee during 2019 incorporated this approach and included an annual review of the structure of reward which provided evidence of how various aspects of reward at the Society align to the Corporate Governance Code.

While the Corporate Governance Code's focus is primarily on Executive remuneration, as the structure of reward at the Society is primarily designed for the workforce as a whole, we can be confident that the characteristics apply Society-wide and not just to the Executive team.

Variable Pay awards for 2019

Rewarding Excellence Award

The Rewarding Excellence Award (REA) is designed to share the benefits of teamwork, financial discipline and customer service with all colleagues across the Society. The two measures of Profit before Tax (PBT) and the Customer Service Net Promoter Score (Maze NPS) are equally weighted at 50% each once the initial risk gateways are met, to provide a maximum award of 6% for each measure, making a total maximum award of 12% of individual's basic salary.

In 2019, the Maze NPS score exceeded the stretch target resulting in the maximum award of 6% for this element of the REA. The PBT result was slightly lower than the on target position leading to an award of 2.3% for this measure. Our hardworking colleagues were rewarded with an award of 8.3% of their salary to thank them for their considerable contribution to this success.

Leading Excellence Award

The Leading Excellence Award (LEA) was introduced in 2019 to replace the previous Long-Term Incentive Plan (LTIP). It is an annual incentive scheme with an element of deferred payment for Executives and Senior Leaders, therefore enabling the Society to reward, attract and retain our most senior leaders.

The key features of the LEA are:

1. That it recognises and rewards our Executives and Senior Leaders for their contribution to the long-term goals of the Society.
2. Subject to capital and liquidity gateways, the level of award is determined by performance against four metrics: Financial (Return on Assets), Customer (GFK NPS), People (Great Place to Work) and Personal Performance.
3. Performance against these four metrics will determine a percentage factor. For Executives, the range will be 0% to 38% of individual salary, with the on-target award (OTA) being 19% of salary. For Senior Leaders, the range will be 0% to 18% of individual salary, with the OTA being 9% of salary.

Financial Performance Return on Assets Target: 0.310% Achieved: 0.29%	**Customer Service** Net Promoter Score (GFK) Target: Top 25%ile Achieved: Top 15%ile
Colleague Engagement Great Place to Work Trust Index Target: 75% Achieved: 77%	**Personal Performance** (Based on achievement of Individual Business Objectives)

Maximum award:
38% for Executives
18% for Senior Leaders

Based on the 2019 results for each of the four equally weighted measures, the maximum award for Executives is 18.52%, with the maximum award for Senior Leaders at 11.02%. 60% of the award is payable in February 2020, with the remaining 40% deferred as follows:

Executive

2019	2020	2021	2022	2023	2024
Scheme year	60% award payment	20% award payment	20% award payment		
	Scheme year	60% award payment	20% award payment	20% award payment	
		Scheme year	60% award payment	20% award payment	20% award payment

Senior Leaders

2019	2020	2021	2022	2023
Scheme year	60% award payment	40% award payment		
	Scheme year	60% award payment	40% award payment	
		Scheme year	60% award payment	40% award payment

Long-Term Incentive Plan (LTIP)

The Leading Excellence Award (LEA) replaced the Long-Term Incentive Plan (LTIP) in 2019 following a full review undertaken by the Remuneration Committee during 2018. The LEA was introduced to address some of the challenges of the LTIP, including the difficulty in setting meaningful targets for a three-year period amongst so much economic uncertainty. As the LTIP was de signed as a three-year plan, there will be a transitional phase where previous LTIP awards will run-off alongside the LEA. The table below illustrates how the 2017 LTIP ended on 31 December 2019 and the 2018 LTIP will come to a close on 31 December 2020, marking the final payment of this plan.

2017	2018	2019	2020	2021	2022	2023	2024
	2017 LTIP		Payment in 2020				
		2018 LTIP		Payment in 2021			
		2019 LEA	60% payment in 2020	20% Executives 40% Senior Leaders	20% Executives		
			2020 LEA	60% payment in 2021	20% Executives 40% Senior Leaders	20% Executives	
				2021 LEA	60% payment in 2022	20% Executives 40% Senior Leaders	20% Executives

The award made under the 2017 LTIP, paid in February 2020, is based upon the results of the challenging targets set by the Board for two key measures: a financial measure and a customer measure. The award of 25.66% was based on the following performance against targets:

Measure	Proportion of award	Targets: Threshold	On Target	Stretch	Result	Award Level
Return on Assets	50%	0.327%	0.342%	0.361%	0.372%	14%
Net Promoter Score	50%	60th percentile	Top 25th percentile	Top 10th percentile	Top 15th percentile	11.66%
Total Award						25.66%

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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. When designing aspects of remuneration, the Committee considers the appropriateness for a Member owned organisation and alignment to our culture, whilst the quantum is carefully positioned to be proportionate to the challenges, encourage the right behaviours and discourage excessive risk taking. We therefore set out in this section the following information:

- Salary increases applied to Executive Directors in 2019
- What the Executive Directors earned for 2019's performance compared to 2018
- CEO pay ratio
- Chairman and Non-Executive Director fees in 2019

Salary increases applied to Executive Directors in 2019

In February 2019, the Remuneration Committee awarded an increase to the base salary of each Executive Director by 2%, in line with the annual salary review approach taken for the rest of the workforce.

In September 2019, the Remuneration Committee agreed an out of cycle increase to the basic salary of the then Chief Executive Officer and the Chief Finance Officer, following a robust and thorough external benchmarking exercise, supported by our external advisors at PwC. The increases of 10% and 11% respectively recognise the experience the then CEO and CFO have gained in their roles and appropriately reflect market conditions.

What Executive Directors earned for 2019's performance

The following table provides the audited information showing a single total figure of remuneration for the 2019 financial year for each of the Executive Directors and compares this figure to the prior year.

Audited Information Individual	Year	Salary & Fees[1] £000	Benefits[2] £000	Pensions[3] £000	Annual variable pay[4,5] £000	Total £000
Chief Executive Officer Stephen Hughes[6] (up to 02/12/19)	2019	305	14	46	-	365
	2018	316	15	47	116	494
Interim Chief Executive Officer/ Chief Risk Officer R Michael Jones	2019	258	13	39	n/a	310
	2018	249	13	37	n/a	299
Chief Financial Officer Tom Denman	2019	205	12	31	107	355
	2018	193	12	29	71	305
Chief Customer Officer Julie-Ann Haines	2019	229	12	34	119	394
	2018	224	12	34	83	353

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. Variable Pay is the total of both the Rewarding Excellence Award and the Leading Excellence Award, plus payment from the 2017 Long Term Incentive Scheme (LTIP) as part of the transitional arrangements. The normal performance period of the LTIP is three years and the 2017 LTIP operated for the performance period 1 January 2017 to 31 December 2019. Awards under the variable pay schemes are non-pensionable. 5. The Chief Risk Officer (and Interim Chief Executive Officer) and Chief Internal Auditor do not participate in the variable pay scheme. 6. Following Stephen Hughes' departure as Executive Director on 2 December 2019, the figures reflect payment up to and including 2 December 2019.

Additional footnotes

- *Under terms of his departure agreement, Graeme Yorston is entitled to receive the final deferred element of the 2017 LTIP which was pro-rated by reference to service, resulting in a payment of £7,338.*
- *Iain Mansfield was appointed to the Board on 31 December 2019 therefore disclosure of his remuneration will begin from 2020.*

Departure arrangements for Stephen Hughes

Following his resignation as Executive Director on 2 December 2019, Stephen Hughes will be on a period of garden leave until 20 April 2020 during which he will continue to receive contractual pay and benefits. As colleagues under notice of resignation are ineligible for variable pay, there is no variable pay award for any current or legacy schemes.

CEO Pay ratio

From 1 January 2019, organisations with over 250 employees are required to disclose the CEO pay ratio in their annual report, in a move to promote transparency and encourage good governance. The CEO pay ratio provides a snapshot of the overall pay gap that exists between the CEO (typically the highest paid person within the organisation) and the average employee in the same organisation and is calculated using the single total figure of remuneration which includes total salary, variable pay, pension and taxable benefits.

The Society has chosen to publish the CEO pay ratio using the recommended and preferred approach (option A), which shows that the CEO pay is 12 times that of the median colleague pay (this means that when all colleagues' pay is listed from highest to lowest, the median is the middle value in that list).

The CEO base pay and total remuneration has been calculated to reflect the change in CEO during the financial year and is includes the proportion of time that Stephen Hughes and R Michael Jones each spent in the role throughout 2019. As neither colleague received a variable pay award in 2019 a nominal pay ratio, based on the expected outcome had been no change in CEO throughout the year and the variable pay award had been paid, is also outlined to provide context:

Year	Method	25th percentile	Median	75th percentile
2019	Option A	17:1	12:1	9:1
2019 - Nominal	Option A	24:1	17:1	12:1

Our fair pay agenda outlines our commitment to ensuring that reward (including base pay, variable pay and benefits) at Principality is transparent, fair, free from discrimination and aligned to the external market.

In 2018, an in-depth pay and grading review was undertaken, the results of which were introduced to all colleagues in January 2019, providing a future-proofed method of maintaining a direct link between the position of our pay and benefits and the relevant comparators within the financial services sector. This approach is consistently applied to all colleagues across the Society, regardless of position, and was communicated to all colleagues prior to implementation. We are therefore content that the CEO pay ratio is consistent with the Society's wider policies on pay, reward and progression.

Chairman and Non-Executive Director fees for 2019

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	
	2019 £000	2018 £000
Laurence Philip Adams	119	117
Nigel Annett CBE (Chair of Technology Committee)	63	62
Derek Howell (Chair of Audit Committee and Senior Independent Director)	71	70
Sally Jones-Evans (Chair of Remuneration Committee)	63	62
David Rigney (Chair of Board Risk Committee)	68	62
Claire Hafner[1]	53	39
Debra Evans-Williams[2]	15	–
Natalie Elphicke OBE[3]	–	31
Total	**452**	**443**

[1] Claire Hafner joined the Board on 1 April 2018.
[2] Debra Evans-Williams joined the Board on 1 September 2019.
[3] Natalie Elphicke stepped down from the Board on 20 July 2018.

Looking ahead to 2020

The Committee undertake a review of the Executive Directors' base salaries on 1 February of each financial year, taking into account factors such as individual and business performance, market conditions, and the level of salary increase applied to other colleagues across the Society. For 2020, performance related pay awards to Executive Directors increased salaries by 1.85%, which is the same approach taken for other colleagues.

Following this review the Executive Directors salaries will be:

- R Michael Jones — Base salary on appointment as Interim CEO is £304,727
  On return to the Chief Risk Officer role the salary will be £258,637
- Julie-Ann Haines — £233,122
- Tom Denman — £224,408
- Iain Mansfield — £204,719

Benefits

No changes have been made to the benefits in kind provided to Executive Directors.

Pension

Executive Directors receive a pension contribution of 15% of base salary, which may be taken as a cash allowance. This provision remains unchanged for existing Executive Directors as it forms part of the contractual entitlements already in place. Any newly appointed Executives or Executive Directors will be entitled to receive a pension contribution that is in line with that of the workforce, currently 8% of base salary, to align with the intent of the Corporate Governance Code.

Variable pay

Both the Rewarding Excellence Award and the Leading Excellence Award will continue to operate from 1 January 2020. A summary is set out below:

	Rewarding Excellence Award	Leading Excellence Award
Performance period	1 January 2020 - 31 December 2020	1 January 2020 - 31 December 2020
Participants	All colleagues at Principality, except leaders of control functions	Executives and Senior Leaders, except leaders of control functions
Administrator	Remuneration Committee	Remuneration Committee
Initial gateway requirements	Capital and liquidity conditions and the absence of any material regulatory breaches	Capital and liquidity conditions and the absence of any material regulatory breaches
Performance measures	Group Profit before Tax – 50% Customer Service Net Promoter Score – 50%	Return on Assets – 25% Net Promoter Score – 25% Colleague Engagement – 25% Shared Strategic Business Objective – 25%
Potential payments	Nil for threshold performance 6% of salary for meeting challenging target performance 12% of salary for attaining highly stretching targets	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

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	Rewarding Excellence Award	Leading Excellence Award
Payment date	Subject to Audit and Remuneration Committee approval, payment will be made in February 2021 There will be no partial deferral of payment	Subject to Audit and Remuneration Committee approval, 60% of the award will be paid to eligible participants in February 2021 Following this, Executives will receive a deferred payment of 20% in February 2022 and a final deferred payment of 20% in February 2023 Senior Leaders will receive a final deferred payment of 40% in February 2022
Clawback (demanding repayment)	The Remuneration Committee can apply clawback to an Executive Director's award and that of other Senior Executives if it is discovered that the award should not have been paid, for example, in the event of a material misstatement of the group's annual results or in the event of a serious regulatory breach	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 has 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.

Statement of Member voting

The Society is committed to open and honest dialogue with our Members and take an active interest in voting outcomes. The 2018 Director's Remuneration Report received 23,449 votes in favour (91.35%) and 2,220 votes against (8.65%).

Approval

This report is approved by the Remuneration Committee and signed on it's behalf by:

Sally Jones-Evans
Chair of the Remuneration Committee
5 February 2020

Directors' Report

for the year ended 31 December 2019

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 2019. The Directors confirm that, to the best of their knowledge, the Annual Report taken as a whole, is fair, balanced, provides an understandable assessment of the Society's position and prospects and provides the information necessary for Members to assess the group's performance, business model and strategy. Further information is provided in the Report of the Audit Committee on pages 72 to 77.

Directors

The names of the Directors at the date of this report, together with brief biographical details, are listed on pages 52 to 56. Details of changes affecting the composition of the Board are set out in the Governance Report on page 57 to 65. 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. All are eligible and willing to continue serving on the Board. Debra Williams and Iain Mansfield joined the Board on 1 September 2019 and 31 December 2019 respectively and in accordance with the Society's Rules will stand for election by Members at the Society's 2020 Annual General Meeting.

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.

The Society has made qualifying third party indemnity provisions for the benefit of its Directors which remain in force at the date of this report.

Auditor

At the Annual General Meeting on 12 April 2019, 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 pages 102 to 103, 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 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:

GOVERNANCE

- 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.

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 52 to 56, 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.

Directors' statement pursuant to the Disclosure and Transparency Rules

As required by the Disclosure and Transparency Rules of the Financial Conduct Authority, the Directors have included a fair review of the business and a description of the principal risks and uncertainties facing the group. This information is contained principally in the Strategic Report. The Directors confirm that, to the best of each of their knowledge and belief:

- The financial statements, prepared in accordance with IFRS as adopted by the EU, present fairly the assets, liabilities, financial position and profit of the group and Society.
- The Strategic Report includes a fair review of the development and performance of the business and the position of the group and Society and a description of the principal risks and uncertainties that they face.

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.

Strategic Report

The information required by Schedule 7 to the Accounting Regulations and the capital structure of the group are set out in the Strategic Report, which also sets out details of how the Board engages with key stakeholder groups.

Anti-Corruption and Anti-Bribery matters

The Society is committed to maintaining the highest standards of ethics and integrity in the way in which 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 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 Anti-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 includes adherence to the Anti-Bribery and Conflicts of Interest Policy can be found on the Society's website.

Employees
The Society remains committed to its policy of treating all employees and job applicants equally at all times. The policy states that no employee, or potential employee, is treated less favourably on the grounds of age, race, colour, religion, nationality, ethnic origin, gender, marital status or sexual orientation. All applications from disabled people are given full consideration in relation to the vacancy concerned and their own aptitudes and abilities.

In the event of an existing employee becoming disabled, every effort is made to maintain their present position or to employ them in alternative suitable work. The group also aims to provide high quality relevant training and development opportunities to all employees, which enables them to achieve their full potential.

The Board receives regular updates on key employee matters as they arise. There is a comprehensive internal communications structure to cascade relevant business information to colleagues throughout the organisation in an appropriate and timely way.

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 2019.

Charitable and political donations
In 2019, the Society made donations to charities of £0.2m (2018: £0.2m). No political donations were made by the Society in the current or prior year.

Creditor payment policy
The Society's policy is to agree terms and conditions with suppliers that outline the way in which business is to be transacted, including the terms of payment, and to pay in accordance with contractual and other legal obligations.

The Society's creditor days stood at 3 days at 31 December 2019 (2018: 5 days).

Whistleblowing Policy
The Society's Whistleblowing Policy sets out the arrangements in place which enable colleagues (and others) to raise concerns relating to wrongdoing. The Society's Board reviewed and approved the Whistleblowing Policy at its December 2019 meeting alongside receiving the annual Board Whistleblowing Champions Report.

On behalf of the Board of Directors.

Laurence Philip Adams
Chairman
5 February 2020

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 of the Society's affairs as at 31 December 2019 and of the group's and the Society's income and expenditure for the year then ended;**
- **have been properly prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union; and**
- **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 34.

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 listed 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 matter that we identified in the current year was: • IFRS 9 Financial Instruments – Expected Credit Loss ('ECL') provisioning. Within this report, key audit matters are identified as follows: Newly identified Increased level of risk Similar level of risk Decreased level of risk
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, we have determined the valuation of the group's provision for regulatory matters is no longer a key audit matter in the current year.

Conclusions relating to going concern, principal risks and viability statement

Going concern

We have reviewed the Directors' statement on page 93 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 12 months from the date of approval of the financial statements.

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 38-49 that describe the principal risks, procedures to identify emerging risks, and an explanation of how these are being managed or mitigated;

Going concern is the basis of preparation of the financial statements that assumes an entity will remain in operation for a period of at least 12 months from the date of approval of the financial statements.

Viability means the ability of the group to continue over the time horizon considered appropriate by the Directors.

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

FINANCIAL STATEMENTS
FINANCIAL STATEMENTS

Principal risks and viability statement (continued)

- the Directors' confirmation on page 93 that they have carried out a robust assessment of the principal and emerging risks facing the group, including those that would threaten its business model, future performance, solvency, liquidity; and
- the Directors' explanation on page 93 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.

IFRS 9 Financial Instruments – Expected Credit Loss provisioning	
Key audit matter description	This is a complex accounting standard which has required considerable judgement, interpretation and modelling complexity to estimate ECL provisions. The models developed estimate the expected loss provisions against loans to customers within the following loan books: • Residential mortgages • Commercial • Secured personal lending The group held £25.6m of impairment provisions against such loans at year-end (2018: £30.5m) against total loans and advances to customers of £9,469.9m (2018: £8,932.1m). ECL provisioning is considered a key audit matter as it involves significant judgements taken by Management, particularly in light of the evolving economic environment in the UK. We have considered the most significant areas of judgement within the group's collective provisioning methodologies to be: • Possession Given Default (PGD) rates: The retail impairment model is highly sensitive to the PGD rate assumptions. Significant judgement is applied by Management in assessing the extent to which these inputs reflect current observable data. • Commercial loan loss overlays: Management has included a number of overlays to address model limitations in calculating ECLs in relation to riskier tranches of their book. The identification and assessment of these overlays is subject to significant Management judgement. • Macroeconomic scenarios, including consideration for Brexit and associated weightings applied: ECLs are required to be calculated on a forward-looking basis under IFRS 9. In determining both the economic scenarios, as well as the probability-weighting of each scenario to be incorporated into the ECL model, significant judgement is applied by Management. Other material judgements include the estimation of probability of default, loss given default and exposure at default. Whilst significant increase in credit risk definitions remain a material judgement, that has been consistently applied in the current year. 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 18. Management's associated accounting policies are detailed on pages 119-121 with detail about judgements in applying accounting policies and critical accounting estimates on page 126. Management's consideration of the effect of the future economic environment is disclosed on page 121. The Audit Committees' consideration of the matter is described on page 73.
How the scope of our audit responded to the key audit matter	Our audit procedures included obtaining an understanding of the relevant controls around the impairment review process and the determination of the judgements within the model. This included evaluating the Model Governance Committee and their assessment of model monitoring and calibrations, the review and approval of macroeconomic scenarios, model change controls, and the flow of the output from the model to the general ledger. Our audit procedures to address the risks identified within the loan impairment process included the following procedures below. **Assessment of model inputs** • We challenged the key assumptions used by Management to support the modelled PGD rates by qualitatively and quantitatively assessing the extent of model conservatism arising from the variation between rates used for current data. We also challenged the underlying data which is used to determine whether the assumptions still hold including challenging Management's consideration of the impact of the ongoing and future economic conditions. • We challenged the appropriateness and completeness of Management overlays, by assessing and independently recalculating those which were included. • We attended the High Risk Exposure Committee to obtain greater understanding of individual commercial watchlist cases, and assessing whether the overlays capture appropriate credit loss risks present within the commercial loan book.

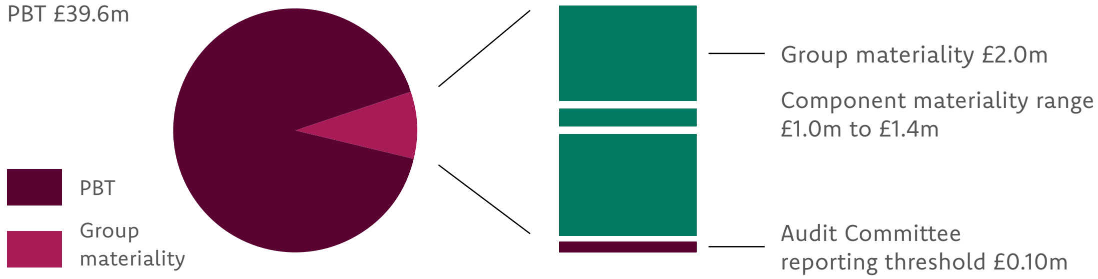
How the scope of our audit responded to the key audit matter	• With involvement of our internal economic modelling specialist , we challenged the macroeconomic scenario forecasts that were incorporated into the ECL model. Management's forecasts and probability-weightings were benchmarked against external sources to assess their reasonableness, considering the forecasts in light of Brexit and any contradictory information. • We challenged the appropriateness of other model inputs including exposure at default, probability at default and loss given default with reference to the most recently observable data. **Assessment of the ECL model** • We audited the models and SAS scripts used to derive the ECL provision and assessed their consistency with Management's model documentation and their compliance with the requirements of IFRS 9. • We assessed whether changes had been made to the Management's processes for the balance enabling us to place reliance on prior year model documentation reviews by our credit risk modelling specialists. **Assessment of data used in the ECL model** We substantively tested the data provided by Management that supported each material judgement for completeness and accuracy.
Key observations	Based on our audit procedures above, we concluded that Management's provision is reasonably stated, and is supported by a methodology that is consistently applied.

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 (2018: £2.0m)	£1.4m (2018: £1.3m)
Basis for determining materiality	5% of income before tax (2018: 5%)	5% of income before tax (2018: 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.



Performance materiality

We set performance materiality at a level lower than materiality to reduce the probability that, in aggregate, uncorrected and undetected misstatements exceed the materiality for the financial statements as a whole. Group performance materiality was set at 70% of group materiality for the 2019 audit (2018: 70%). In determining performance materiality, we considered the following factors:

a. the quality of the control environment and whether we were able to rely on controls;
b. whether there were any significant changes in the business that might affect our ability to forecast misstatements; and
c. prior year uncorrected and corrected misstatements and the likelihood of errors occurring based on our previous experience.

Error reporting threshold

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £0.1m (2018: £0.1m) 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

Our group audit was scoped by obtaining an understanding of the group and its environment, including group-wide controls, and assessing the risks of material misstatement at the group level. Based on that assessment, we performed an audit of the Society and all of its trading subsidiaries, executed at levels of materiality applicable to each individual entity which were lower than group materiality and in the range of £1.0m to £1.4m (2018: £1.0m to £1.3m).

As the group auditors, we are responsible for performing the audit of each subsidiary. At the group level we also tested the consolidation process.

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 provides 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, we considered the following:

- the nature of the industry and sector, control environment and business performance including the design of the group's remuneration policies, key drivers for Directors' remuneration, bonus levels and performance targets;
- results of our enquiries of Management, internal audit, and the Audit Committee about their own identification and assessment of the risks of irregularities;
- any matters we identified having obtained and reviewed the group's documentation of their policies and procedures relating to:
  - o identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
  - o detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud; and
  - o the internal controls established to mitigate risks of fraud or non-compliance with laws and regulations;
  - o the matters discussed among the audit engagement team and involving relevant internal specialists, including tax, financial instrument, internal economic modelling, valuations, prudential regulation, pensions, IT, and credit risk modelling specialists regarding how and where fraud might occur in the financial statements and any potential indicators of fraud.

As a result of these procedures, we considered the opportunities and incentives that may exist within the organisation for fraud and identified the greatest potential for fraud in the following areas: ECL provisioning. In common with all audits under ISAs (UK), we are also required to perform specific procedures to respond to the risk of Management override.

We also obtained an understanding of the legal and regulatory frameworks that the group operates in, focusing on provisions of those laws and regulations that had a direct effect on the determination of material amounts and disclosures in the financial statements. The key laws and regulations we considered in this context included the Building Societies Act 1986 for the Society and the UK Companies Act for the subsidiaries.

In addition, we considered provisions of other laws and regulations that do not have a direct effect on the financial statements but compliance with which may be fundamental to the group's ability to operate or to avoid a material penalty. The key laws and regulations we considered in this context included those set by the Financial Conduct Authority in respect of the mis-selling of payment protection insurance and other conduct related matters. In addition, we considered the regulation set by the Prudential Regulation 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 related to the potential risk of fraud. 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 provisions of relevant laws and regulations described as having a direct effect on the financial statements;
- enquiring of Management, the Audit Committee and in-house legal counsel concerning actual and potential litigation and claims;
- 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 the Financial Conduct 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 matter prescribed by the Capital Requirements (Country-by-Country Reporting) Regulations 2013

In our opinion the information given on page 94 for the financial year ended 31 December 2019 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 13 years, covering the years ending 31 December 2007 to 31 December 2019.

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 2020

Consolidated income statement *for the year ended 31 December 2019*

	Notes	2019 £m	2018 £m
Interest receivable and similar income	4	233.9	226.0
Interest payable and similar charges	5	(122.5)	(106.4)
Net interest income		111.4	119.6
Fees and commission receivable	6	4.9	5.7
Fees and commission payable		(1.5)	(1.6)
Net fee and commission income		3.4	4.1
Other operating income		1.0	1.5
Other fair value losses	7	(0.2)	(2.4)
Net operating income		**115.6**	**122.8**
Administrative expenses	8	(72.8)	(75.7)
Depreciation and amortisation	21 & 22	(7.3)	(5.8)
Operating expenses		(80.1)	(81.5)
Impairment provision release/(charge) on loans and advances	18	4.1	(0.6)
Operating profit and profit before taxation		**39.6**	**40.7**
Taxation expense	12	(7.6)	(7.8)
Profit for the year		**32.0**	**32.9**

Consolidated statement of other comprehensive income

	Notes	2019 £m	2018 £m
Profit for the year		32.0	32.9
Items that will not be reclassified subsequently to profit and loss:			
Actuarial gain on retirement benefit obligations	11	0.3	1.1
Tax on retirement benefit obligations	12	(0.1)	(0.2)
Items that may be reclassified subsequently to profit and loss:			
Gain/(loss) on fair value through other comprehensive income		0.6	(0.7)
Tax on fair value through other comprehensive income	12	(0.1)	0.1
Total comprehensive income for the year		**32.7**	**33.2**

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 113 to 181 form part of these accounts.

Income statement of the Society *for the year ended 31 December 2019*

	Notes	2019 £m	2018 £m
Interest receivable and similar income	4	223.3	211.4
Interest payable and similar charges	5	(121.8)	(106.3)
Net interest income		101.5	105.1
Fees and commission receivable	6	4.9	5.5
Fees and commission payable		(1.5)	(1.5)
Net fee and commission income		3.4	4.0
Other operating income		1.3	1.9
Other fair value gains/(losses)	7	0.7	(4.3)
Net operating income		**106.9**	**106.7**
Administrative expenses	8	(72.1)	(73.7)
Depreciation and amortisation	21 & 22	(7.1)	(5.8)
Operating expenses		(79.2)	(79.5)
Impairment provision release/(charge) on loans and advances	18	0.5	(1.9)
Operating profit and profit before taxation		**28.2**	**25.3**
Taxation expense	12	(5.4)	(5.2)
Profit for the year		**22.8**	**20.1**

Statement of other comprehensive income of the Society

	Notes	2019 £m	2018 £m
Profit for the year		22.8	20.1
Items that will not be reclassified subsequently to profit and loss:			
Actuarial gain on retirement benefit obligations	11	0.3	1.1
Tax on retirement benefit obligations	12	(0.1)	(0.2)
Items that may be reclassified subsequently to profit and loss:			
Gain/(loss) on fair value through other comprehensive income		0.6	(0.7)
Tax on fair value through other comprehensive income	12	(0.1)	0.1
Total comprehensive income for the year		**23.5**	**20.4**

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 113 to 181 form part of these accounts.

Consolidated statement of financial position *as at 31 December 2019*

	Notes	2019 £m	2018* £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		1,201.9	931.8
Loans and advances to credit institutions	13	202.6	147.8
Debt securities	14	165.1	32.9
		1,569.6	1,112.5
Derivative financial instruments	15	21.3	24.8
Loans and advances to customers:			
Loans fully secured on residential property		8,721.7	8,220.6
Other loans		311.4	278.1
	16	9,033.1	8,498.7
Intangible fixed assets	21	17.5	4.6
Property, plant and equipment	22	34.8	25.0
Investment properties	22	6.9	9.8
Deferred tax assets	27	1.8	3.1
Other assets		3.9	3.0
Prepayments and accrued income		6.9	5.9
Total assets		**10,695.8**	**9,687.4**
Liabilities			
Shares	23	7,588.5	6,989.8
Deposits and debt securities:			
Amounts owed to credit institutions	24	1,072.5	867.1
Amounts owed to other customers		197.9	141.4
Debt securities in issue	25	1,107.7	1,010.9
		2,378.1	2,019.4
Derivative financial instruments	15	50.4	31.6
Current tax liabilities		2.8	2.8
Other liabilities	26	14.0	6.2
Provision for liabilities	19	4.4	5.1
Accruals and deferred income		11.8	13.7
Deferred tax liabilities	27	1.2	0.6
Retirement benefit obligations	11	–	3.9
Subscribed capital	28	61.2	63.6
Total liabilities		10,112.4	9,136.7
General reserve		582.1	550.1
Other reserves		1.3	0.6
Total equity and liabilities		**10,695.8**	**9,687.4**

* Restated as set out in note 1

The accounting policies and notes on pages 113 to 181 form part of these accounts. These accounts were approved by the Board on 5 February 2020. Signed on behalf of the Board:

Laurence Philip Adams
Chairman

R Michael Jones
Interim Chief Executive Officer

Tom Denman
Chief Financial Officer

Statement of financial position of the Society *as at 31 December 2019*

	Notes	2019 £m	2018* £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		1,201.9	931.8
Loans and advances to credit institutions	13	107.8	67.6
Debt securities	14	165.1	32.9
		1,474.8	1,032.3
Derivative financial instruments	15	16.5	21.2
Loans and advances to customers:			
Loans fully secured on residential property		8,542.3	7,984.4
Other loans		311.4	278.1
	16	8,853.7	8,262.5
Investments in subsidiary undertakings	20	68.6	135.3
Intangible fixed assets	21	17.5	4.6
Property, plant and equipment	22	34.2	24.4
Investment properties	22	6.9	9.8
Deferred tax assets	27	1.7	2.8
Other assets		2.5	2.9
Prepayments and accrued income		6.7	5.8
Total assets		**10,483.1**	**9,501.6**
Liabilities			
Shares	23	7,588.5	6,989.8
Deposits and debt securities:			
Amounts owed to credit institutions	24	1,783.3	1,499.9
Amounts owed to other customers		197.9	141.4
Debt securities in issue	25	301.5	297.7
		2,282.7	1,939.0
Derivative financial instruments	15	47.7	31.3
Current tax liabilities		1.7	1.5
Other liabilities	26	12.3	5.7
Provision for liabilities	19	1.7	1.8
Accruals and deferred income		10.8	12.4
Deferred tax liabilities	27	1.0	0.6
Retirement benefit obligations	11	–	3.9
Subscribed capital	28	61.2	63.6
Total liabilities		10,007.6	9,049.6
General reserve		474.2	451.4
Other reserves		1.3	0.6
Total equity and liabilities		**10,483.1**	**9,501.6**

* Restated as set out in note 1

The accounting policies and notes on pages 113 to 181 form part of these accounts. These accounts were approved by the Board on 5 February 2020. Signed on behalf of the Board:

Laurence Philip Adams
Chairman

R Michael Jones
Interim Chief Executive Officer

Tom Denman
Chief Financial Officer

Statement of changes in Members' interests *for the year ended 31 December 2019*

	2019			2018		
	General Reserve £m	Fair Value through OCI Reserve £m	Total equity attributable to Members £m	General Reserve £m	Fair Value through OCI Reserve £m	Total equity attributable to Members £m
Group						
At 1 January	550.1	0.6	550.7	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	–	–	–	0.7	–	0.7
Changes on initial application of IFRS 15	–	–	–	0.3	–	0.3
Restated balance at 1 January	550.1	0.6	550.7	516.3	1.2	517.5
Comprehensive income for the year	32.0	0.7	32.7	33.8	(0.6)	33.2
At 31 December	**582.1**	**1.3**	**583.4**	**550.1**	**0.6**	**550.7**
Society						
At 1 January	451.4	0.6	452.0	432.9	1.1	434.0
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	451.4	0.6	452.0	430.4	1.2	431.6
Comprehensive income for the year	22.8	0.7	23.5	21.0	(0.6)	20.4
At 31 December	**474.2**	**1.3**	**475.5**	**451.4**	**0.6**	**452.0**

The group's capital comprises the general reserve and subscribed capital (Permanent Interest-Bearing Shares or PIBS), adjusted in line with regulatory rules. The group complied with all regulatory capital requirements throughout the current and prior year.

Consolidated statement of cash flows *for the year ended 31 December 2019*

	2019 £m	2018* £m
Net cash inflow from operating activities (see below)	406.8	55.7
Cash flows from investing activities		
Purchase of intangible assets	(13.0)	(4.2)
Purchase of property, plant and equipment	(7.6)	(7.6)
Purchase of investment securities	(200.3)	(6.3)
Proceeds from sale and maturity of investment securities	68.9	97.1
Proceeds from sale of non current assets	–	4.2
Net cash flows from investing activities	**(152.0)**	**83.2**
Cash flows from financing activities		
Interest paid on subscribed capital	(4.2)	(4.2)
Interest paid on debt securities in issue	(23.3)	(17.2)
Proceeds from issuance of debt securities in issue	431.7	11.8
Redemption of debt securities in issue	(332.4)	(244.8)
Repayment of lease liabilities	(1.7)	–
Net cash flows from financing activities	**70.1**	**(254.4)**
Increase/(decrease) in cash and cash equivalents	324.9	(115.5)
Cash and cash equivalents at the beginning of year	1,079.6	1,195.1
Cash and cash equivalents at the end of year	**1,404.5**	**1,079.6**
Represented by:		
Cash and balances with the Bank of England	1,201.9	931.8
Loans and advances to credit institutions repayable on demand	202.6	147.8
	1,404.5	**1,079.6**
Cash flows from operating activities		
Profit before taxation	39.6	40.7
Adjusted for:		
Depreciation and amortisation	7.3	5.8
Charge on defined benefit scheme	0.1	0.8
Impairment on loans and advances to customers	(4.1)	0.6
Change in fair values	(28.0)	(2.2)
Equity adjustment for accounting policy changes	–	(3.7)
Interest on debt securities in issue	24.5	17.5
Interest on subscribed capital	4.2	4.2
Non-cash items included in profit before tax	0.2	0.9
Changes in net operating assets		
Loans and advances to customers	(505.6)	(640.4)
Other operating assets	(2.2)	(1.2)
Derivative financial instruments	22.3	7.2
Shares	595.9	427.8
Deposits	261.9	218.4
Other operating liabilities	0.2	(5.4)
Contributions paid into defined benefit scheme	(3.7)	(4.6)
Taxation paid	(5.8)	(10.7)
	406.8	**55.7**

* Restated as set out in note 1

The group is required to maintain interest-free balances with the Bank of England which at 31 December 2019 amounted to £26.3m (2018: £21.4m).

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Statement of cash flows of the Society *for the year ended 31 December 2019*

	2019 £m	2018* £m
Net cash inflow/(outflow) from operating activities (see below)	474.8	(146.8)
Cash flows from investing activities		
Purchase of intangible assets	(13.0)	(4.2)
Purchase of property, plant and equipment	(7.6)	(7.6)
Purchase of investment securities	(200.3)	(6.2)
Proceeds from sale and maturity of investment securities	68.9	97.1
Proceeds from sale of non-current assets	-	4.2
Net cash flows from investing activities	**(152.0)**	**83.3**
Cash flows from financing activities		
Interest paid on subscribed capital	(4.2)	(4.2)
Interest paid on debt securities in issue	(7.0)	(7.1)
Redemption of debt securities in issue	-	(13.5)
Repayments of lease liabilities	(1.3)	-
Net cash flows from financing activities	**(12.5)**	**(24.8)**
Increase/(decrease) in cash and cash equivalents	310.3	(88.3)
Cash and cash equivalents at the beginning of year	999.4	1,087.7
Cash and cash equivalents at the end of year	**1,309.7**	**999.4**
Represented by:		
Cash and balances with the Bank of England	1,201.9	931.8
Loans and advances to credit institutions repayable on demand	107.8	67.6
	1,309.7	**999.4**
Cash flows from operating activities		
Profit before taxation	28.2	25.3
Adjusted for:		
Depreciation and amortisation	7.1	5.8
Charge on defined benefit scheme	0.1	0.8
Impairment on loans and advances to customers	(0.5)	1.9
Change in fair values	20.9	(2.2)
Equity adjustment for accounting policy changes	-	(3.1)
Interest on debt securities in issue	7.1	7.1
Interest on subscribed capital	4.2	4.2
Non-cash items included in profit before tax	0.3	0.6
Changes in net operating assets		
Loans and advances to customers	(566.1)	(717.3)
Decrease in loans to subsidiary companies	66.7	83.5
Other operating assets	(0.9)	(0.9)
Derivative financial instruments	21.1	9.7
Shares	595.9	427.8
Deposits	339.9	25.8
Other operating liabilities	(0.3)	(3.5)
Contributions paid into defined benefit scheme	(3.7)	(4.6)
Taxation paid	(3.4)	(7.7)
Net cash flows generated from operating activities	**474.8**	**(146.8)**

* Restated as set out in note 1

Notes to the accounts *for the year ended 31 December 2019*

1. Accounting policies

Basis of preparation

These financial statements for the year ended 31 December 2019 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, 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 16 Leases and early adopted the amendments to IFRS 9, IAS 39 and IFRS 7 Interest Rate Benchmark Reform with effect from 1 January 2019, the impact from which is set out below. IFRIC 23 Uncertainty over Income Tax Treatments was also adopted from 1 January 2019, with no significant impact on the financial statements. Adoption of other amendments to existing standards and annual improvements did not have any impact on the group's accounting policies and did not require retrospective adjustments.

Adoption of IFRS 16 Leases

IFRS 16 specifies how an entity recognises, measures and presents leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases, including bringing those leases previously classified as 'operating leases' onto the balance sheet. IFRS 16's approach to lessor accounting is substantially unchanged from its predecessor, IAS 17.

The group has applied the modified retrospective transition approach, under which the value of the right of use asset is set equal to the value of the lease liability on the date of transition and there is no requirement to restate prior financial periods. In applying IFRS 16 for the first time, the only significant practical expedient taken was to use a single discount rate for all leases with reasonably similar characteristics.

The lease liability was measured as the present value of all remaining lease payments, discounted at the group's incremental borrowing rate. The impact of adopting IFRS 16 is to increase both assets and liabilities by £5.9m on adoption at 1 January 2019. The majority of the adjustment to assets and liabilities relates to the group's branch property portfolio. The right of use asset is held within 'Property, Plant and Equipment' and the lease liability within 'Other Liabilities' on the balance sheet

1. Accounting policies (continued)

Below is a reconciliation between group operating lease commitments previously disclosed as at 31 December 2018 and the recognised lease liability at 1 January 2019.

	1 January 2019 £m
Operating lease commitments at 31 December 2018	7.6
IT equipment lease not previously identified	0.4
Impact of discounting at the incremental borrowing rate	(1.6)
Lease liability recognised as at 1 January 2019	**6.4**
Onerous lease already recognised	(0.5)
Net adjustment on transition as at 1 January 2019	**5.9**

	1 January 2019 £m
Right-of-use asset by type:	
Properties	5.2
Motor vehicles	0.3
IT equipment	0.4
Right of use asset recognised as at 1 January 2019	**5.9**
Impairment already recognised	0.5
Lease liability recognised as at 1 January 2019	**6.4**

From 1 January 2019, all leases entered into are recognised as a right of use asset and a corresponding lease liability at the date on which the leased asset is available for use. Assets and liabilities arising from a lease are initially measured at the present value of the lease payments over the term of the lease. The lease payments are discounted using the interest rate implicit in the lease or, if that rate cannot be determined, the group's incremental borrowing rate is used.

The finance cost is charged to the income statement so as to produce a constant periodic rate of interest on the remaining balance of the lease liability for each period. The right of use asset is depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis.

Interest Rate Benchmark Reform – Amendments to IFRS 9, IAS 39 and IFRS 7

These amendments were issued by the IASB in September 2019 and endorsed by the EU in December 2019. They modify specific hedge accounting requirements to allow hedge accounting to continue for affected hedges during the period of uncertainty before impacted hedged items and hedging instruments are amended as a result of the on-going interest rate benchmark reforms.

The amendments are relevant to the group as it hedges and applies hedge accounting to its benchmark interest rate exposure. The application of the amendments impact the group's accounting in the following ways:

- The group has loan advances to Commercial lending customers, linked to GBP LIBOR. The interest rate risk of these advances is hedged using GBP LIBOR interest rate swaps. A portion of the advances and associated swaps are included in a portfolio fair value hedge, with the remainder included in micro hedge relationships.
- The amendments permit continuation of hedge accounting even though there is uncertainty about the timing and amount of the hedged cash flows due to the interest rate benchmark reforms.
- The group will not discontinue hedge accounting should the assessment of hedge effectiveness fall outside the 80-125 per cent range and the hedging relationship is subject to interest rate benchmark reforms. For those hedging relationships that are not subject to the interest rate benchmark reforms, the group will continue to cease hedge accounting if effectiveness is outside the 80-125 per cent range.

The group has chosen to early apply the amendments to IAS 39, which are mandatory for annual reporting periods beginning on or after 1 January 2020. Adopting these amendments allows the group to continue hedge accounting during the period of uncertainty arising from interest rate benchmark reforms.

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. None are expected to have a significant impact for the group.

Restatements of prior financial periods

There have been two disclosure changes in the year which impact the prior year comparatives:

1. Portions of properties which are not occupied by the group but instead are used to generate rental income, have been reclassified from property, plant and equipment to investment properties in the statement of financial position, to better represent the nature of their usage by the group.
2. Within the consolidated statement of cash flows, cash flows in respect of subscribed capital and debt securities in issue were previously shown within cash flows from operating activities. These have been reclassified as cash flows from financing activities to better reflect the nature of these items.

Comparatives have been restated as shown below. Only impacted balances are shown.

Consolidated statement of financial position extract for the year ended 31 December 2019	As previously presented £m	Adjustments £m	As restated £m
Property, plant and equipment	34.8	(9.8)	25.0
Investment properties	–	9.8	9.8
	34.8	**–**	**34.8**

Statement of financial position of the Society extract for the year ended 31 December 2019	As previously presented £m	Adjustments £m	As restated £m
Property, plant and equipment	34.2	(9.8)	24.4
Investment properties	–	9.8	9.8
	34.2	**–**	**34.2**

Consolidated statement of cash flows extract for the year ended 31 December 2019	As previously presented £m	Adjustments £m	As restated £m
Cash flows from operating activities *Adjusted for:*			
Interest on debt securities in issue	-	17.5	17.5
Interest on subscribed capital	-	4.2	4.2
Non-cash items included in profit before tax	0.8	0.1	0.9
Changes in net operating assets			
Proceeds from debt securities in issue	0.3	(0.3)	-
Redemption of debt securities in issue	(233.0)	233.0	-
Movement in subscribed capital	0.1	(0.1)	-
Cash flows from financing activities			
Interest paid on debt securities in issue	-	(17.3)	(17.3)
Proceeds from issuance of debt securities in issue	-	11.9	11.9
Redemption of debt securities in issue	-	(244.8)	(244.8)
Interest paid on subscribed capital	-	(4.2)	(4.2)
	(231.8)	**-**	**(231.8)**

Statement of cash flows of the Society extract for the year ended 31 December 2019	As previously presented £m	Adjustments £m	As restated £m
Cash flows from operating activities *Adjusted for:*			
Interest on debt securities in issue	-	7.1	7.1
Interest on subscribed capital	-	4.2	4.2
Non-cash items included in profit before tax	0.2	0.4	0.6
Changes in net operating assets			
Proceeds from debt securities in issue	0.3	(0.3)	-
Redemption of debt securities in issue	(13.5)	13.5	-
Movement in subscribed capital	0.1	(0.1)	-
Cash flows from financing activities			
Interest paid on debt securities in issue	-	(7.1)	(7.1)
Redemption of debt securities in issue	-	(13.5)	(13.5)
Interest paid on subscribed capital	-	(4.2)	(4.2)
	(12.9)	**-**	**(12.9)**

These restatements had no impact on net assets or Member's interests, or on cash and cash equivalents at either 1 January or 31 December 2018.

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. Income is recognised when it is highly probable that it will be received. Other fees and commissions and other income are recognised on an accruals basis when the service has been provided.

Classification and measurement of financial assets and liabilities

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.
- 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).

Financial liabilities are initially recognised at fair value, being the issue proceeds net of premiums, discounts and transaction costs incurred. Thereafter, the majority of financial liabilities 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.

In certain instances financial liabilities will be classified and measured at FVTPL. This classification is adopted where such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise. Changes in fair value are recognised in other fair value gains/losses.

Impairment losses on loans and advances to customers and credit institutions
In accordance with IFRS 9, the group uses 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. This assessment is performed on a monthly basis.

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; 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.

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; 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.

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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.

Treasury assets

Significant judgements included within the treasury assets expected credit loss model include the credit default swap (CDS) price and the haircut applied within the LGD model. Significant judgements are reviewed on an ongoing basis as part of the IFRS 9 model governance process or earlier where new treasury assets are acquired.

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.	PDs for balances with the Bank of England 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.	PDs for loans and advances to credit institutions 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.	PDs for debt securities are based on historical default rates 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 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. Economic scenarios are selected which take account of a range of possible economic outcomes.

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)

iii) Hedge accounting (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.

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.

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.

Leases
i) As lessor
Lease income receivable is credited to the income statement on a straight-line basis over the life of the lease.

ii) As lessee
Prior to the adoption of IFRS 16 on 1 January 2019, the accounting policy for which is set out on page 113, all leases entered into by the group as lessee were classified as operating leases, with lease payments charged to the income statement on a straight-line basis over the life of the lease.

1. Accounting policies (continued)

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.

Investment properties, property, plant and equipment

Investment properties comprise parts of freehold properties that are not used in the business. These primarily include flats above branches and floors one to four of Principality Buildings in Queen Street, Cardiff which are used to generate rental income. Investment properties are stated at cost less accumulated depreciation and any provision for impairment.

Freehold and long leasehold properties comprise mainly branches and office buildings. Property, plant and equipment is 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 (including investment properties)	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.

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.

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.

1. Accounting policies (continued)

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.

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 estimates applied in determining expected credit loss provisions are:

- determining criteria for identifying a 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.

Further information is included in note 18.

Retirement benefit obligations
The group has to make significant estimations in relation to the assumptions on 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 complaints
The group holds provisions for customer complaints, primarily in relation to past sales of secured personal lending products. Estimations are involved in determining the level of provision to hold for such 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 is included in note 19.

3. Business segments

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

	2019			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	86.2	14.7	10.5	111.4
Other income and charges	2.4	1.7	0.1	4.2
Net operating income	**88.6**	**16.4**	**10.6**	**115.6**
Operating expenses	(75.2)	(3.6)	(1.3)	(80.1)
Impairment provision for losses on loans and advances	(2.3)	2.7	3.7	4.1
Operating profit and profit before taxation	**11.1**	**15.5**	**13.0**	**39.6**
Taxation expense				(7.6)
Profit after taxation				**32.0**

	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)
Operating profit and profit before taxation	**14.2**	**13.1**	**13.4**	**40.7**
Taxation expense				(7.8)
Profit after taxation				**32.9**

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3. Business segments (continued)

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

	Group	
	2019 £m	2018 £m
Total assets by business segments		
Retail financial services	9,665.9	8,679.4
Commercial lending	850.3	771.3
Secured personal lending	179.6	236.7
Total assets	**10,695.8**	**9,687.4**
Total liabilities & equity by business segment		
Retail financial services & Commercial lending	10,516.2	9,450.7
Secured personal lending	179.6	236.7
Total liabilities & equity	**10,695.8**	**9,687.4**

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	
	2019 £m	2018 £m	2019 £m	2018 £m
On loans fully secured on residential property	221.3	222.5	205.1	201.0
On other loans	11.9	5.8	11.9	5.8
On loans to subsidiaries	-	-	5.7	7.1
On debt securities	1.2	1.1	1.2	1.1
On other liquid assets	7.7	6.5	7.6	6.3
On derivative financial instruments	(8.2)	(9.9)	(8.2)	(9.9)
	233.9	**226.0**	**223.3**	**211.4**

5. Interest payable and similar charges

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
On shares held by individuals	92.8	83.1	92.8	83.1
On deposits and debt securities	28.8	24.8	26.9	23.4
On subscribed capital	4.2	4.2	4.2	4.2
On lease liabilities	0.3	-	0.2	-
On derivative financial instruments	(3.6)	(5.7)	(2.3)	(4.4)
	122.5	**106.4**	**121.8**	**106.3**

Interest on lease liabilities is as a result of the adoption of IFRS 16 Leases, from 1 January 2019. See note 1 for further information.

6. Fees and commission receivable

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Insurance and related financial service products	1.3	1.6	1.3	1.6
Mortgage related fees	3.5	3.9	3.5	3.9
Other fees and commission	0.1	0.2	0.1	-
	4.9	**5.7**	**4.9**	**5.5**

7. Other fair value gains and losses

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Losses on derivatives in hedging relationships	(23.0)	(4.3)	(23.0)	(4.3)
Gains/(losses) on derivatives not in hedging relationships	1.9	(1.0)	2.8	(2.9)
Losses on derivatives	**(21.1)**	**(5.3)**	**(20.2)**	**(7.2)**
Gains on economic hedged items	5.9	4.5	5.9	4.5
Gains/(losses) on hedged items attributable to the hedged risk	15.0	(1.6)	15.0	(1.6)
Gains on hedged items	**20.9**	**2.9**	**20.9**	**2.9**
	(0.2)	**(2.4)**	**0.7**	**(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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8. Administrative expenses

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Wages and salaries	37.2	38.8	37.2	38.8
Social security costs	4.0	3.8	4.0	3.8
Other pension costs	2.2	2.7	2.2	2.7
	43.4	**45.3**	**43.4**	**45.3**
Other administrative expenses	29.4	30.4	28.7	28.4
	72.8	**75.7**	**72.1**	**73.7**

	Group		Society	
	2019 £000	2018 £000	2019 £000	2018 £000
Other administrative expenses include:				
Auditor's remuneration				
For audit of the Society's Annual Accounts	270	230	270	230
For audit of the Society's subsidiaries	65	35	–	–
Total	335	265	270	230
For other services				
Further assurance services	79	91	79	91
Total other services	79	91	79	91
Operating lease charges – motor vehicles	–	214	–	214
– land and buildings	–	943	–	1,054

All of the group's operating leases are now classified as right of use assets following the adoption of IFRS 16 Leases on 1 January 2019. See note 1 for further information.

9. Employees

The average number employed including Executive Directors was:

	Full-time		Part-time	
	2019 Number	2018 Number	2019 Number	2018 Number
Society's Customer Support Centre and administration office	671	720	119	123
Society branches	205	192	126	116
Employed by the group	**876**	**912**	**245**	**239**

10. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee 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 (2018: £1.9m).

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 2019 was £2.2m (2018: £1.9m). 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 scheme is currently undergoing a triennial valuation with a reference date of 30 September 2019, it is due to be completed by 31 December 2020.

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 & General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal & 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 £3.7m was paid into the pension scheme from the Society (2018: £4.6m). The agreed contributions to be paid by the Society in 2020 amount 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.

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11. Retirement benefit obligations (continued)

Defined benefit scheme (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. The Scheme's investment assets, excluding the insured assets which are held by Legal & General, are held under a Fiduciary Management arrangement with Legal & 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 LLP are engaged 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 £31.4m (2018: £31.7m).

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

	At 31 December				
	2019 %	2018 %	2017 %	2016 %	2015 %
Rate of increase of pensions in payment	2.15	2.25	2.25	2.25	2.20
Discount rate	2.00	2.80	2.40	2.55	3.75
Inflation assumption (RPI)	3.00	3.20	3.20	3.25	3.15
Inflation assumption (CPI)	2.15	2.20	2.20	2.25	2.15

The assumptions on mortality are determined by the following tables:

	2019	2018
Retired and non-retired members	S3NA CMI 2018 LTR 1.25%	S2NA CMI 2017 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	22.1
Females currently aged 65	24.4	24.2
Non-retired members		
Males currently aged 45	23.4	23.5
Females currently aged 45	25.8	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				
	2019 £m	2018 £m	2017 £m	2016 £m	2015 £m
Target return funds	–	–	29.0	27.4	27.1
Multi asset	36.5	29.0	–	–	–
LDI	8.5	6.7	–	–	–
Annuities	25.5	23.9	25.9	26.4	23.5
Bonds and cash	3.8	3.4	8.5	4.3	3.5
Total fair value of plan assets	**74.3**	**63.0**	**63.4**	**58.1**	**54.1**
Present value of funded obligations	(73.8)	(66.4)	(71.8)	(72.9)	(57.7)
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)**

The deficit has decreased primarily as a result of £3.7m of contributions paid into the pension scheme by the Society in 2019, together with movements in the discount rate which impacts the scheme liabilities.

The actual gain on plan assets was £9.9m during the year (2018: loss of £1.3m).

11. Retirement benefit obligations (continued)

Defined benefit scheme (continued)

The amounts recognised in the income statement are as follows:

	Group and Society	
	2019 £m	2018 £m
Analysis of the amounts recognised in the income statement		
Interest on pension scheme assets	(1.8)	(1.5)
Interest on pension scheme liabilities	1.9	1.7
Net interest expense	**0.1**	**0.2**
Past service cost	-	0.6
Total amount recognised in the income statement	**0.1**	**0.8**
Analysis of amount recognised in statement of other comprehensive income		
Gain/(losses) on scheme assets in excess of interest	8.1	(2.8)
Experience Gains/(losses) on liabilities	0.8	(0.1)
Losses from changes to demographic assumptions	(0.4)	(0.4)
(Losses)/gains from changes to financial assumptions	(8.2)	4.5
Total remeasurement	**0.3**	**1.2**
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(3.9)	(8.9)
Movement in year:		
Net interest expense	(0.1)	(0.2)
Remeasurements	0.3	1.2
Contributions paid and accrued	3.7	4.6
Past service cost	-	(0.6)
Deficit in scheme at end of year	**-**	**(3.9)**
Analysis of the movement in the fair value of pension scheme assets		
Fair value of assets at the beginning of the year	63.0	63.4
Interest on assets	1.8	1.5
Society contributions	3.7	4.6
Benefits paid	(2.2)	(3.7)
Return on plan assets less interest	6.4	(0.8)
Change in fair value of the annuity policy	1.6	(2.0)
Fair value of assets at the end of the year	**74.3**	**63.0**
Analysis of the movement in the present value of the pension scheme liabilities		
Present value of liabilities at the beginning of the year	66.9	72.3
Interest expense	1.8	1.7
Remeasurement losses/(gains):		
Actuarial gains and losses arising from changes in demographic assumptions	0.4	0.4
Actuarial gains and losses arising from changes in financial assumptions	8.2	(4.5)
Actuarial gains and losses arising from experience adjustments	(0.8)	0.1
Benefits paid	(2.2)	(3.7)
Past service cost	-	0.6
Present value of liabilities at the end of the year	**74.3**	**66.9**

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	(5.1)	5.7
Inflation	5.0	(4.5)
Life expectancy (+1 year/-1 year)	3.0	(3.0)

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	
	2019 £m	2018 £m	2019 £m	2018 £m
Current tax				
UK corporation tax charge for the year	8.1	7.4	5.6	4.8
Adjustments in respect of prior years	(0.8)	0.1	(0.6)	0.1
	7.3	7.5	5.0	4.9
Deferred tax				
Deferred tax charge for year	(0.2)	0.4	(0.2)	0.4
Adjustments in respect of prior years	0.5	(0.1)	0.6	(0.1)
	0.3	0.3	0.4	0.3
Taxation expense	**7.6**	**7.8**	**5.4**	**5.2**

The statutory rate of corporation tax has remained at 19.0% during 2019. 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	
	2019 £m	2018 £m	2019 £m	2018 £m
Profit before taxation	39.6	40.7	28.2	25.3
Profit multiplied by the standard rate of corporation tax at 19.0% (2018: 19.0%)	7.5	7.7	5.3	4.8
Effects of:				
Expenses not deductible for tax purposes	0.3	0.1	0.1	0.4
Adjustments to prior years	(0.2)	–	–	–
Taxation on profit from ordinary activities	**7.6**	**7.8**	**5.4**	**5.2**

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	
	2019 £m	2018 £m	2019 £m	2018 £m
Current tax				
Relating to retirement benefit obligations	(0.9)	(1.0)	(0.9)	(1.0)
	(0.9)	(1.0)	(0.9)	(1.0)
Deferred tax				
Relating to retirement benefit obligations	1.0	1.2	1.0	1.2
Gain/(loss) on fair value through other comprehensive income	0.1	(0.1)	0.1	(0.1)
	1.1	1.1	1.1	1.1
Total charged to other comprehensive income	**0.2**	**0.1**	**0.2**	**0.1**

13. Loans and advances to credit institutions

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Loans and advances to credit institutions	202.6	147.8	107.8	67.6

Included in the above amount for the group is £104.1m of collateral given under Credit Support Annex (CSA) agreements (2018: £64.9m).

14. Debt securities

	Group and Society	
	2019 £m	2018 £m
Issued by the UK Government	90.9	–
Issued by other borrowers and unlisted	23.8	32.9
Issued by Supranational entities	50.4	–
	165.1	**32.9**

Debt securities are held at fair value through other comprehensive income.

The movement in debt securities is summarised as follows:

	Group and Society	
	2019 £m	2018 £m
At 1 January	32.9	124.9
Additions	200.3	6.3
Disposals and maturities	(68.9)	(97.1)
Gain/(losses) from changes in fair value	0.6	(0.7)
Increase/(decrease) in accrued interest	0.2	(0.5)
At 31 December	**165.1**	**32.9**

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 is recorded gross and 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	
	2019 £m	2018 £m	2019 £m	2018 £m
Derivative assets:				
Interest rate swaps	2,599.4	3,776.7	21.3	23.9
Equity and RPI linked interest rate swaps	–	6.1	–	0.9
Total recognised derivative assets	**2,599.4**	**3,782.8**	**21.3**	**24.8**
Derivative liabilities:				
Interest rate swaps	4,495.0	3,356.9	50.4	31.6
Total recognised derivative liabilities	**4,495.0**	**3,356.9**	**50.4**	**31.6**

	Society			
	Contract/notional amount		Fair Value	
	2019 £m	2018 £m	2019 £m	2018 £m
Derivative liabilities:				
Interest rate swaps	3,000.6	3,884.4	16.5	20.3
Equity and RPI linked interest rate swaps	-	6.1	-	0.9
Total recognised derivative assets	**3,000.6**	**3,890.5**	**16.5**	**21.2**
Derivative liabilities:				
Interest rate swaps	5,275.0	3,863.5	47.7	31.3
Total recognised derivative liabilities	**5,275.0**	**3,863.5**	**47.7**	**31.3**

Derivative financial instruments held or issued for hedging purposes

The group uses derivatives for economic hedging purposes as part of its asset and liability management 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	
	2019 £m	2018 £m	2019 £m	2018 £m
Derivatives				
Total derivatives in economic hedge relationships				
Interest rate swaps	628.7	765.5	1,809.9	1,379.7
Equity swaps	–	6.1	–	6.1
	628.7	**771.6**	**1,809.9**	**1,385.8**
Total derivatives used as fair value hedges				
Interest rate swaps	6,465.7	6,368.1	6,465.7	6,368.1
Derivative assets in economic hedge relationships				
Interest rate swaps	344.1	417.4	344.1	525.1
Equity swaps	–	6.1	–	6.1
	344.1	423.5	344.1	531.2
Derivative assets used as fair value hedges				
Interest rate swaps	2,255.3	3,359.3	2,656.5	3,359.3
Derivative liabilities in economic hedge relationships				
Interest rate swaps	284.6	348.1	284.6	854.7
Derivative liabilities used as fair value hedges				
Interest rate swaps	4,210.4	3,008.8	4,990.4	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	
	2019 £m	2018 £m	2019 £m	2018 £m
Fair value hedges				
Micro hedges				
Commercial loans	120.1	127.2	120.1	127.2
Wholesale	300.0	360.0	300.0	360.0
FV adjustment on hedged item (asset)	1.0	4.5	1.0	4.5
FV adjustment on hedged item (liability)	2.1	(4.7)	2.1	(4.7)
Macro hedges				
Residential and commercial loans	4,563.6	4,393.9	4,563.6	4,393.9
Retail savings	1,457.4	3,422.7	1,457.4	3,422.7
FV adjustment on hedged item (asset)	(20.8)	3.6	(20.8)	3.6
FV adjustment on hedged item (liability)	2.5	(1.7)	2.5	(1.7)
Other underlying adjustments				
Economic hedges – equity	(0.9)	(1.6)	(0.9)	(1.6)
Amortisation/unwinds	(4.9)	(2.9)	(4.9)	(2.9)

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Hedging strategy outcome				
Micro hedge – asset				
Commercial loans – hedged items	1.0	4.5	1.0	4.5
Commercial loans – hedged instruments	1.5	(2.5)	1.5	(2.5)
Micro hedge – liability				
Wholesale – hedged items	2.1	(4.7)	2.1	(4.7)
Wholesale – hedged instruments	(2.2)	4.4	(2.2)	4.4
Macro hedge – asset				
Residential and commercial loans – hedged items	(20.8)	3.6	(20.8)	3.6
Residential and commercial loans – hedged instruments	26.4	1.1	26.4	1.1
Macro hedge – liability				
Retail savings – hedged items	2.5	(1.7)	2.5	(1.7)
Retail savings – hedged instruments	(2.6)	1.3	(2.6)	1.3
Economic hedge items				
Equity	(0.9)	(1.6)	(0.9)	(1.6)
Amortisation/unwinds	(4.9)	(2.9)	(4.9)	(2.9)
Economic hedge instruments				
Dedesignation	(1.2)	(0.5)	(1.2)	(0.5)
Economic hedges – awaiting designation	(2.4)	0.7	(2.4)	0.7
Economic hedges – basis swaps	0.5	(0.9)	0.5	(0.9)
Economic hedges – equity	0.9	1.6	0.9	1.6
Other adjustments	–	0.1	–	0.1
Economic hedges – securitisation	–	–	(0.9)	1.9

The Society's fair value gains and losses is shown in the table above are 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 2019	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	–	–	–	47.2	82.2	129.4
EMTN interest rate swaps	–	–	–	300.0	–	300.0
Macro hedge						
Retail mortgages interest rate swaps	90.0	214.0	1,252.0	2,941.0	10.0	4,507.0
Commercial interest rate swaps	–	–	3.0	43.8	26.6	73.4
Savings interest rate swaps	80.0	95.0	795.0	486.0	–	1,456.0
Economic hedges						
Retail mortgages interest rate swaps	–	–	–	95.0	180.0	275.0
Commercial interest rate swaps	–	–	–	16.0	2.5	18.5
Savings interest rate swaps	–	–	70.0	–	–	70.0
Basis interest rate swaps	–	–	183.0	–	–	183.0
PIBS swap	–	–	60.0	–	–	60.0
Dedesignated swaps	–	3.2	14.6	0.3	4.1	22.2
	170.0	**312.2**	**2,377.6**	**3,929.3**	**305.4**	**7,094.5**

Society As at 31 December 2019	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	–	–	–	47.2	82.2	129.4
EMTN interest rate swaps	–	–	–	300.0	–	300.0
Macro hedge						
Retail mortgages interest rate swaps	90.0	214.0	1,252.0	2,941.0	10.0	4,507.0
Commercial interest rate swaps	–	–	3.0	43.8	26.6	73.4
Savings interest rate swaps	80.0	95.0	795.0	486.0	–	1,456.0
Economic hedges						
Retail mortgages interest rate swaps	–	–	–	95.0	180.0	275.0
Commercial interest rate swaps	–	–	–	16.0	2.5	18.5
Savings interest rate swaps	–	–	70.0	–	–	70.0
Basis interest rate swaps	–	–	183.0	–	–	183.0
PIBS swap	–	–	60.0	–	–	60.0
Dedesignated swaps	–	3.2	14.6	0.3	4.1	22.2
Securitisation interest rate swaps	–	–	–	1,181.1	–	1,181.1
	170.0	**312.2**	**2,377.6**	**5,110.4**	**305.4**	**8,275.6**

15. Derivative financial instruments (continued)

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 hedges						
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	13.7
	63.7	**356.9**	**1,614.3**	**4,888.1**	**216.7**	**7,139.7**

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 hedges						
Retail mortgages interest rate swaps	–	–	–	222.0	110.0	332.0
Commercial interest rate swaps	–	–	–	4.8	2.5	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	13.7
Securitisation interest rate swaps	–	–	–	614.2	–	614.2
	63.7	**356.9**	**1,614.3**	**5,502.3**	**216.7**	**7,753.9**

Interest Rate Benchmark Reform

Within its hedge accounting relationships, the Society is exposed to GBP LIBOR which is subject to interest rate benchmark reform. The hedged items consist solely of advances to Commercial customers linked to GBP LIBOR.

In addition, the Society has other derivative and non-derivative financial instruments linked to GBP LIBOR that are not included in hedge accounting relationships. Given hedge accounting is not applied in these cases, there is no accounting relief. The fair value of these financial assets and liabilities therefore reflects the uncertainties arising from the interest rate benchmark reforms.

The Society is closely monitoring the market and the output from the various industry working groups managing the transition to new benchmark interest rates. This includes announcements made by LIBOR regulators, including the Financial Conduct Authority (FCA) regarding the transition away from LIBOR (including GBP LIBOR) to the Sterling risk free rate, Sterling Overnight Index Average Rate (SONIA) or other alternative rates.

In response to the announcements, the Society has set up a LIBOR transition programme under the governance of the Chief Financial Officer who reports to the Board. The aim of the programme is to ensure the Society transitions its current LIBOR exposures, including Commercial loans linked to LIBOR, to an alternative benchmark rate by the end of 2021. A project team is in place and an implementation plan has been agreed. Work began on the project last year and is expected to accelerate throughout 2020 to ensure the Society achieves a smooth transition by the required deadline.

Below are details of the hedging instruments and hedged items in scope of the IAS 39 amendments due to interest rate benchmark reform, by hedge type. The terms of the hedged items listed match those of the corresponding hedging instruments.

Group As at 31 December 2019	**Contract/notional amounts**				
	Less than 3 month £m	Between 3 months and 1 year £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Fair value hedges – Portfolio hedging of Commercial mortgages					
Receive 3 month GBP LIBOR, pay Sterling fixed rate interest rate swaps	–	3.0	37.7	9.0	49.7
Fair value hedges – Micro hedging of Commercial mortgages					
Receive 3 month GBP LIBOR, pay Sterling fixed rate interest rate swaps	–	–	43.7	65.3	109.0

16. Loans and advances to customers

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Fully secured on residential property	8,695.2	8,216.6	8,514.5	7,979.2
Fully secured on land	311.4	282.8	311.4	282.8
	9,006.6	**8,499.4**	**8,825.9**	**8,262.0**
Provision for impairment losses	(25.5)	(30.5)	(19.0)	(21.6)
Effective Interest Rate adjustments	19.7	22.2	14.5	14.5
Fair value adjustment for hedged risk	32.3	7.6	32.3	7.6
	9,033.1	**8,498.7**	**8,853.7**	**8,262.5**

Retail financial services & Secured personal lending

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

Stage	31 December 2019 %	31 December 2018 %
1	91	92
2	8	7
3	1	1

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

Staging reason	31 December 2019 %	31 December 2018 %
PD grade deterioration	85	85
30-60 days past due	14	14
Forbearance	1	1

Commercial

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

Stage	31 December 2019 %	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	31 December 2019 %	31 December 2018 %
Risk grade deterioration	92	100
30-60 days past due	8	-

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 2019, the encumbrance ratio was 23.25% (31 December 2018: 22.88%). All other assets are defined as unencumbered.

An analysis of the group's encumbered and unencumbered on-balance sheet assets as at 31 December 2019 and 2018 is set out below.

	2019		2018	
	Encumbered £m	Unencumbered £m	Encumbered £m	Unencumbered £m
Cash in hand & balances at the Bank of England	-	1,201.9	-	931.8
Loans and advances to credit institutions	198.9	3.7	145.0	2.8
Debt securities	-	165.1	-	32.9
Derivative financial instruments	-	21.3	-	24.8
Loans and advances to customers	2,288.2	6,744.9	2,072.1	6,426.6
Other assets	-	71.8	-	51.4
Total	**2,487.1**	**8,208.7**	**2,217.1**	**7,470.3**

18. Provision for impairment losses

Group 2019	Retail £m	Commercial lending £m	Secured personal lending £m	Total £m
New loans	1.0	1.8	-	2.8
Settled loans	(1.0)	(3.9)	(1.0)	(5.9)
Changes in model assumptions	(1.2)	(0.2)	(1.1)	(2.5)
Changes in credit quality	3.2	(2.1)	(0.3)	0.8
Utilised provision	0.3	1.7	(1.3)	0.7
Income statement impact	**2.3**	**(2.7)**	**(3.7)**	**(4.1)**
Balance sheet impact	**2.0**	**(4.4)**	**(2.4)**	**(4.8)**

18. Provision for impairment losses (continued)

Group 2018	Retail £m	Commercial lending £m	Secured personal lending £m	Total £m
New loans	0.8	1.1	–	1.9
Settled loans	(0.9)	(8.0)	(1.1)	(10.0)
Changes in model assumptions	2.7	0.5	1.6	4.8
Changes in credit quality	(0.2)	2.5	(1.9)	0.4
Utilised provision	–	3.4	0.1	3.5
Income statement impact	**2.4**	**(0.5)**	**(1.3)**	**0.6**
Balance sheet impact	**2.3**	**(3.9)**	**(1.3)**	**(3.0)**

Provision for impairment losses at 31 December 2019 include £25.5m for loan loss provisioning impairment (2018: £30.5m) and £0.9m on other debt instruments (2018: £0.8m).

The following tables analyse the movements in gross loan balances during the year by stage. The difference between gross loan balances shown in the tables below and loans and advances to customers as per the balance sheet relates to commitments and undrawn balances.

Group 2019	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2019	8,200.7	668.7	62.7	8,932.1
Transfers:				
Stage 1 transfers	(3.7)	–	–	(3.7)
Stage 2 transfers	–	0.5	–	0.5
Stage 3 transfers	–	–	3.2	3.2
New loans	1,772.6	65.0	–	1,837.6
Settled loans	(938.3)	(62.4)	(14.5)	(1,015.2)
Repayments	(239.3)	(16.1)	(2.3)	(257.7)
Gross loan balance at 31 December 2019	**8,792.0**	**655.7**	**49.1**	**9,496.8**

Society 2019	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2019	8,022.0	624.5	49.6	8,696.1
Transfers:				
Stage 1 transfers	(5.8)	–	–	(5.8)
Stage 2 transfers	–	2.3	–	2.3
Stage 3 transfers	–	–	3.5	3.5
New loans	1,772.5	65.0	–	1,837.5
Settled loans	(907.3)	(57.9)	(12.4)	(977.6)
Repayments	(223.9)	(13.1)	(1.7)	(238.8)
Gross loan balance at 31 December 2019	**8,657.3**	**620.8**	**39.0**	**9,317.1**

Group 2018	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2018	7,560.7	554.1	74.8	8,189.6
Transfers:				
Stage 1 transfers	(148.2)	–	–	(148.2)
Stage 2 transfers	–	134.9	–	134.9
Stage 3 transfers	–	–	13.3	13.3
New loans	2,149.1	79.7	0.5	2,229.3
Settled loans	(1,087.7)	(75.4)	(21.3)	(1,184.4)
Repayments	(273.2)	(24.6)	(4.6)	(302.4)
Gross loan balance at 31 December 2018	**8,200.7**	**668.7**	**62.7**	**8,932.1**

Society 2018	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
At 1 January 2018	7,318.6	501.2	57.8	7,877.6
Transfers:				
Stage 1 transfers	(148.5)	–	–	(148.5)
Stage 2 transfers	–	135.0	–	135.0
Stage 3 transfers	–	–	13.5	13.5
New loans	2,149.1	79.6	0.5	2,229.2
Settled loans	(1,043.0)	(70.3)	(18.5)	(1,131.8)
Repayments	(254.2)	(21.0)	(3.7)	(278.9)
Gross loan balance at 31 December 2018	**8,022.0**	**624.5**	**49.6**	**8,696.1**

The following tables analyse the movements in loan loss provisions during the year by stage.

Group 2019	Stage 1 12 month ECL £m	Stage 2 Lifetime ECL £m	Stage 3 Lifetime ECL £m	Total £m
At 1 January 2019	3.1	17.0	10.4	30.5
Transfers:				
Stage 1 transfers	(0.3)	–	–	(0.3)
Stage 2 transfers	–	0.7	–	0.7
Stage 3 transfers	–	–	0.3	0.3
New loans	1.2	1.6	–	2.8
Settled loans	(0.5)	(1.1)	(4.2)	(5.8)
Changes in credit quality	0.3	(0.2)	(0.2)	(0.1)
Changes in model assumptions	(0.1)	(2.2)	(0.2)	(2.5)
Loss allowance at 31 December 2019	**3.7**	**15.8**	**6.1**	**25.6**

18. Provision for impairment losses (continued)

Society 2019	Stage 1 12 month ECL £m	Stage 2 Lifetime ECL £m	Stage 3 Lifetime ECL £m	Total £m
At 1 January 2019	2.9	11.7	7.0	21.6
Transfers:				
Stage 1 transfers	(0.3)	-	-	(0.3)
Stage 2 transfers	-	0.5	-	0.5
Stage 3 transfers	-	-	0.5	0.5
New loans	1.2	1.6	-	2.8
Settled loans	(0.5)	(0.7)	(3.7)	(4.9)
Changes in credit quality	0.3	-	(0.2)	0.1
Changes in model assumptions	(0.1)	(1.2)	-	(1.3)
Loss allowance at 31 December 2019	**3.5**	**11.9**	**3.6**	**19.0**

Group 2018	Stage 1 12 month ECL £m	Stage 2 Lifetime ECL £m	Stage 3 Lifetime ECL £m	Total £m
At 1 January 2018	3.3	12.4	17.8	33.5
Transfers:				
Stage 1 transfers	0.2	-	-	0.2
Stage 2 transfers	-	1.6	-	1.6
Stage 3 transfers	-	-	0.8	0.8
New loans	0.9	1.0	-	1.9
Settled loans	(0.6)	(0.6)	(8.9)	(10.1)
Changes in credit quality	(0.7)	(0.6)	(0.8)	(2.1)
Changes in model assumptions	-	3.2	1.5	4.7
Loss allowance at 31 December 2018	**3.1**	**17.0**	**10.4**	**30.5**

Society 2018	Stage 1 12 month ECL £m	Stage 2 Lifetime ECL £m	Stage 3 Lifetime ECL £m	Total £m
At 1 January 2018	3.0	7.0	13.3	23.3
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)	(0.3)	(8.1)	(8.9)
Changes in credit quality	(0.6)	-	-	(0.6)
Changes in model assumptions	-	2.3	0.7	3.0
Loss allowance at 31 December 2018	**2.9**	**11.7**	**7.0**	**21.6**

The following tables show an analysis of expected credit losses by PD band and the average provision coverage within each PD band as at 31 December 2019:

Retail and Secured personal lending	2019		2018	
	Sum of ECL £m	Coverage %	Sum of ECL £m	Coverage %
0.00% - 0.11%	0.1	0.00	0.1	0.02
0.11% - 0.17%	0.2	0.01	0.2	0.04
0.17% - 0.25%	0.1	0.02	0.3	0.11
0.25% - 0.41%	0.2	0.03	0.6	0.12
0.41% - 0.60%	0.8	0.26	0.6	0.32
0.60% - 0.88%	0.8	0.46	0.6	0.59
0.88% - 1.49%	2.2	2.04	1.7	2.73
1.49% - 2.96%	1.7	3.06	1.9	5.92
2.96% - 6.84%	1.1	4.50	1.5	11.17
6.84%+	10.3	8.24	10.6	23.44
Grand Total	**17.5**		**18.1**	

Commercial lending	2019		2018	
	Sum of ECL £m	Coverage %	Sum of ECL £m	Coverage %
PD:				
0.28%	0.2	0.1	0.1	0.1
0.56%	0.3	0.1	0.3	0.2
1.13%	1.3	0.4	1.3	0.4
2.25%	1.2	1.0	1.6	1.3
4.50%	1.0	2.8	1.4	3.2
9.00%	1.2	3.3	1.2	7.9
18.00%	1.2	23.7	0.9	17.6
36.00%	0.2	24.5	0.9	94.0
100.00%	1.4	21.2	4.7	47.3
Grand Total	**8.0**		**12.4**	

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18. Provision for impairment losses (continued)

The IFRS 9 models calculate expected credit losses for each of the scenarios and then apply the relative weightings of the forward-looking economic scenarios to generate the weighted output for each model.

The scenarios consist of the following:

Scenario	Weighting at 31 December 2019 %	GDP growth %	Unemployment growth %	House price growth %
Base	45.0	3.5	1.0	1.0
Stronger near term growth	–	4.6	(1.0)	4.0
Slower near term growth	25.0	2.7	1.0	(1.0)
Protracted slump	15.0	(0.5)	4.0	(7.0)
Stagflation	15.0	1.8	3.0	(3.0)

Scenario	Weighting at 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)

In addition to applying the scenarios and weightings set out above, further allowance was made in the prior year for the impact of the UK not achieving an orderly exit from the EU by the deadline of 29 March 2019. This allowance totalled £3.6m at 31 December 2018.

Following developments in 2019, the remaining uncertainty in relation to Brexit has been captured within the weightings applied to the scenarios as set out above, with no additional allowance made. Within these, the decision has been taken to apply a zero weighting to stronger near term growth in the current year, in reflection of the political, economic and environmental uncertainty that exists both in the UK and globally at the time of finalising these financial statements.

The IFRS 9 models calculate expected credit losses for each scenario 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. The table below shows the range of ECL impact between the most optimistic 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	14.2
Secured personal lending	5.9
Commercial lending	0.4

19. Provision for liabilities

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
At 1 January	5.1	6.1	1.8	2.2
Charge for the year	0.2	–	0.2	–
Utilisation	(0.9)	(1.0)	(0.4)	(0.4)
At 31 December	**4.4**	**5.1**	**1.7**	**1.8**

At 31 December 2019, the group held a provision of £4.4m (2018: £5.1m) in respect of various claims. This 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.

Although a significant degree of uncertainty remains with regard to the ultimate cost of settling customer claims, the provision balance is expected to be sufficient to meet any remaining obligations. The provision will continue to be monitored and customer trends and behaviour analysed in order to ensure the provision remains appropriate.

20. Investments in subsidiary undertakings

	Society	
	2019 £m	2018 £m
Shares in subsidiary undertakings	0.1	0.1
Loans to subsidiary undertakings	68.5	135.2
	68.6	**135.3**

	Subsidiary undertakings	
	Shares £m	Loans £m
Movement in investments in subsidiary undertakings:		
At 1 January 2019	0.1	135.2
Loan repayment	–	(66.7)
At 31 December 2019	**0.1**	**68.5**

The Directors have reviewed the recoverability of outstanding loans and holdings in subsidiary undertakings and no impairment provision is deemed necessary.

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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 mortgage & financial advice	Ordinary	100%	Direct
Principality Covered Bond LLP	England and Wales	Covered bond LLP	Ordinary	100%	Direct

Principality Building Society consolidates funding vehicles Friary No.2 PLC, Friary No.3 PLC, Friary No.4 PLC, Friary No.5 PLC and Friary No.6 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 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.

Energy Assess Wales Limited
Home Information Pack Wales Limited
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
Principality (IFA Services) Limited
Principalty Independant Financial Advisors Limited
Principality Life Assurance Services Limited
Principality (Life & 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

	Group & Society	
	2019 £m	2018 £m
Cost:		
At 1 January	12.7	8.5
Additions	13.0	4.2
At 31 December	**25.7**	**12.7**
Amortisation:		
At 1 January	8.0	7.7
Charge for the year	0.2	0.4
At 31 December	**8.2**	**8.1**
Net book value:		
At 31 December	**17.5**	**4.6**

Computer software capitalised during the year relates to the group's transformation programme and associated technology investment. The total cost at 31 December 2019 includes £17.3m (2018: £4.2m) of assets in the course of construction which are not yet ready for use and therefore have no amortisation charged against them.

22. Property, plant and equipment

	Right of use assets		Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:								
At 1 January 2019	–	–	44.7	43.5	39.2	31.8	83.9	75.3
Right of use asset upon adoption of IFRS 16	5.9	5.7	–	–	–	–	5.9	5.7
Additions	0.5	0.5	4.9	5.0	2.6	2.6	8.0	8.1
Transfer from investment properties	–	–	4.6	4.6	–	–	4.6	4.6
Disposals	–	–	–	–	(0.2)	(0.2)	(0.2)	(0.2)
At 31 December 2019	**6.4**	**6.2**	**54.2**	**53.1**	**41.6**	**34.2**	**102.2**	**93.5**
Depreciation:								
At 1 January 2019	–	–	30.6	30.1	28.2	20.8	58.8	50.9
Charge for the year	1.1	1.0	1.1	1.1	4.3	4.3	6.5	6.4
Transfer from investment properties	–	–	2.0	2.0	–	–	2.0	2.0
Impairment in the year	–	–	0.1	0.1	–	–	0.1	0.1
Disposals	–	–	–	–	(0.1)	(0.1)	(0.1)	(0.1)
At 31 December 2019	**1.1**	**1.0**	**33.8**	**33.3**	**32.4**	**25.0**	**67.3**	**59.3**
Net book value:								
At 31 December 2019	**5.3**	**5.2**	**20.4**	**19.8**	**9.2**	**9.2**	**34.8**	**34.2**
At 31 December 2018	–	–	14.1	13.4	11.0	11.0	25.0	24.4

Right of use assets primarily comprise leased branch properties which were brought on balance sheet following the adoption of IFRS 16 on 1 January 2019.

	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	44.6	43.4	32.9	25.5	77.5	68.9
Additions	0.6	0.6	6.3	6.3	6.9	6.9
Disposals	(0.5)	(0.5)	–	–	(0.5)	(0.5)
At 31 December 2018	**44.7**	**43.5**	**39.2**	**31.8**	**83.9**	**75.3**
Depreciation:						
At 1 January 2018	30.1	29.6	24.3	16.9	54.4	46.5
Charge for the year	1.0	1.0	3.9	3.9	4.9	4.9
Impairment in the year	–	–	–	–	–	–
Disposals	(0.5)	(0.5)	–	–	(0.5)	(0.5)
At 31 December 2018	**30.6**	**30.1**	**28.2**	**20.8**	**58.8**	**50.9**
Net book value:						
At 31 December 2018	**14.0**	**13.4**	**11.0**	**11.0**	**25.0**	**24.4**
At 31 December 2017	14.5	13.8	8.6	8.6	23.1	22.4

Investment properties	Group & Society	
	2019 £m	2018 £m
Cost:		
At 1 January	17.8	17.1
Additions	0.1	0.7
Transfers to property, plant and equipment	(4.6)	–
At 31 December	**13.3**	**17.8**
Depreciation:		
At 1 January	8.0	7.5
Charge for the year	0.4	0.5
Transfers to property, plant and equipment	(2.0)	–
At 31 December	**6.4**	**8.0**
Net book value:		
At 31 December	**6.9**	**9.8**

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22. Property, plant and equipment (continued)

Included within land and buildings additions is £5.1m (2018: £0.2m) on account of assets in the course of construction. This principally relates to the redevelopment of the Friary Centre which is scheduled for completion in early 2020. Further details about the Friary redevelopment can be found in the case study on page 35. With the exception of investment properties, all properties are occupied by the group.

Each year Principality employs an independent third party to complete all valuations of land and buildings. 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 £0.1m of impairments during 2019 (2018: £nil).

The fair value of investment properties as at 31 December 2019 is £9.3m (2018: £10.0m).

23. Shares

	Group and Society	
	2019 £m	2018 £m
Held by individuals	7,582.9	6,987.1
Other shares	4.2	4.1
Fair value adjustment for hedged risk	1.4	(1.4)
	7,588.5	**6,989.8**

24. Amounts owed to credit institutions

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Amounts owed to credit institutions	1,072.5	867.1	1,783.3	1,499.9

Included in the above amounts is £3.3m of collateral held under Credit Support Annex (CSA) agreements (2018: £0.3m).

25. Debt securities in issue

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Senior unsecured debt	301.5	297.7	301.5	297.7
Residential mortgage backed securities	806.2	713.2	–	–
	1,107.7	**1,010.9**	**301.5**	**297.7**

26. Other liabilities

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Other taxation and social security	1.0	1.1	1.0	1.1
Other creditors	13.0	5.1	11.3	4.6
	14.0	**6.2**	**12.3**	**5.7**

Other creditors includes £5.3m (group) and £3.2m (Society) in respect of lease liabilities following the adoption of IFRS 16 from 1 January 2019.

The undiscounted maturity profile of lease payments at 31 December 2019 is shown below:

Group	Property £m	Cars £m	IT Lease £m	Total £m
Year 1	0.8	0.1	0.2	1.1
Year 2	0.7	0.3	0.1	1.1
Year 3	0.7	–	–	0.7
Year 4	0.7	–	–	0.7
Year 5	0.7	–	–	0.7
5 years >	1.8	–	–	1.8
Total	**5.4**	**0.4**	**0.3**	**6.1**

27. Deferred tax

The movement in net deferred tax is as follows:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
At 1 January	2.4	3.1	2.2	2.9
Income statement charge	(0.6)	(0.3)	(0.4)	(0.3)
Statement of other comprehensive income charge	(1.2)	(0.4)	(1.1)	(0.4)
At 31 December	**0.6**	**2.4**	**0.7**	**2.2**

27. Deferred tax (continued)

Deferred tax assets and liabilities are attributable to the following items:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Deferred tax assets				
Retirement benefit obligation	0.2	1.2	0.2	1.2
Accelerated tax depreciation	0.9	1.1	0.8	0.9
Fair value through other comprehensive income	0.1	0.1	0.1	0.1
Other temporary differences	0.6	0.7	0.6	0.6
	1.8	**3.1**	**1.7**	**2.8**
Deferred tax liabilities				
Other temporary differences	(1.2)	(0.6)	(1.0)	(0.6)
	(1.2)	**(0.6)**	**(1.0)**	**(0.6)**

The deferred tax (charge)/credit in the income statement comprises the following temporary differences:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Accelerated tax depreciation	(0.2)	0.1	(0.1)	0.1
Fair value volatility on financial instruments in securitisation entities	0.2	(0.4)	0.2	(0.4)
Other movements	(0.6)	-	(0.4)	-
	(0.6)	**(0.3)**	**(0.3)**	**(0.3)**

The Finance No.2 Act 2015 provides that the rate of corporation tax from 1 April 2020 will be 17%.

The statement of other comprehensive income includes a deferred tax loss of £0.1m (2018: £0.2m loss) arising from the actuarial gain 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 can be found in note 11.

28. Subscribed capital

	Group and Society	
	2019 £m	2018 £m
7.00% Permanent Interest-Bearing Shares	60.0	60.0
Unamortised issue costs	-	(0.1)
Fair value adjustment for hedged risk	1.2	3.7
	61.2	**63.6**

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 whole 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.

29. Financial commitments and contingent liabilities

a) Other provisions for liabilities and charges

At 31 December 2019, the group holds a provision of £4.4m (2018: £5.1m), which 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.

Although a significant degree of uncertainty remains with regard to the ultimate cost of settling customer claims, the provision balance is expected to be sufficient to meet any remaining obligations. The provision will continue to be monitored and customer trends and behaviour analysed in order to ensure the provision remains appropriate.

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29. Financial commitments and contingent liabilities (continued)

b) Commitments under non-cancellable operating leases:

	2018	
	Property £m	Vehicles, plant and equipment £m
Group commitments in respect of operating lease rentals:		
Due within one year	1.7	0.1
Due between two and five years	3.3	0.2
Due after five years	2.3	-
	7.3	**0.3**
Society commitments in respect of operating lease rentals:		
Due within one year	1.2	0.1
Due between two and five years	2.9	0.2
Due after five years	2.3	-
	6.4	**0.3**

Following the adoption of IFRS 16 from 1 January 2019, all operating lease commitments are now on balance sheet and included within lease liabilities as per note 26.

c) Income receivable under non-cancellable operating leases:

Property rental income earned during the year was £0.7m (2018: £1.1m). At the statement of financial position date, the Society had contracted with tenants for the following future minimum lease payments:

	Group & Society	
	2019 £m	2018 £m
Receivable within one year	0.8	0.7
Receivable between two and five years	2.8	2.6
Receivable after five years	6.2	6.7
	9.8	**10.0**

On 28 January 2011, a 25-year lease of floors one to four of Principality Buildings was granted to Travelodge Hotels Limited.

d) Capital commitments:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Capital expenditure contracted for but not provided for	3.6	0.6	3.6	0.6

d) Capital commitments:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
Loan commitments contracted but not paid	119.5	113.1	119.5	113.1

30. 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 2019	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	1,201.9	-	-	1,201.9
Loans and advances to credit institutions	202.6	-	-	202.6
Debt securities	-	165.1	-	165.1
Derivative financial instruments	-	-	21.3	21.3
Loans and advances to customers	9,033.1	-	-	9,033.1
Total financial assets	**10,437.6**	**165.1**	**21.3**	**10,624.0**
Total non-financial assets				71.8
Total group assets				**10,695.8**
Group liabilities				
Shares	7,588.5	-	-	7,588.5
Amounts owed to credit institutions	1,072.5	-	-	1,072.5
Amounts owed to other customers	197.9	-	-	197.9
Debt securities in issue	1,106.0	-	1.7	1,107.7
Derivative financial instruments	-	-	50.4	50.4
Subscribed capital	61.2	-	-	61.2
Total financial liabilities	**10,026.1**	**-**	**52.1**	**10,078.2**
Total non-financial liabilities				34.2
General reserve and other reserves				583.4
Total group reserves and liabilities				**10,695.8**

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30. Financial instruments (continued)

Categories of financial instruments

Society As at 31 December 2019	At amortised cost £m	Fair value through OCI £m	Fair value through profit and loss £m	Total £m
Society assets				
Cash in hand & balances with Bank of England	1,201.9	-	-	1,201.9
Loans and advances to credit institutions	107.8	-	-	107.8
Debt securities	-	165.1	-	165.1
Derivative financial instruments	-	-	16.5	16.5
Loans and advances to customers	8,853.7	-	-	8,853.7
Loans to and investments in subsidiaries	68.6	-	-	68.6
Total financial assets	**10,232.0**	**165.1**	**16.5**	**10,413.6**
Total non-financial assets				69.5
Total Society assets				**10,483.1**
Society liabilities				
Shares	7,588.5	-	-	7,588.5
Amounts owed to credit institutions	1,783.3	-	-	1,783.3
Amounts owed to other customers	197.9	-	-	197.9
Debt securities in issue	299.8	-	1.7	301.5
Derivative financial instruments	-	-	47.7	47.7
Subscribed capital	61.2	-	-	61.2
Total financial liabilities	**9,928.8**	**-**	**51.3**	**9,980.1**
Total non-financial liabilities				27.5
General reserve and other reserves				475.5
Total Society reserves and liabilities				**10,483.1**

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**

FINANCIAL STATEMENTS

30. Financial instruments (continued)

Categories of financial instruments

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 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 Society reserves and liabilities				**9,501.6**

Carrying and fair value

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	2019		2018	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Group assets					
Cash in hand and balances with Bank of England	i.	1,201.9	1,201.9	931.8	931.8
Loans and advances to credit institutions	ii.	202.6	202.6	147.8	147.8
Debt securities	iii.	165.1	165.1	32.9	32.9
Derivative financial instruments	iv.	21.3	21.3	24.8	24.8
Loans and advances to customers	v.	9,033.1	9,341.2	8,498.7	8,594.8
		10,624.0	**10,932.1**	**9,636.0**	**9,732.1**
Group liabilities					
Shares	vii.	7,588.5	7,625.0	6,989.8	6,999.4
Amounts owed to credit institutions	viii.	1,072.5	1,072.5	867.1	867.1
Amounts owed to other customers	viii.	197.9	197.9	141.4	141.4
Debt securities in issue	ix.	1,107.7	1,112.7	1,010.9	998.5
Derivative financial instruments	iv.	50.4	50.4	31.6	31.6
Subscribed capital	ix.	61.2	60.6	63.6	61.0
		10,078.2	**10,119.1**	**9,104.4**	**9,099.0**

	Note	2019		2018	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Society assets					
Cash in hand and balances with Bank of England	i.	1,201.9	1,201.9	931.8	931.8
Loans and advances to credit institutions	ii.	107.8	107.8	67.6	67.6
Debt securities	iii.	165.1	165.1	32.9	32.9
Derivative financial instruments	iv.	16.5	16.5	21.2	21.2
Loans and advances to customers	v.	8,853.7	8,977.8	8,262.5	8,355.7
Loans and advances to subsidiaries	vi.	68.6	68.6	135.3	135.3
		10,413.6	**10,537.7**	**9,451.3**	**9,544.5**
Society liabilities					
Shares	vii.	7,588.5	7,625.0	6,989.8	6,999.5
Amounts owed to credit institutions	viii.	1,783.3	1,783.3	1,499.9	1,499.9
Amounts owed to other customers	viii.	197.9	197.9	141.4	141.4
Debt securities in issue	ix.	301.5	306.6	297.7	288.5
Derivative financial instruments	iv.	47.7	47.7	31.3	31.3
Subscribed capital	ix.	61.2	60.6	63.6	61.0
		9,980.1	**10,021.1**	**9,023.7**	**9,021.6**

30. Financial instruments (continued)

Carrying and fair value (continued)

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 are 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 are considered as a Level 2 item within the hierarchy for fair value disclosures.

iii) Debt securities 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 168.

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.

	Group			
	2019 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	21.3	–	13.7	7.6
Financial assets at fair value through other comprehensive income:				
Debt securities	165.1	165.1	–	–
Total	**186.4**	**165.1**	**13.7**	**7.6**
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	1.9	–	1.9	–
Debt securities in issue	1.7	1.7	–	–
Derivative financial instruments	50.4	–	42.8	7.6
Total	**54.0**	**1.7**	**44.7**	**7.6**

	Society			
	2019 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	16.5	–	13.8	2.7
Financial assets at fair value through other comprehensive income:				
Debt securities	165.1	165.1	–	–
Total	**181.6**	**165.1**	**13.8**	**2.7**
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	1.9	–	1.9	–
Debt securities in issue	1.7	1.7	–	–
Derivative financial instruments	47.7	–	42.8	4.9
Total	**51.3**	**1.7**	**44.7**	**4.9**

30. Financial instruments (continued)

Carrying and fair value (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**

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.

Hierarchy for fair value disclosures

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.

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 2019 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.

31. Credit risk

The credit risk to which the group is exposed is described in the Risk Overview on pages 38 to 49. 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	
	2019 £m	2018 £m	2019 £m	2018 £m
In respect of loans and advances to customers:				
Secured by a first charge on residential property	8,514.5	7,979.3	8,514.5	7,979.3
Secured by a first charge on land	311.4	282.7	311.4	282.7
Secured by a second charge on residential property	180.7	237.4	-	-
	9,006.6	8,499.4	8,825.9	8,262.0
Provision for impairment losses	(25.5)	(30.5)	(19.0)	(21.6)
Effective Interest Rate adjustments	19.7	22.2	14.5	14.5
Fair value adjustments	32.3	7.6	32.3	7.6
	9,033.1	**8,498.7**	**8,853.7**	**8,262.5**

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	
	2019 £m	2018 £m	2019 £m	2018 £m
Retail financial services	7,993.5	7,494.3	7,993.5	7,494.3
Commercial lending	827.9	760.6	827.9	760.6
Secured personal lending	179.4	236.2	-	-
Fair value adjustments	32.3	7.6	32.3	7.6
	9,033.1	**8,498.7**	**8,853.7**	**8,262.5**

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31. Credit risk (continued)

a) Loans and advances to customers (continued)

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	
	2019 %	2018 %	2019 %	2018 %
In Wales	34.1	33.4	31.1	30.7
Outside Wales	65.9	66.6	68.9	69.3
	100.0	**100.0**	**100.0**	**100.0**

The group holds a high quality buy-to-let portfolio with an amortised cost of £2,151.2m (2018: £1,929.4m). At the end of the year, 76% of buy-to-let mortgages were on interest only products, 23% were 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 58.7% (2018: 57.0%). Index-linked LTV banding is shown below:

	Group		Society	
	2019 %	2018 %	2019 %	2018 %
Less than 70%	67.7	68.3	67.7	68.3
More than 70% but less than 80%	15.3	14.1	15.2	14.1
More than 80% but less than 90%	10.4	10.8	10.5	10.8
More than 90% but less than 100%	4.5	4.7	4.5	4.7
More than 100%	2.1	2.1	2.1	2.1
	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 0.42% (2018: 0.49%) which compares favourably with the industry average of 0.73% (UK Finance arrears and possession data at 30 September 2019). 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 2018: £0.8m) with 164 cases (31 December 2018: 174).

The percentage of secured personal loans currently in arrears of two months or more by number is 5.72% (2018: 4.76%), which by value is 5.92% (2018: 5.67%). These increases are due to the run off of the book and therefore the arrears proportion is higher.

The table below provides further information on the first and second charge retail loans secured on residential property by payment due status:

	Group			
	2019		2018	
	£m	%	£m	%
Current	8,100.1	99.1	7,648.2	98.9
Past due up to 3 months	41.7	0.5	46.8	0.7
Past due 3 months up to 6 months	15.7	0.2	17.7	0.2
Past due 6 months up to 12 months	8.3	0.1	10.9	0.1
Past due over 12 months	6.2	0.1	5.3	0.1
Possessions	0.9	–	1.6	–
	8,172.9	**100.0**	**7,730.5**	**100.0**

	Society			
	2019		2018	
	£m	%	£m	%
Current	7,935.8	99.2	7,430.4	99.1
Past due up to 3 months	31.6	0.4	34.5	0.5
Past due 3 months up to 6 months	14.4	0.2	15.4	0.2
Past due 6 months up to 12 months	6.5	0.1	8.8	0.1
Past due over 12 months	4.4	0.1	3.6	0.1
Possessions	0.9	–	1.6	–
	7,993.6	**100.0**	**7,494.3**	**100.0**

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 business segment with Nationwide and Hometrack indices being used in the Secured Personal Lending business segment. 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 £18,583.3m (2018: £18,093.1m).

The group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £0.5m (2018: £2.3m) 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.

31. Credit risk (continued)

a) Loans and advances to customers (continued)

i) Retail financial services and secured personal lending credit risk (continued)

Performance (continued)

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:

	2019 £m	2018 £m
Retail financial services	11.0	9.2
Secured personal loans	6.5	8.9
	17.5	**18.1**

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. 6 properties were taken into possession during 2019 (2018: 36) with balances of £0.5m (2018: £3.0m).

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.

2019	Revised payment schedule £m	Transfer to interest-only £m	Term extensions £m	Other £m	Total £m
Current	10.4	6.8	0.2	1.1	18.5
Past due up to 3 months	7.3	0.4	-	0.1	7.8
Past due 3 months up to 6 months	3.7	-	-	0.3	4.0
Past due 6 months up to 12 months	1.6	-	-	0.3	1.9
Past due over 12 months	0.5	0.2	-	0.4	1.1
	23.5	**7.4**	**0.2**	**2.2**	**33.3**

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**

The underlying performance of previous forbearance activities are reflected in the provisioning methodology and are not individually or collectively material.

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 Overview on page 38.

The commercial loan portfolio is managed by a relationship team with many years of 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 of the following:

	Group and Society			
	2019		2018	
	£m	%	£m	%
Loans to Registered Social Landlords secured on residential property	168.0	20.0	145.9	18.8
Other loans secured on residential property	368.4	43.9	352.8	45.5
Loans secured on commercial property	302.9	36.1	277.4	35.7
	839.3	**100.0**	**776.1**	**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			
	2019		2018	
	£m	%	£m	%
Office	106.9	35.3	98.0	35.3
Retail	111.8	36.9	103.3	37.3
Industrial	58.1	19.2	51.1	18.4
Leisure	7.6	2.5	6.0	2.2
Land	1.3	0.4	2.0	0.7
Other	17.2	5.7	17.0	6.1
	302.9	**100.0**	**277.4**	**100.0**

31. Credit risk (continued)

a) Loans and advances to customers (continued)

ii) Commercial lending credit risk (continued)

Risk concentrations (continued)

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			
	2019		2018	
	£m	%	£m	%
Wales	396.4	47.3	365.6	47.2
Greater London	252.6	30.1	251.8	32.4
South East/East of England	50.8	6.0	41.3	5.3
Midlands	25.8	3.1	27.4	3.5
South West/South of England	51.6	6.1	39.6	5.1
North West/North of England	21.7	2.6	22.6	2.9
Mixed/other	40.4	4.8	27.8	3.6
	839.3	100.0	776.1	100.0

The average loan to value (LTV) in respect of the group's commercial loans is estimated to be 49.0% (2018: 52.8%). 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.

£10.8m of exposures have an LTV of greater than 100% (2018: £7.0m). Of these, £1.3m are already classified as impaired.

The largest exposure to one counterparty is £29.6m (2018: £29.6m) or 3.5% (2018: 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 33.

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):

Region	Group and Society			
	2019		2018	
	£m	%	£m	%
Exposures not classified as higher risk	832.2	99.1	765.4	98.6
Watch-list	2.2	0.3	0.8	0.1
Impaired or past due up to 3 months	4.9	0.6	9.9	1.3
	839.3	100.0	776.1	100.0

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	168.0	–	–	–	–	–	168.0	20.0
Commercial Investment (including Owner Occupier)	–	8.0	235.1	48.6	5.1	2.7	299.5	35.7
Residential Investment	–	2.3	271.7	37.0	–	2.2	313.2	37.3
Commercial Development	–	–	3.4	–	–	–	3.4	0.4
Residential Development	–	–	40.9	13.9	0.4	–	55.2	6.6
	168.0	10.3	551.1	99.5	5.5	4.9	839.3	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 in 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			
	2019		2018	
	£m	%	£m	%
Unimpaired				
Current	834.4	99.4	766.2	98.7
Past due 1 to 3 months	–	–	–	–
Impaired				
Past due 3 to 6 months	0.7	0.1	0.6	0.1
Past due 6 to 12 months	–	–	–	–
Past due over 12 months	–	–	–	–
Defaulted but not past due	4.2	0.5	9.3	1.2
Law of Property Act (LPA) Receivers appointed	–	–	–	–
	839.3	100.0	776.1	100.0

FINANCIAL STATEMENTS

31. Credit risk (continued)

a) Loans and advances to customers (continued)
ii) Commercial lending credit risk (continued)

Performance (continued)
There are 3 commercial cases (2018: 2) three months or more in arrears (fixed charge receiver appointed). Total arrears of one month or more are £0.7m (2018: £0.6m).

The total collateral held against commercial loans is estimated to be £1,753m (2018: £1,608m). 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:

2019	Group and Society		
	Stage 1 £m	Stage 2 £m	Stage 3 £m
Commercial lending provisions	2.8	3.7	1.5
Total provisions	**2.8**	**3.7**	**1.5**

2018	Group and Society		
	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**

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 2019, 5 (2018: 3) accounts with balances totalling £6.7m (2018: £4.5m) in value were granted forbearance concessions.

The total exposure in forbearance at December 2019 stands at balances of £11.8m and 14 accounts (2018: £10.3m, 12 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 Overview on page 41.

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.

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
UK Government securities	90.9	-	90.9	-
Supranational securities	50.4	-	50.4	-
UK Financial institutions	188.0	156.9	93.1	76.7
	329.3	**156.9**	**234.4**	**76.7**

None of these exposures were 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 (2018: £0.3m) is held over derivative financial instruments.

The following table shows the exposures broken down by Fitch ratings:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
AAA to AA-	193.6	92.5	193.6	48.8
A+ to A-	132.4	61.5	37.5	25.0
BBB+ to BBB-	3.3	2.9	3.3	2.9
	329.3	**156.9**	**234.4**	**76.7**

The geographical distribution of these exposures is as follows:

	Group		Society	
	2019 £m	2018 £m	2019 £m	2018 £m
UK	278.9	156.9	184.0	76.7
Multilateral development banks	50.4	-	50.4	-
	329.3	**156.9**	**234.4**	**76.7**

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.

FINANCIAL STATEMENTS

32. 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 fair value adjustments.

2019	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	–	4,098.4	1,634.5	1,854.2	–	7,587.1
Amounts owed to credit institutions	4.8	63.9	11.0	565.9	425.0	1,070.6
Other customers	–	80.0	117.8	–	–	197.8
Debt securities in issue	–	27.2	84.1	994.7	–	1,106.0
Subscribed capital	–	–	0.4	60.0	–	60.4
	4.8	**4,269.5**	**1,847.8**	**3,474.8**	**425.0**	**10,021.9**
Society:						
Non-derivative liabilities						
Shares	–	4,098.4	1,634.5	1,854.2	–	7,587.1
Amounts owed to credit institutions	3.3	89.9	81.5	1,181.7	425.0	1,781.4
Other customers	–	80.0	117.8	–	–	197.8
Debt securities in issue	–	–	0.8	298.9	–	299.7
Subscribed capital	–	–	0.4	60.0	–	60.4
	3.3	**4,268.3**	**1,835.0**	**3,394.8**	**425.0**	**9,926.4**
Group:						
Derivative liabilities						
Interest rate swaps	–	–	3.2	37.6	9.6	50.4
	–	**–**	**3.2**	**37.6**	**9.6**	**50.4**
Society:						
Derivative liabilities						
Interest rate swaps	–	–	3.2	34.8	9.6	47.6
	–	**–**	**3.2**	**34.8**	**9.6**	**47.6**

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	–	4,014.8	1,171.0	1,805.3	–	6,991.1
Amounts owed to credit institutions	0.3	177.9	12.0	675.0	–	865.2
Other customers	–	75.5	65.9	–	–	141.4
Debt securities in issue	–	37.8	117.6	857.3	–	1,012.7
Subordinated liabilities	–	–	–	–	–	–
Subscribed capital	–	–	0.4	60.0	–	60.4
	0.3	**4,306.0**	**1,366.9**	**3,397.6**	**–**	**9,070.8**
Society:						
Non-derivative liabilities						
Shares	–	4,014.8	1,171.0	1,805.3	–	6,991.1
Amounts owed to credit institutions	0.3	213.2	113.9	1,170.7	–	1,498.1
Other customers	–	75.5	65.9	–	–	141.4
Debt securities in issue	–	–	0.8	298.7	–	299.5
Subordinated liabilities	–	–	–	–	–	–
Subscribed capital	–	–	0.4	60.0	–	60.4
	0.3	**4,303.5**	**1,352.0**	**3,334.7**	**–**	**8,990.5**
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**

33. 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 daily and operates within parameters set by Board Risk Committee. The results of each of the six interest rate scenarios (parallel and non-parallel) are actively managed by Finance Committee to ensure they remain consistent with the Society's current interest rate view. As 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 the Board Risk Committee. As at 31 December 2019, the economic value of the group's balance sheet would have reduced by £9.4m in the case of a 2% parallel shift upwards.

Currency risk
The group has no material exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates.

34. 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.

Loans to and shares held by Directors
There was an aggregate of £0.2m (2018: £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 29 April 2020.

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 (2018: £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:

	Interest paid to Society £m	Fees paid to Society £m
Year ended 31 December 2019		
Nemo Personal Finance Limited	5.6	0.3
	5.6	**0.3**
Year ended 31 December 2018		
Nemo Personal Finance Limited	7.1	0.4
	7.1	**0.4**

At the year end the following balances were outstanding:

	Loans owed to Society 2019 £m	Loans owed to Society 2018 £m
Nemo Personal Finance Limited	68.5	135.2
	68.5	**135.2**

Annual Business Statement

for the year ended 31 December 2019

1. Statutory percentages

	At 31 December 2019 %	At 31 December 2018 %	Statutory limit %
The lending limit	3.6	3.4	25.0
The funding limit	23.9	22.5	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

	2019 %	2018 %
As a percentage of shares and borrowings:		
Gross capital	6.5	6.8
Free capital	5.9	6.4
Liquid assets	15.8	12.4
As a percentage of mean total assets:		
Profit for the year as a percentage of statutory mean total assets	0.31	0.35
Management expenses as a percentage of statutory mean total assets	0.79	0.86

- Gross capital – the aggregate of general reserve, fair value through other comprehensive income reserve, subscribed capital and subordinated liabilities.
- Free capital – gross capital plus collective impairment provisions less intangible assets and property, plant and equipment.
- Liquid assets – the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.
- Mean total assets – the average of the total assets in the consolidated statement of financial position at the beginning and end of the year.
- Management expenses – the aggregate of administrative expenses, depreciation and amortisation.

3. Directors

Details of Directors are contained on pages 52 to 56. Details of Directors' service contracts are included in the report of the Remuneration Committee on page 80.

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, multi-family housing buildings, warehouses and garages.
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.
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.
Internal 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.
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.

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.
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).

Glossary (continued)

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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