Annual Report and Accounts 2013

At the heart of our communities

PRINCIPALITY
BUILDING SOCIETY

Highlights

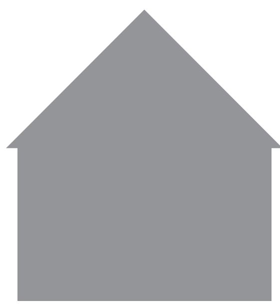
for the year ended 31 December 2013

6TH LARGEST BUILDING SOCIETY IN THE UK

£28.7M PROFIT BEFORE TAX

IRB STATUS ACHIEVED DURING THE YEAR

SOCIETY GROSS MORTGAGE LENDING OF £1.1BN



OUR 95% LTV MORTGAGE HELPED OVER 600 HOME BUYERS

OVER £7BN TOTAL ASSETS

NET RETAIL MORTGAGE GROWTH OF 10.7%

MOST RECOMMENDED SAVINGS PROVIDER IN WALES*

* Source: GfK NOP Financial Research Survey (FRS), 12 months ending December 2013, NPS score of savings customers in Wales, answering likelihood to recommend , c. 2,400 adults.
† Competitor list includes the following: Barclays, Halifax, HSBC, Lloyds TSB, NatWest, Nationwide, NS&I, Santander.

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Chairman's statement

Principality Building Society's Chairman, Dyfrig John

Performance

In a year where the economy has shown increasing signs of recovery, Principality has continued to grow both profitability and mortgage assets. In 2013, we achieved a profit before tax of £28.7m (2012: £25.7m restated*), further consolidating our already strong Tier 1 capital position. The Society has increased mortgage lending by 10.7%, and we are now the sixth largest building society in the UK with assets at £7.1bn.

Our Members

At Principality, our Members are at the heart of everything we do. We have 70 branches and agencies across Wales and the borders and remain wholly committed to maintaining a strong presence across our communities. In recent years, we have invested in technology to further enhance our capability and to provide Members with new ways to do business with us – our website is already used by 55,000 Members. In 2013, we established a Customer Experience team, tasked with identifying ways to improve our already strong Member and customer service standards. Talking and listening with our Members and acting on what they tell us is key to that improvement, and during 2013 we held four Member Forums and four Member Talkback sessions to allow Members to meet our senior management team and to ensure that the voices of our Members are heard. Thank you to everyone who participated in these events.

Mutuality, community and heritage

The mutual sector has a critical part to play in supporting the UK economy. Across the UK, mutual deposit takers and lenders have assets of over £300bn. We strongly believe in the benefits of being a mutual organisation owned by you, our Members, and welcome the opportunity that this has given us to support the Welsh economy and the communities in which we live and work. In 2013, we have built on that strong foundation through our continued support of sustainable and affordable housing initiatives. We continue to support The Mill development at Ely Bridge, Cardiff – a scheme to transform 53 acres of urban wasteland into an innovative £100m housing development. We also continue to work with Welsh housing associations – this year saw the 10th anniversary of our partnership with Valleys to Coast in Bridgend, the first stock transfer of social housing in Wales, which has enabled thousands of families to be housed in good quality homes. We have supported and introduced initiatives to ensure that people across Wales are able to own their own homes. In May, nearly 14% of first time buyers in Wales chose Principality as their lender, and we supported the Welsh Government in introducing the Help to Buy - Wales scheme in November. All of this has been bolstered by the tremendous effort that the people who work for this organisation put in to support local charities and community projects. That has ranged from members of our arrears team redecorating Rhoose Community Centre, to colleagues helping bring a pond back into use at Whitchurch Primary School.

At Principality, we are immensely proud of our Welsh heritage and culture and have adopted a wide ranging sponsorship programme that allows us to help celebrate sports, the arts and culture in Wales. We have been sponsors of Principality Premiership rugby since 2005, continue to support the National Eisteddfod and since 2012 sponsored Access all Eirias, a major music festival held in North Wales. We were delighted to sponsor two major farming awards – the NFU Cymru/Principality Welsh Rural Community Champion and the NFU Cymru/Principality Wales Woman Farmer of the Year. These awards recognise

* Restated following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies and International Accounting Standard (IAS) 19 Employee Benefits (2011)

Staff from our Whitchurch branch helping bring a pond back into use at Whitchurch Primary School

the hard work of Welsh farmers in helping their local communities and the huge contribution that women in farming make to rural life in Wales.

The Society's Charity of the Year in 2013 was British Heart Foundation Cymru, and we have raised over £60k, a record for the Society. This donation will be invested back into Wales through the foundation's "No Time to Wait" appeal, helping to buy more life-saving defibrillators and training people in emergency skills. I would like to thank everyone who has participated in these events ranging from sponsored cycles to cake sales and to those who sponsored people to achieve this fantastic contribution to the charity.

Your Board

The strength of an organisation's Board is critical to the strength and continued success of the organisation, and Principality is no exception. In a year where the Boards of a number of organisations have come under intense criticism, you can be assured that Principality has a Board of the highest calibre and is utterly committed to protecting your interests for the future. In early 2013, two new Executive Directors were appointed. Stephen Hughes stepped up from the role of Deputy Group Finance Director to become Group Finance Director and Michael Jones, Director of Risk, who has been with the Society for over 16 years, was appointed Group Risk Director. Guy Thomas became Group Chief Operating Officer. These are key appointments, and all three of them bring great depth of skill and knowledge. There have also been some changes among non-executive directors. Christopher Jones and Keith Brooks stepped down from the Board in April and September after serving seven and six years respectively. Everyone at Principality would like to thank them for their contribution to the success of the Group over that time.

We have recruited two new non-executive directors, Laurence Adams and Nigel Annett, whose skills and experience will enhance and strengthen your Board further, and I welcome them both. Laurence has extensive experience of working in financial services, and Nigel's background in a highly regulated environment will serve us well as the regulator makes continuing demands on the Group. My thanks go to the whole Board for the very significant additional time commitment and for their support throughout the year and during my time as Chairman. As I step down from the Board in April I am confident that I leave a strong Society focused for growth in the future. On behalf of the entire Board, I would also like to thank all of Principality Group's employees for their continued hard work. Without their commitment, Principality would not be the thriving business it is today.

2014 outlook

The year ahead will bring new challenges for Principality Group and the UK economy as a whole, although there is room for some cautious optimism. With a firm focus on ensuring great outcomes for our Members and customers, a strong Board and management team, and a solid commitment to supporting our local communities, Principality will continue to make a healthy contribution to Wales and its people.

Dyfrig D. J. John
Chairman
4 February 2014

Group Chief Executive's review

Principality's Group Chief Executive, Graeme Yorston

Having completed my first full year as Group Chief Executive, I am pleased to report another strong year for the Principality Group. Following a strategic review in 2012, I am delighted with the significant progress we have made on our plan. We have increased overall lending by 5.6%, grown our mortgage market share of first-time buyers in Wales, delivered value to loyal Members and created 58 new jobs to help stimulate the local economy. We have stayed true to our core principles of providing a secure home for savings and helping people to buy homes, as well as continuing to play an important role in supporting the housing market in Wales. I am delighted to report on some important building blocks that we have laid down for the future.

It is clear that the past few years have been building up to a seismic shift in our industry as the regulator seeks to learn from past mistakes and build a more sustainable, consumer-focused financial sector. I have worked in financial services for almost 40 years, but never in that time has there been a period of such profound and rapid change as I see in the current climate. The opportunity that this creates for our Member-focused mutual business model is exciting, and I firmly believe that Principality can continue to lead the industry through this change.

Our balance sheet remains strong with appropriate provisions, high quality assets and diversified funding. We have continued to invest in improving our infrastructure and capabilities to deliver our business strategy. Recognising that the growth in internet and mobile application use is changing the way that customers behave, we believe that offering customers a way to do business through the channel of their choice is becoming an expectation rather than a differentiator and combining these channels seamlessly is critical to future success. I believe that our 70 strong branch and agency network across Wales and the borders is a vital part of this multi-channel approach, but we must foster the essence of this and translate it for the digital age. Over the last year we have made progress improving functionality across our website to help customers better manage their accounts online. There is still much to do within this area, and we remain focused on moving our business forward to embrace the modern world of money and help further simplify banking for our customers. We recognise that many of our customers do value the traditional branch service that we offer, and this remains an important part of what we will continue to provide.

We have increased overall lending by 5.6%

In this increasingly complex and volatile world, we have seen growing trust in our approach, and our internal customer surveys show continued improvements in satisfaction. We have a rich pool of talent across the business that we continue to bolster with strong, experienced appointments to the Board and management team. This, coupled with a culture that is centred on truly listening and delivering value for our Members and customers, is the key to our success.

Meeting the demands of a new regulatory environment

Navigating the new world of the regulator and understanding

Principality Commercial supported the regeneration of Port Talbot's Habourside Business Park

the government's desire to reinvigorate the economy continues to present challenges.

As a mutual society, our main aim is not to maximise profits, but to achieve the right balance between savers, borrowers and profit. We must not lose sight of the fact that profit is the only way currently to create more capital for the Society, providing essential protection for the business in the long term.

During 2013 we received recognition from the regulator for our expert risk management capability in the form of approval to use the Internal Ratings Based approach (IRB). We believe that we are the first financial institution in the UK to be granted this since the onslaught of the credit crisis. We are one of only three existing building societies to have received this approval, and this demonstrates the level of confidence in Principality and the management team.

In 2014 there will be another significant change in regulation with the implementation of the Mortgage Market Review. This requires that customers satisfy lenders that they can afford the mortgage, and most interactive sales (for example face-to-face and telephone) must be advised. We are well advanced with our preparations for this, which will represent the biggest change in the market since 2004. As a responsible lender we have, for some time, been acting in accordance with a number of the changes, but there is no doubt that the additional changes will increase costs and complexity in our business which will ultimately have to be met.

There is growing evidence that market stimulants have been successful in aiding economic recovery. While borrowers are experiencing greatly improved access to mortgage funding, we recognised that this was still difficult for some. The launch of our 95% mortgage in early 2013 has helped over 600 first-time buyers and home movers overcome the deposit barrier. Furthermore, we have worked closely with the Welsh Government towards the successful launch of Help to Buy - Wales, making mortgages available to home buyers who are purchasing a new-build property and who meet the Help to Buy - Wales scheme criteria.

The launch of our 95% mortgage in early 2013 has helped over 600 first-time buyers and home movers overcome the deposit barrier

Nevertheless, the result of a volatile housing market over the past few years has been a structural shift in the number of people aspiring to own their own home. The average age of a first-time buyer has increased, and this means that the rental market now has a much stronger role to play in the provision of housing. Recognising this, we have responded and supported the buy-to-let mortgage market, helping to ensure that landlords can continue to meet the demand of this new generation.

The question of whether this is a sustainable recovery however, remains. Fundamentally there is an imbalance between housing supply and demand, and there is not adequate provision now or planned for the future to meet the expected growth in demand. This imbalance will, until addressed, continue to underpin the house pricing structure for a number of years to come. While the housing market may appear resilient, there are still obstacles to overcome, particularly as we look to the future when support schemes

will begin to draw to a close. In light of this, we will continue to focus on high quality, prudent lending, concentrating on ensuring that borrowers are able to afford their mortgage both now and in the years to come.

Delivering value to our loyal Members

In the current market conditions we understand the frustration keenly felt by savers. Our savers are hugely important to us as a business, and as a management team we have frequent discussions around how we can protect our loyal customers against the backdrop of a low interest rate environment. We have stayed reliant on retail savings for funding, paying above the average market rate on the high street for the past year. We positioned our Promise Saver as the leading account on the high street and rewarded over 6,000 Members through our loyalty bond. Above all we are focused on delivering outstanding levels of service, and I am pleased to report that we were awarded Best Internet Account Provider in the Moneyfacts 2013 Awards for our consistently competitive rates and straightforward approach. We have also maintained our position as Wales' most recommended savings provider.*

Importance of Group businesses in delivering our strategy

All of our Group businesses play an important role in overall Group performance.

Peter Alan Estate Agents in particular has delivered an exceptional performance. House sales have increased by 17%, reflecting the improving confidence in the housing market. Recognising the growth in the lettings sector, we have also developed a very successful lettings agency business which has now become South Wales' biggest lettings agent, following the acquisition of Mead Property Management and Thomas George Lettings Agent in Cardiff.

Our newest division of Peter Alan, pa black, has seen a 64% increase in sales year on year with an increased market share. I am delighted that our success in this sector has been recognised as Peter Alan was awarded The Sunday Times Estate Agent Award for Best Wales Estate Agency for the third consecutive year.

Our secured personal loans business, Nemo Personal Finance, has also performed very strongly, fulfilling an important role in helping consumers manage their finances more effectively, despite an impairment provisions charge of £5.3m (2012: £3.5m) and £8.0m in light of potential costs in relation to a review of compliance with consumer credit legislation. After these provisions, Nemo delivered a profit before tax of £16.4m (2012: £17.6m). Nemo is widely recognised as a leading player in the UK, and as the economy recovers and banks complete the restructuring of their balance sheets, we are seeing increased competition in this space. Despite this, I am confident that Nemo will continue to play a key role going forward and is very well placed to cope with competition and increasing regulatory changes that are set to be implemented over the next 12 to 24 months.

Reflecting the negative sentiment towards commercial property and the uncertainty surrounding the economic outlook for this sector, we have made provisions of £16.7m in the year. I do think that perhaps a corner has been turned in the commercial market, and with this I anticipate an improved performance in 2014.

Preparing for the future

There are now sufficient signals that a recovery is underway; however, challenges remain in the Eurozone, and the global recovery, while upbeat, remains fragile. We also recognise that there is pressure on household income with wage inflation failing to keep pace with overall inflation, and this could reach a peak when rates inevitably start to rise, potentially putting prolonged recovery at risk. Our job at Principality is to ensure that people who borrow from us can stay in their homes for the long term, even through rising interest rates. We therefore, unashamedly, will continue to test a borrower's ability to pay their mortgage not only at the point of borrowing from us but also against this rising interest rate scenario. This will ensure that our prudent approach to lending continues and we have a sustainable business into the future as well as ensuring that as many people as possible maintain a roof over their heads.

We recognise that to deliver the right outcomes for our Members we must form a deeper relationship with them. We have, and will continue to collect unique customer insights via a variety of conversations and feedback mechanisms, including our Member Talkback events, to help us enrich and improve our products, services and processes. Our brand is about more than simply providing a product; it's about the service that we deliver, the way that we work, the values that we stand for and live by and the legacy that we leave our communities. Our culture is centred on delivering value for our Members, and this puts us in a unique position to meet the new regulatory world and remain true to our core value of delivering excellent service across all of our channels.

I would like to take this opportunity to express my thanks to Chairman Dyfrig John, who will step down at our forthcoming Annual General Meeting, for his support, particularly over the past year since I took over as Group Chief Executive. Dyfrig's knowledge, experience and wise counsel have been incredibly valuable in what have been very testing economic times. We are certainly better for Dyfrig's stewardship over the last few years, and I am confident that he leaves a strong team with the right mix of experience, determination and drive to deliver our ambitions and create further value for Members and customers over the coming years. The process to appoint a new Chairman is currently underway.

Graeme H. Yorston
Group Chief Executive
4 February 2014

* Source: GfK NOP Financial Research Survey (FRS), 12 months ending December 2013, NPS score of savings customers in Wales, answering likelihood to recommend , c. 2,400 adults.
† Competitor list includes the following: Barclays, Halifax, HSBC, Lloyds TSB, NatWest, Nationwide, NS&I, Santander.

Strategic report
for the year ended 31 December 2013

Group strategy

Principality is a Welsh financial services institution with a UK focused retail mortgages and savings business model at its core and is described in the Chief Executive's Report and in the remainder of this Strategic Report. This model is supplemented with the provision of other complementary products and services. The Principality Group also incorporates a UK commercial lending business and a second charge residential lending business. The current Group strategy is based on two components:

- Strengthening the Member offering by providing a sector leading service to Members and customers; and
- Growing the Society's residential first charge mortgage portfolio. Income in the second charge residential lending portfolio will be optimised whilst risk is reduced in the commercial lending portfolio.

This strategy resonates with our core purpose as a building society established over 150 years ago – to provide safety and protection for Members' funds whilst helping other Members to own their own homes.

The strategy will be delivered through these key strategic objectives:

- Putting our Members first by providing a sector leading seamless service regardless of the channel through which Members choose to interact with us;
- Making it easy for customers and Members to transact with us by making the appropriate investment in technology;
- Delivering superior Member and customer insight; and
- Developing tailored products that meet Member needs.

By leveraging these capabilities and actively driving our market share in Wales, we believe we can help Wales and the wider economy prosper and deliver strong, stable and sustainable returns for Members.

Group performance

Measuring performance

Progress against the strategy is tracked using a range of performance measures. These measures indicate whether and how quickly we are delivering our strategic objectives and when corrective action may be necessary.

Examples of key measures include:

- Net Promoter Score (NPS)
- Net interest margin
- Retail mortgage growth
- Management expense ratio
- Core Tier 1 capital ratio
- Liquidity coverage ratio
- Colleague engagement score
- Customer complaints

Market share measures are also used to ensure we are delivering savings and mortgage products to our Members in our target operating areas.

Alignment of remuneration with performance

Colleagues play a key part in delivering our strategy. We have four clearly defined values (discussed in more detail on page 22) which underpin our strategy and are embedded within our culture. Colleague and Executive performance measures are designed to ensure that we achieve our strategic objectives through these values and behaviours. In addition, executive remuneration, in particular the annual bonus, is assessed against a balanced scorecard of measures which is discussed in more detail in the Report of the Remuneration Committee on page 39.

Driving the right culture and behaviours is essential to our future success and to the delivery of our strategy.

Business review

Income statement overview

The Group's profit before tax for the year to 31 December 2013 was £28.7m (2012: £25.7m restated). Underlying profit, excluding items not reflective of current trading performance, which can vary significantly in their nature and value year-on-year, were:

	2013	2012
	£m	£m (restated)
Profit before tax	28.7	25.7
Gain on repurchase of subordinated liabilities	-	(1.5)
Gain on the sale of gilts	(0.6)	(3.2)
Provisions for other liabilities and charges	12.5	11.9
Profit on the disposal of loan portfolios	(1.6)	(1.6)
Underlying profit	**39.0**	**31.3**

Prior year comparatives have been restated where appropriate following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies and International Accounting Standard (IAS) 19 Employee Benefits (2011). These are discussed in more detail on page 51.

Profit

Net interest margin

Net interest margin is the sum of the amount earned on assets (a combination of retail mortgages, commercial mortgages and liquid assets) less amounts paid on liabilities (savings products and borrowings) divided by total average assets. At 1.68% (2012: 1.50% restated) the Group's net interest margin has increased as a result of the growth in mortgage balances during the year enhanced by customer balances reverting to the Society's Standard Variable Rate (SVR). The Group continues to benefit from higher margins earned in our secured personal lending business.

The introduction of the Funding for Lending Scheme (FLS) in late 2012 has helped support the interest margin. FLS utilisation amounted to £350.0m. The direct interest cost saving, relative to the Group's average cost of funding, is estimated to have reduced interest payable by £3.7m, an impact of 5bps on the net interest margin. The cost of retail deposits fell by an average of 21bps compared with 2012; however, this is still 2bps higher than in 2011.

Net interest margin has been enhanced by gains of £0.6m (2012: £3.2m), equivalent to 1 basis point (2012: 5 basis points), arising from the profit on the sale of gilts.

Other income

The Group's non-interest income at £24.0m (2012: £24.3m) includes insurance income, estate agency income, property services income and income generated from a number of other complementary activities. These together generated 17.2% (2012: 19.6%) of total income. Commissions on sales of life, investment and general insurance products have declined by 34.2% on the same period last year as a result of the introduction of new regulations relating to the provision of financial advice and the discontinuance of some structured products.

An active lettings market over the first half of the year coupled with the acquisition of Mead Property Management Limited and Thomas George Cardiff Limited, small lettings companies in the Cardiff area, has helped support a strong performance in Peter Alan. House sales have increased by 16.6% during the year with overall income 12.4% ahead of the same period last year and its most profitable year since 2006.

Nemo, the secured personal lending business, sold further loan portfolios totalling £44.4m (2012: £42.4m) which realised a profit on disposal of £1.6m (2012: £1.6m). The Group has retained the servicing rights to these assets, ensuring future income streams. Substantially all the risks and rewards of the assets were transferred on sale. The assets have been derecognised from the Group statement of financial position.

Administrative expenses

Ongoing strategic investments to enhance the Society's technology capabilities and operational infrastructure have resulted in an increase in the ratio of operating expense as a percentage of total mean assets to 1.09% (2012: 1.08% restated). The cost to income ratio was 54.3% (2012: 57.6% restated). A significant element of this investment is necessary to meet new regulatory requirements, but it also includes investment focused on improving customer service. The Board has implemented a continuous improvement programme to drive cost efficiencies.

Impairment provisions for losses on loans and advances

The charge for impairment provisions of £22.4m (2012: £16.3m) for the Group was £6.1m higher than last year.

	2013	2012
	£m	£m
Retail financial services	0.4	1.8
Commercial lending	16.7	11.0
Secured personal lending	5.3	3.5
Total	**22.4**	**16.3**

Consistent quality of lending, stable house prices, a low interest rate environment and prudent arrears management policies have contained arrears growth in first and second charge residential lending. However post default recovery, potential impairment indicators and forbearance assumptions have been reviewed and revised in the second charge residential lending portfolio, which has resulted in a provision charge of £4.0m.

In the commercial lending book there are seven exposures greater than three months in arrears (2012: 11). The increased impairment charge for the period reflects the continuing negative sentiment towards commercial property and the uncertainty surrounding the economic outlook in the UK. Accumulated impairment on loans secured on commercial property is 3.27% (2012: 3.23%). 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.

Provisions for other liabilities and charges

The Group is undertaking a detailed and comprehensive review of processes and documentation in relation to compliance with consumer credit legislation which commenced in the second half of 2013 and is planned to be completed during the first half of 2014. To date a number of areas, which require further review have been identified and a charge of £8.0m has been recognised in respect of potential costs which will require remediation over the next 12 months.

Other provisions of £0.3m (2012: £9.7m) have been made in respect of various customer claims. No additional provisions have been made during the period in relation to previous sales of payment protection insurance.

The Group has recognised a Financial Service Compensation Scheme (FSCS) interest charge of £2.3m in respect of scheme year April 2013 to March 2014 and the first instalment of the capital repayment of £1.9m.

During the year, the IASB issued IFRIC 21 Levies, which is effective for periods beginning on or after 1 January 2014. The IFRIC clarifies when a liability should be recognised for a levy, defining when the obliging event occurs. The change to the PRA handbook combined with the IFRIC changes how the industry has recognised FSCS for both capital and interest, changing the trigger for recognition in the financial statements from the year end to 1 April of the subsequent year in line with the start of the FSCS scheme year. The Group has early adopted IFRIC 21, and the comparatives for 2012 and opening reserves have been restated.

The restatement has an impact on the prior year profit figures. The charge for 2012 has decreased from £3.2m to £2.2m, and the charge for 2011 has increased from £1.5m to £1.8m. The tax charge has also been restated to take account of this. The impact on the statement of financial position is described in Note 22.

Further information on the level of provisions and the uncertainties therein can be found in Notes 2 and 39.

Derivatives and hedge accounting

All derivatives are recorded on the statement of financial position at fair value with any valuation movements being taken to the income statement. Derivatives are used only to the extent to which the Group will be affected by changes in interest rates or other market indices, and are therefore used solely to hedge risk exposures and not for speculative purposes.

The £1.2m loss (2012: £0.2m gain) relating to fair value adjustments on derivatives and hedge accounting represents the net fair value adjustments on derivative instruments that are matching risk exposures on an economic basis. Some income statement volatility arises on these items due to accounting ineffectiveness of designated hedges or because hedge accounting has not been adopted or is not achievable. The loss is primarily due to timing differences in cash flows and interest rate reset dates between the derivative instrument and the hedged assets and liabilities. The impact will trend to zero over time.

During the year the Group transitioned from using a London Interbank Offered Rate (LIBOR) curve to a Sterling Overnight Index Average (SONIA) curve to discount future swap cash flows. This change resulted in a charge of £0.6m which is included in the loss for the year on derivatives.

Taxation

The statutory rate of corporation tax was reduced to 23.00% from 1 April 2013. The Group is subject to corporation tax at a rate of 24.00% for the period 1 January to 31 March 2013, and 23.00% for the period 1 April to 31 December 2013, resulting in an effective statutory rate of corporation tax of 23.25% for the full year in 2013.

The actual effective tax rate for the Group was 22.7% (2012: 26.1% restated) compared with the statutory rate of tax of 23.25% (2012: 24.5%). The rate differential is mainly due to disallowable expenditure.

The reduction of the UK corporation tax rate to 20.0% on 1 April 2015 has resulted in a deferred tax adjustment of less than £0.1m arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the liability is expected to reverse.

Statement of financial position

Loans and advances to customers including forbearance

The Group continues to focus on the quality of business written, concentrating on affordability and credit risk in underwriting loans and mortgages. There has been a strong performance during 2013 in residential first charge mortgages with mortgage assets increasing by 10.7% to £4,505.8m. Whilst this is as a result of a deliberate strategy to grow the core Society statement of financial position, the Board continues to apply prudent controls to lending, reflecting the continued uncertainty in the wider economy.

The ongoing risk reduction strategy implemented for the secured personal lending and commercial lending portfolios is reflected in the declining loan and mortgage balances for these divisions.

Excluding fair value adjustments, loans and advances to customers were:

	2013		2012	
	£m	%	£m	%
Retail financial services	4,505.8	76.4	4,069.6	73.4
Commercial lending	822.9	14.0	897.7	16.2
Secured personal lending	565.9	9.6	576.9	10.4
Total	**5,894.6**	**100.0**	**5,544.2**	**100.0**

In 2013, the Society lent £63.8m in 95% LTV products as it seeks to support first-time buyers and home movers in Wales. Notwithstanding this, the average LTV of the residential first and second charge portfolios has decreased to 63.2% (2012: 63.7%) due to the positive movement in house prices. At year end, 78.8% of the portfolio was under 80% LTV and 4.5% in negative equity based on indexed property values. Buy-to-let mortgages make up 23.7% of mortgages in the retail financial services division (2012: 24.0%).

The Group continues to support Members and customers who are experiencing financial difficulties and agree the most appropriate course of action. Short-term temporary actions could include revised payment schedules, payment holidays or a switch to "interest only". Where revised payment schedules are insufficient to meet normal contractual monthly instalments or where a customer fails to meet the revised payment terms, the case will continue to accrue arrears and impairment provisions will be made where appropriate.

If a Member or customer demonstrates they are able to meet a payment schedule at a normal commercial rate for a period of six months, and only if they request it, the arrears may be "capitalised" on their account. This will result in an enlarged outstanding balance but no arrears. Consequently these cases will no longer be reported as in arrears but are still considered as such for impairment provisioning.

Our approach to dealing with Members and customers in financial difficulties means that we will only take possession of a property as a last resort. The number of properties taken into possession during the year was 70 (2012: 62) with 38 remaining unsold at the end of the year (2012: 35). The number of accounts in arrears are at their lowest level since July 2008.

Treasury and liquid assets

Liquid assets typically comprise cash deposits held with central banks and unencumbered securities that may be sold or pledged through a repurchase agreement (repo) either directly with the central banks to which the Group has access or with other market counterparties.

The Liquid Asset Buffer (LAB), as defined by the Prudential Regulatory Authority (PRA), a successor to the Financial Services Authority (FSA), includes highly liquid assets which typically comprise cash held with central banks and gilts. The proportion of Liquid Assets assigned to the buffer is 75.8% (2012: 74.1%) and represents a surplus of 36.6% (2012: 61.0%) of the buffer liquidity requirement. Of the other liquid assets not assigned to the LAB, which typically comprise investments with other financial institutions, 6.70% (2012: 3.85%) are less than A rated under Fitch credit ratings. The Group's core liquidity ratio was 13.18% (2012: 16.23%).

The European Parliament has now approved new capital and liquidity reforms (referred to as CRD IV), which implement Basel III in Europe from 1 January 2014. The objective of the reform package is to improve the financial services sector's ability to absorb shocks arising from financial and/or economic stress, thus reducing the potentially destabilising impact on the financial sector into the real economy. Basel III includes a short-term liquidity stress metric, the Liquidity Coverage Ratio (LCR), and a longer-term stable funding metric, the Net Stable Funding Ratio (NSFR). The Group monitors compliance against these metrics, and they are estimated at 156% and 126% respectively against proposed regulatory requirements of 100% for both measures (2012: 227% and 122% respectively). Estimations are made using the Society's interpretation of the directive which has been incorporated into the European and UK regulatory framework on 1 January 2014.

Other than £116.0m (2012: £107.4m) of AAA rated Supranational Bonds issued by the European Investment Bank and the Council of Europe and effectively guaranteed by the European Union member states, the Group does not hold any direct bank exposures outside the UK. The Group has indirect exposures through bank counterparties that themselves have direct exposures to Greece, Italy, Portugal, Spain, Ireland and Cyprus. Based on available

information, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, the Board has concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

During the year the Group continued to perform internal stress tests on its liquidity which consistently demonstrates a strong position after allowing for a range of extreme market-wide stress scenarios and mitigating actions. The results of these scenarios are brought together into the Group's Individual Liquidity Adequacy Assessment (ILAA) document, which is reviewed at least annually by the Board.

A weekly review is undertaken by the Treasury Committee, a sub-committee of the Asset and Liability Committee, on current and expected credit risk, liquidity risk and interest rate risk of all treasury assets with a view to highlighting the likelihood of any future performance difficulties and losses based on emerging published data and intelligence.

Funding

The Society has a strong funding base, predominantly represented by retail savings. As a result, less reliance is placed on short-term wholesale markets. Savings balances represent 94.2% (2012: 97.7%) of all mortgage and loan balances.

In October 2012, the Group became a member of the FLS and during 2013 drew down additional funding of £350.0m. This funding has predominantly been used to support mortgage growth and supplement maturing wholesale funding. The maximum funding available to the Group under the Scheme was £829.4m. The Group has entered the extended FLS which will allow access to low-cost funding until January 2015.

The amortised value of the mortgage assets held within the Residential Mortgage Backed Security (RMBS) is £510.4m (2012: £657.0m). These assets are encumbered. The Group holds £358.9m (2012: £422.8m) of the notes, £131.1m of which have been subject to repurchase agreement which are not recognised in the statement of financial position as the Group retains the risks and rewards of the mortgages.

Asset encumbrance is 16.8% (2012: 10.6%) of total assets. The Board has set an encumbrance limit of 30.0%.

The Society's long-term debt ratings with Fitch and Moody's remain unchanged from last year.

	2013 and 2012	
	Short-term	**Long-term**
Moody's	NP	Ba1
Fitch	F2	BBB+

Defined benefit pension scheme

During the year the Group contributed £0.9m to the pension scheme. This contribution is recognised in the statement of other comprehensive income. The final instalment of £0.4m in relation to the 2012 buy-in of the pensioner element of the scheme with Legal and General Assurance Society Limited has been paid during the year.

The pension deficit has increased from £13.2m to £17.1m, largely as a result of increases in the expected long-term Retail Prices Index (RPI).

The defined benefit scheme is subject to a triennial valuation by the scheme's independent actuary, most recently on 30 September 2013. It is expected that this valuation will be approved by the Trustees within the next 12 months.

The revision of IAS 19 Employee Benefits became effective for accounting periods on or after 1 January 2013. This standard changed the recognition of the rate of return on assets in the income statement. The prior year comparatives have been restated with an additional charge of £0.4m recognised in the income statement for 2012. The impact for 2013 was a charge of £0.6m.

Capital

Capital comprises the Group's general reserve, Permanent Interest-Bearing Shares (subscribed capital) and subordinated debt. This capital is held to support the development of the business, is stress tested and assessed to protect Members' deposits and provide a buffer against unexpected losses. The amount of capital required is assessed in relation to the Group's overall risk appetite, the material risks to which the Group is exposed and the management strategies employed to manage those risks.

During the year the Group obtained approval from the PRA to adopt an Internal Ratings Based (IRB) approach for capital calculations. This allows the Group to use its own internal information to estimate risk weightings, rather than standard risk weightings prescribed by the PRA and will further enhance the Group's risk management processes. As at 31 December 2013 the Society's first charge retail and commercial mortgage assets had adopted the IRB approach. Comparatives have not been re-stated as the Group was still on the standardised basis at 31 December 2012. The Group's second-charge mortgage assets will adopt the IRB approach during 2014.

A reconciliation of total capital to regulatory capital is presented overleaf:

The award winning marketing team with the Canmol Award for professional services

	2013	2012
	£m	£m
	IRB	Standardised
Total capital	517.2	511.5*
Adjusted for:		
Other reserves not eligible for inclusion in regulatory capital	3.0	(3.4)
Intangibles	(4.4)	(2.6)
Fair value adjustments to subscribed capital	(10.7)	(17.0)
Amortisation adjustments to subordinated liabilities	(46.2)	(27.7)
Expected loss adjustments to provisions	(29.9)	-
Regulatory capital	**429.0**	**460.8**

The subordinated liabilities, as a lower Tier 2 instrument, will amortise out of regulatory capital over five years to 2016 when they are scheduled to be repaid. This will reduce the solvency ratio, over the five year period, to the same percentage as the Tier 1 ratio.

At the end of the year, risk weighted assets were £2,123.2m (2012: £2,888.3m) with key capital ratios standing at:

	2013	2012
	%	%
	IRB	(restated*) Standardised
Core Tier 1	16.85	11.75
Tier 1	18.73	13.71
Solvency ratio	20.20	15.95
Leverage ratio (with PIBS)	5.38	5.55
Leverage ratio (without PIBS)	4.68	4.72

The Group will be subject to Basel III regulations from 1 January 2014. The impact on capital and capital ratios can be found in the Group's 2013 Pillar 3 disclosure, published on the Society's website (www.principality.co.uk).

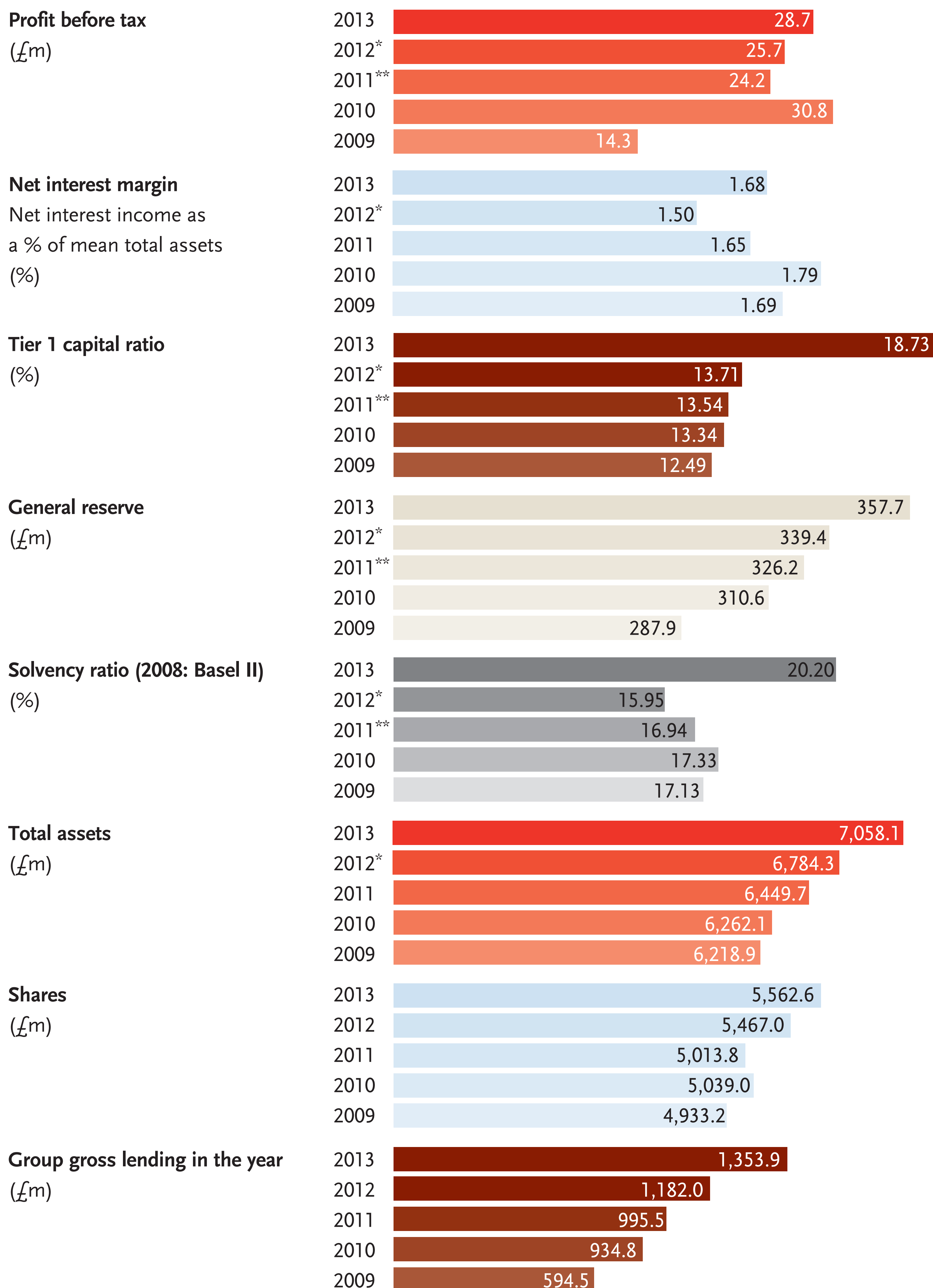
The key elements of Basel III for capital requirements are as follows:

- Reduced capital resources through changes to the definition of capital and grandfathering of old instruments. Permanent Interest Bearing Shares (PIBS) will be phased out over ten years from 2013. Over the period 2014-18, there will be changes and additions to capital deductions from Core Tier 1 and Tier 2 capital including pension deficit and AFS reserve;
- Increased capital requirements through Credit Valuation Adjustments and the treatment of deferred tax assets;
- New limits and capital buffers. Higher thresholds for all forms of capital with an increased focus on Core Tier 1, with a potential requirement to hold a ratio of up to 12.5% including Capital Conservation, Countercyclical and Systemic Risk Buffers; and
- Introduction of the Leverage Ratio. The Basel Committee is using a period to 2017 to test a minimum Tier 1 leverage ratio of 3.0%. The Group's Tier 1 leverage ratio under Basel III transitional rules is 5.02% (2012: 5.39%).

* Restated following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies and International Accounting Standard (IAS) 19 Employee Benefits (2011).

Key performance indicators

The following indicators illustrate Principality Group's performance during 2013 compared to the preceding four years:



* Restated following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies and International Accounting Standard (IAS) 19 Employee Benefits (2011).
** Restated following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies.

Key performance indicators

The following indicators illustrate Principality Group's performance during 2013 compared to the preceding four years:

Year ended 31 December	2013	2012 (restated*)	2011 (restated**)	2010	2009
Capital and profit					
Gross capital ratio	8.00%	8.28%*	8.77%**	8.71%	8.52%
Free capital ratio	8.12%	8.57%*	9.06%**	8.93%	8.71%
Profit after tax as a % of mean total assets	0.32%	0.29%*	0.27%	0.37%	0.17%
Other income as a % of net operating income	17.17%	19.63%*	16.44%	13.25%	15.12%
Operating expenses as a % of mean total assets	1.09%	1.08%*	1.04%	1.00%	0.95%
Assets					
Growth	4.03%	5.19%*	2.99%	0.69%	(2.81%)
Loans and advances to customers	£5,904.6m	£5,591.7m	£5,220.1m	£4,960.4m	£4,736.9m
Liquid assets	£1,042.1m	£1,074.3m	£1,114.7m	£1,194.8m	£1,380.3m
Liquid assets as a % of shares and borrowings	16.12%	17.39%	19.14%	21.12%	24.49%
Core liquidity ratio	13.18%	16.23%	16.88%	12.53%	10.44%
Funding					
Borrowings	£902.8m	£710.5m	£808.6m	£618.6m	£713.6m
Funding limit	14.03%	11.57%	13.96%	11.03%	12.78%
Employees					
Average number of people employed	1,317	1,242	1,173	1,126	1,049
Other measures					
Number of branches	53	53	52	51	51
Number of agency branches	17	16	14	13	5
Number of estate agency branches	27	25	23	23	23

* Restated following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies and International Accounting Standard (IAS) 19 Employee Benefits (2011).
** Restated following the implementation of International Financial Reporting Interpretations Committee (IFRIC) 21 Levies.

Stephen Hughes
Group Finance Director
4 February 2014

Risk management report

Risk overview

The management of the Group's business and the execution of the Group's strategy involve the potential exposure to a number of risks. The Group aims to manage appropriately all the risks that arise from its activities and believes that its risk management philosophy should reflect an awareness of actual and potential risk exposures, the quantification of the probable impact of such exposures and the development and implementation of measures that manage such exposures within agreed limits.

Governance structure

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

Risk governance is provided by a structure consisting of five key risk management committees. Each committee includes appropriate representation from the Group Management Committee (GMC), divisional management and risk specialists:

Group Risk Committee (GRC) is chaired by a non-executive director, and has responsibility for ensuring a Group-wide co-ordinated approach towards the oversight and management of key strategic and corporate risks.

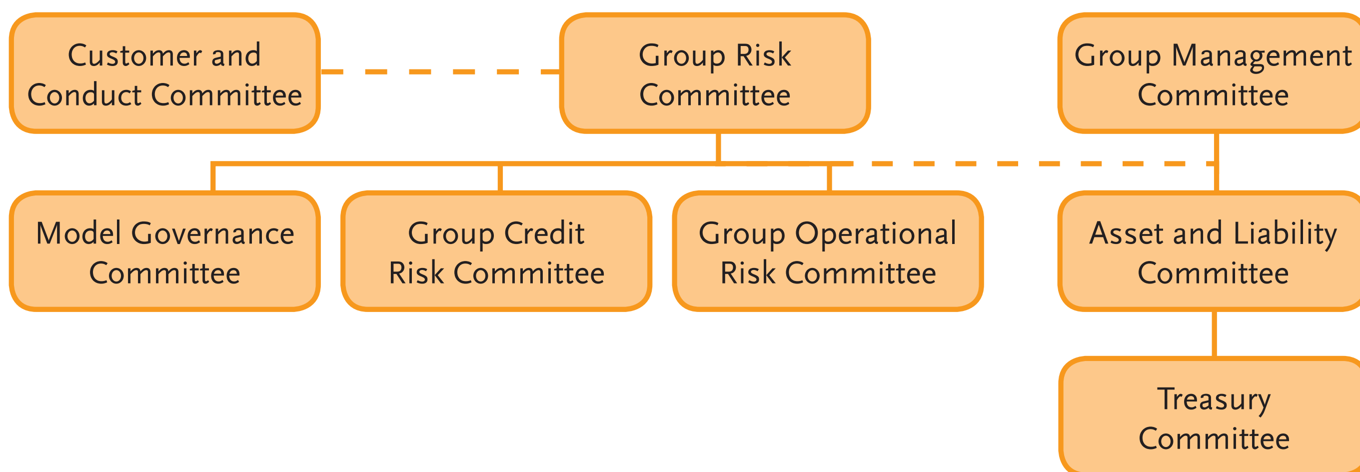
Group Credit Risk Committee (GCRC) is chaired by the Group Risk Director and is responsible for monitoring and reviewing exposure to credit risks in the Group's retail and commercial loan portfolios.

Asset and Liability Committee (ALCO) is chaired by the Group Finance Director and has responsibility for the assessment of exposure to Treasury Counterparty credit, liquidity and market risk. ALCO reports to the Group Management Committee and to the GRC. Weekly monitoring is conducted by the Society's Treasury Committee, which is a subsidiary of ALCO.

Model Governance Committee (MGC) is chaired by the Group Finance Director and is responsible for the approval and oversight of models used by the Group to assess and quantify exposure to credit, liquidity and market risk.

Group Operational Risk Committee (GORC) is chaired by the Group Risk Director, and is responsible for monitoring and reviewing exposure to operational risks arising from the Group's day-to-day activities.

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



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

Principal risks

The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, conduct risk, operational risk and pension obligation risk. As a mutual, the Group maintains a relatively low risk appetite. Quantitative assessment of credit risk, liquidity risk and market risk can be found in Note 40 on pages 83 to 98.

Group Internal Audit provides independent assurance regarding the activities of the business units and the specialist functions across the Group and reports on the effectiveness of the control environment to the Audit Committee on a quarterly basis. The GRC monitors the arrangements for assessing risk inherent in the Group's business activities on behalf of the Board and receives quarterly risk reports. The Board receives risk reports at each of its meetings and has continued its programme of regular reviews of major strategic risks. This includes an assessment of the potential impact of changes in the macro-economic environment, new regulation, competitor strategy, customer preferences and emerging technology.

The key risks to the Group are linked to the overall performance of the economy and the resultant effect on unemployment, house price indices, commercial property market values and performance, and overall liquidity as the markets seek to refinance borrowings over the medium term against a background of continuing uncertainty and the risk of sovereign default. The impact of emerging regulatory changes and any potential replacement funding scheme for the FSCS also represents a direct risk for the Group. Specific risks are reviewed as part of the Group's capital and liquidity assessments, the Internal Capital Adequacy Assessment Process (ICAAP) and the Individual Liquidity Adequacy Assessment (ILAA).

The Board is fully committed to the promotion and encouragement of a culture where the fair treatment of customers is regarded as central to all activities. During the last 12 months, continued emphasis has been placed upon the development and implementation of a framework designed to ensure that due consideration is given to all business conduct matters and associated risks when evaluating current and future strategic choices. The Customer and Conduct Committee, chaired by a non-executive director, exists for that purpose and, reporting directly to the Board, also oversees the Group's response to related elements of the emerging regulatory agenda following the transfer of those specific responsibilities from the Financial Services Authority to the Financial Conduct Authority last year.

Credit risk

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

Market background

The pace and sustainability of economic recovery is uncertain, with political challenges continuing to place additional strain on the sector. For that reason the Group's forecasts and plans continue to take account of scenarios that model stresses on the ability of customers and counterparties to repay their financial obligations. These stress factors include the risk of rising interest rates, decreases in house prices, impacts on commercial property market values, performance and the ability to re-finance at maturity, a sustained deterioration in the macro-economic environment and consequential increases in unemployment. These forecasts have been prepared by Management and stressed accordingly in line with PRA guidance.

Risk mitigation

The controlled management of credit risk is critical to the success of the Group's lending strategy. The quality of individual lending decisions and subsequent management and control together with the application of a credit policy that reflects the risk appetite of the Group have a direct impact on the achievement of the financial objectives of the Group. Each of the four business areas, residential first and second charge lending, commercial lending and treasury, has its own individual Credit Risk Policy Statement setting out its risk appetite including policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring. In addition, each business area maintains a detailed procedures manual setting out operating rules and standards.

During 2013 the Group's application to use the advanced Internal Ratings Based (IRB) approach for the calculation of Credit Risk Capital requirements under the terms of the Basel II Accord was formally approved by the PRA.

Day-to-day management of credit risk is undertaken by specialist teams working in each business area using credit risk management techniques adopted as part of the Group's overall approach to measure, mitigate and manage credit risk in a manner consistent with the risk appetite approved by the GRC and the Board. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

First and second charge retail credit risk

The Group continues to focus on the underlying quality of business written, and lending criteria remain conservative. Applicant quality is monitored closely, defined in terms of creditworthiness, loan to value (LTV) ratios and affordability profile. The GCRC receives regular reports on the performance of retail credit risk portfolios with further oversight provided by the GRC.

The Group's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. The Group encourages early two-way communication with borrowers, obtaining their commitment to maintain payment obligations, typically through repayment plans. Experience in these areas allows for feedback into the underwriting process. In common with other building societies, the Society participates in

the Government's Mortgage Rescue Scheme but has chosen not to take part in the Homeowner Mortgage Support Scheme. When accounts are in default, careful consideration is given to the most appropriate realisation strategy likely to result in the best outcome for the Group and the customer.

Commercial credit risk

Commercial risk appetite is regularly reviewed in the light of changing economic and market conditions and is also subject to annual review. The Group remains cautious with regard to commercial lending which is undertaken on a prudent basis reflected in decreased representation on the statement of financial position year-on-year, and where Management continues to pursue a strategy geared towards reducing overall exposure to development finance and larger, single counterparty loans. Commercial lending is operated within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

Concentration risk within the commercial portfolio is controlled and monitored via a series of credit exposure limits which are aimed at producing a diverse portfolio. Commercial lending relationships are subject to regular reviews to ensure that facilities are fully performing in accordance with the terms of original sanction. Watchlist 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 realisation strategy likely to result in the best outcome for the Group and the customer.

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 Group Risk, the GCRC and the GRC.

Treasury credit risk

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

Treasury counterparty lines of credit are reviewed on a weekly basis by the Treasury Committee and on a monthly basis by ALCO. This entails an analysis of the counterparties' financial performance, their ratings status and recent market intelligence to ensure that limits remain consistent with the Group's risk appetite. Changes to lines and limits are approved by ALCO within a framework set down by the Board.

Liquidity risk

Liquidity risk is the risk that the Group is not able to meet its financial obligations as they fall due, or can do so only at excessive cost. The objective of the Group's liquidity policy is therefore to maintain sufficient liquid assets to cover cash flow imbalances and fluctuations in funding, to maintain full public confidence in the Group and to ensure that all financial obligations are met.

Market background

Wholesale funding markets remain relatively subdued, with underlying confidence in the interbank market continuing to reflect broader concerns regarding the possibility of contagion risk arising from sovereign default or the second order impact of corporate failure across the UK and Eurozone. The relative cost of funds has reduced significantly as a consequence of the Bank of England's decision to provide medium-term support to the banking sector through the Funding for Lending Scheme (FLS), although these benefits may prove to be relatively short lived, given proposed restrictions in eligibility announced in November of last year.

Liquidity regulations encourage firms to seek longer-term funding and to hold better quality Government issued debt for use as liquid assets. The Bank of England has recently provided greater clarity with regard to the support firms can rely upon in a future liquidity crisis. This clarity allows firms to operate safely with lower levels of liquidity whilst meeting all the requirements of emerging European regulation for liquidity risk management.

Risk mitigation

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

ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing. The Group conducts an Individual Liquidity Adequacy Assessment (ILAA) at least annually. This is used to assess the Group's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Group. The resulting funding and liquidity strategy takes into consideration the full repayment of the FLS.

The most recent ILAA was approved by the Board in December 2013. The Group's ILAA includes stress tests that consider a range of severe scenarios and their impact on the Group, particularly with respect to retail saving outflows. The ILAA concludes that the Group's liquidity reserves are adequate to sustain the Group over an extended severe stress during which contingent actions aimed at stabilising the situation would be deployed.

Market risk

Market risk is the risk that the value of, or income arising from, the Group's assets and liabilities changes as a result of changes in market prices, the principal elements being interest rate risk, including the use of derivatives, and foreign currency risk.

The Group Treasury Department is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's Treasury Policies. Oversight is provided by the Treasury Committee, ALCO, GMC and GRC which approves the market risk policy and receives regular reports on all aspects of market

Champions of the Principality Premiership, Pontypridd RFC

risk, including interest rate risk and foreign currency risk. Reporting lines and terms of reference are set out clearly by the Board which also receives monthly reports from the Group Finance Director covering significant issues dealt with by ALCO.

The Group's defined benefit pension scheme is also subject to market risk, and this risk is managed by the Trustees of the scheme.

Interest rate risk

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

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

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

Market background

Over the last year, customer preference has shifted away from variable rate mortgages towards fixed rate products to achieve a level of certainty against a growing view that the extended period of low interest rates may be coming to an end. Along with other mortgage providers, the lower interest rate environment and the availability of credit have exposed the Group to changes in customer behaviour, and we are alert to a possible reversal of these trends and the potential effects this may have on the Group as economic prospects improve.

Risk mitigation

Interest rate risk is subject to continual management, within the risk appetite set by the Board, using appropriate financial instruments including derivatives. Risks relating to specific products are mitigated through appropriate related product terms and conditions, offer procedures, as well as 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.

ALCO regularly considers, in particular, the Society's options and strategies in the current low interest rate environment and the impact of any potential future increases in interest rates. The Group's forecasts and plans take account of the risk of interest rate changes and are prepared and stressed accordingly, in line with PRA guidance.

Use of derivatives

Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other indices which affect fair values or cash flows. Derivatives are therefore used exclusively to hedge risk exposures.

The principal derivatives currently used by the Group are interest rate exchange contracts, commonly known as interest rate swaps.

The table below describes the principal activities undertaken by the Group, the related interest rate risks associated with those activities and the types of derivatives which are typically used to manage such risks:

Activity	Risk	Type of derivative
Fixed rate savings products and fixed rate funding	Sensitivity to changes in interest rates	Interest rate swaps
Fixed rate mortgage lending and fixed rate investments	Sensitivity to changes in interest rates	Interest rate swaps
Equity linked investment products	Sensitivity to equity indices	Interest rate swaps and equity linked options

The Group uses derivatives in accordance with the terms of the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and, accordingly, they are used exclusively to reduce the risk of loss arising from changes in interest rates, foreign exchange rates or other factors specified in the legislation.

Foreign currency risk

Currency risk is the risk of a loss resulting from movements in foreign exchange rates or changes in foreign currency interest rates, particularly on the Group's non-Sterling funding. The majority of currency balances arise from transactions instigated by Group Treasury to manage wholesale funding costs and returns on liquid assets and to provide diversity in funding and asset markets.

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

Conduct risk

Conduct risk is the risk of the Principality Group treating its customers unfairly and delivering inappropriate outcomes.

The sustainability of the Group's business model and achievement of its longer-term strategy are dependent upon the consistent and fair treatment of customers. The emergence of the "twin peaks" regulatory regime reflects the increasing scrutiny of the measures adopted by firms in relation to business conduct and has been mirrored by the Society's approach towards the governance of conduct risk.

Risk mitigation

The role of the Group's conduct of business function is to advise the Group on and oversee the risks that could lead to unfair treatment of customers. The Group is further developing its approach to the management of its exposure to conduct risk, and this is reflected in a Board approved Retail Conduct Strategy. The Board is responsible for setting and agreeing the Group's conduct risk strategy and associated risk appetite statements.

The Group's Customer and Conduct Committee forms part of the overall governance and control framework and is responsible for ensuring adherence to the risk strategy and the conduct risk appetite statement. The Committee is responsible for the governance and oversight of business conduct and structures this around a framework which reflects the four pillars of the product lifecycle:

Pillar	Desired outcome
Target market, product design and governance	The Group's products and services are designed to meet the needs of identified customer groups and targeted accordingly.
Sales sustainability and process management	Where customers receive advice, that advice is suitable and takes account of their needs and circumstances.
	We lend responsibly, ensuring that loans are affordable.
	Information provided to customers is timely, clear, fair and not misleading, so that they can make an informed choice regarding products and services.
Servicing and arrears management	Customers are provided with clear information and kept appropriately informed before, during and after the point of sale.
	Minimum service standards are maintained which meet the realistic expectations of customers. These will be effectively communicated, monitored and reviewed.
	The Group will take all reasonable measures to protect customers from financial crime, information security and business continuity risk.
	Borrowers in financial difficulty who work with us towards an appropriate resolution will be treated sympathetically.
Complaints management	Customers do not face unreasonable post sale barriers when they wish to submit a claim or make a complaint.
	All complaints will be resolved promptly and fairly based on the customer's individual circumstances.

Only Boys Aloud Academi performing in the Royal Welsh College of Music and Drama

The Customer and Conduct Committee is chaired by a non-executive director and supported by the Customer Experience Forum, an operational committee which meets monthly, reviews all aspects of Conduct Risk management and is attended by representatives from across the Group.

Operational risk

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

Market background

The rapid pace of change, driven in particular by technological innovation, regulation, customer expectations and the competitive environment, exposes the Group to increased levels of operational risk, for example in terms of systems resilience and capability and staff competencies. The financial services sector also faces growing levels of financial and cyber crime which require increasingly sophisticated anti-fraud controls.

Risk mitigation

The role of the Group's operational risk management function is to ensure appropriate strategies are in place to manage and mitigate the risks that could impact the ability of the Group to meet its business objectives whilst protecting its reputation. The Group manages its exposure to operational risk, considering the impact by reference to a number of discrete categories which include process management, systems failure, reputational issues, business continuity planning and fraud risk.

The Group's operational risk management framework sets out the strategy to identify, assess and manage operational risk, with senior management having responsibility for understanding the nature and extent of the 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 and the external operating environment.

Oversight is provided by the GORC, and the assessment of the Group's exposure to operational risks is based on both quantitative and qualitative considerations. The crystallisation of operational risks is captured through the recording of operational losses, near misses and incidents. The analysis of loss events is used to identify any potential systemic weaknesses in operational processes. The ICAAP includes a series of hypothetical scenarios designed to assess the ability of the Group to mitigate or withstand the impact of a range of operational failures. The scope and relevance of this analysis is reviewed not less than annually by the GORC.

Pension obligation risk

The Group has funding obligations for a defined benefit scheme which is closed to new entrants. It was closed to future accrual on 31 July 2010. Pension risk is the risk that the value of the Fund's assets, together with ongoing employer and member contributions, will be insufficient to cover the projected obligations of the Fund over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates. The projection of the Fund's obligations includes estimates of mortality, inflation and future salary rises, the actual out-turn of which may differ from the estimates. The Fund is also exposed to possible changes in pension legislation.

To mitigate these risks, Management and the Trustees of the Fund regularly review reports prepared by the Fund's

independent actuaries and take appropriate action which may, for example, include adjusting the investment strategy and/or contribution levels. In September 2012, the Society concluded a "buy-in" arrangement in order to reduce future uncertainty regarding ongoing costs and liabilities associated with its closed defined benefit pension scheme.

Capital management

The Group conducts an Internal Capital Adequacy Assessment Process (ICAAP) to assess the Group's capital adequacy and determine the levels of capital required to support the current and future risks in the Group. The ICAAP covers all material risks to determine the capital requirement over a five-year horizon and includes stress scenarios which are intended to meet internal and regulatory requirements. The capital requirements are presented to the Board for approval with the most recent review being completed and approved by the Board in December 2012. The ICAAP is used by the PRA to determine and set the Group's Individual Capital Guidance (ICG).

The amounts and composition of the Group's capital requirements are determined by assessing the Basel II Pillar 1 minimum capital requirement, the requirement for other risks not included in Pillar 1 and the impact of stress and scenario tests under Pillar 2 and the ICG. The Group manages its capital above the minimum ICG threshold, including a capital planning buffer, at all times. Capital levels for the Group are reported to, and monitored by, the Board on a monthly basis.

To meet Basel II Pillar 3 requirements, the Group publishes further information about its exposures and its risk management procedures and policies. This will be published on the Society's website (www.principality.co.uk) in April 2014.

Preparations for the new Basel III requirements are well progressed, and the Board remains confident that existing capital levels will continue to be assessed as adequate when transition to the new regime commences in 2014.

R. Michael Jones
Group Risk Director
4 February 2014

Member, Colleague and Community

Member

At Principality our core principles are to provide a secure home for savings and to help people to buy homes, and these have underpinned our business activities for over 153 years. During this time we have grown to become the 6th largest building society in the UK, with over 500,000 Members and employing over 1,300 colleagues.

By opening up a savings account or taking out a mortgage with us, a customer will become a Member of the Society, and this Membership entitles them to certain rights, including having their say on the election of Directors and resolutions.

As an organisation run for the benefit of Members and not shareholders, we are focused on putting Members first, and we recognise that the better we understand our Members, the more we can adapt to meet their needs. We also know that our strength as an organisation lies in our colleagues and the service they deliver. That's why we always make sure we treat colleagues as individuals and create the right environment to foster talent so that they can make a real contribution to the success of the Society.

Being recommended every day

Our strategy is underpinned by the objective of being recommended by our Members to their family and friends based on the experience and service we offer.

We carefully review feedback from Members in order to understand the strengths in our service offering and where it can be improved. Members frequently tell us that they value our friendliness and helpfulness, and that they feel we treat them as individuals. They also tell us that they appreciate how knowledgeable our colleagues are when helping them. These are aspects of our service that we continually seek to enhance and improve.

The key metric we use to measure this strategic objective is the industry-wide Net Promoter Score which measures Member loyalty based on a single question, 'How likely are you to recommend Principality's products or services?'. Over the past year we have seen consistent improvement in this score, maintaining our position as the most recommended savings provider in Wales*. We aim to achieve the same status as a mortgage provider.

Providing a sector leading multi-channel service to Members

We are committed to providing safety and security, excellent value and a sector leading service for our Members. Over the last few years, we have been working hard to provide a seamless cross-channel service offering, and our branch network remains central to this.

The recent expansion of our high street presence shows our commitment to offering a sector leading face-to-face financial service to the communities of Wales and the borders, especially at a time when other high street financial services providers are closing their branches. The last two years have seen the successful opening of a new branch and an additional three agencies, and we now have a network of 53 branches and 17 agencies located in Wales and the key border towns with England.

Our website has already become our "largest branch" and is used by 55,000 of our Members and customers. A key part of our strategy is ensuring that customers who use our website to perform transactions or seek help will always obtain the same level of service there that they would expect when visiting any one of our branches or contacting our Wales-based call centre.

During the year, a new Customer Experience team has been created, dedicated solely to monitoring and improving all aspects of our Members' and customers' interactions with us. We are committed to keeping our Members, and the high-calibre service we offer, central to our strategy.

Listening to our Members

We recognise that by investing time in our Members, we can understand how best to meet their needs. Our Customer Insight team is dedicated to increasing our understanding of what our customers want so we can drive our business decisions in the right way for our Members.

We develop this understanding in several ways – by seeing patterns in behaviour and trying to anticipate Members' next steps when we see consistent trends occurring, and also through an extensive programme which enables us to talk to our Members directly.

We have a panel of 7,000 Members who regularly take time to give us feedback on many aspects of our business. Whenever we write new literature explaining our products, for example, we will ask our Member panel whether we have been clear enough and whether there is anything we can do to improve it further.

In addition, we hold regular Talkback events around Wales to which all of our Members are welcome, and attended by our senior leadership team. These provide Members with the opportunity to hear about our business performance and also to have their say on what they love about Principality and what they would like to see improved.

By continually putting our Members at the heart of our decisions and involving them in every step of the process, we have been able to shape and improve our business. In direct response to Member feedback we developed a tiered savings product to reward Members based on the length of their relationship with the Society. Furthermore, Members tell us that the traditional branch service remains important to them, reinforcing our commitment to maintaining a strong high street presence across Wales and the borders. We have

* Source: GfK NOP Financial Research Survey (FRS), 12 months ending December 2013, NPS score of savings customers in Wales, answering likelihood to recommend , c. 2,400 adults.
† Competitor list includes the following: Barclays, Halifax, HSBC, Lloyds TSB, NatWest, Nationwide, NS&I, Santander.

also recognised that a proportion of our Members would like greater online accessibility, and we have responded to this by establishing a multi-channel customer experience, investing heavily in developing our online capability further. This resulted in the Society being awarded Best Internet Account Provider in the Moneyfacts 2013 Awards for our consistently competitive rates and our straightforward approach.

Actively listening to our Members underpins our commitment to be 'The most recommended financial services provider in Wales'.

Keeping Members at the heart of our business

In 2012, the appointment of a new Chief Executive brought with it a change of structure including the appointment of a new Customer Director position, responsible for overseeing all customer-facing teams. In addition, a new Director of Distribution has been appointed, reporting to the Customer Director.

Within the Customer Directorate, we have also created a new Customer Experience team, dedicated solely to monitoring and improving all aspects of our customers' interactions.

This new structure is supported further by the Customer and Conduct Committee, a sub-committee of the Board. In doing so, the Committee oversees the Group's Conduct of Business Framework and Customer Conduct Strategy to provide assurance that procedures are in place that lead to the fair treatment of Members and the delivery of good outcomes.

The change in structure shows the Society's commitment to keeping our Members central to our strategic focus across all parts of our business.

Our people

We recognise that our colleagues, and the way that they behave, underpins the delivery of our strategy. Our ambition is for our colleagues to give their best, putting service first and achieving the right outcomes for Members. By doing this consistently, we anticipate that our Members will recommend us to their friends and family.

Creating the right culture

At Principality, we recognise that our values and the way that we behave drive the culture of our organisation. Creating the right culture means having an organisation that people want to join, and this drives staff satisfaction which in turn drives customer satisfaction. To unlock the great potential in our business and to ensure we are all aligned in supporting the strategy, we have redefined our four values:

- We're proud to be at the heart of our **communities**;
- Members and colleagues **trust** us to fulfil our promises;
- We challenge ourselves to always **perform** better; and
- We **work together** to build value for our Members.

Managers are working with all our colleagues to help them achieve results through these behaviours, which are an important part of performance reviews and reward schemes. We believe that by focusing on our values, we will become even more resilient, effective and successful as an organisation.

Colleagues

A breakdown of colleagues by gender is presented below:

	Female (%)	Male (%)
Directors (including non-executive directors)	25.0	75.0
Senior managers	50.0	50.0
Colleagues	36.8	63.2

Labour turnover, which measures how many of our colleagues are leaving of their own choice, is low at 11.5%. A number of factors contribute to this outcome:

- Colleague engagement;
- Job satisfaction;
- How our managers lead their teams; and
- The development of our colleagues to enhance their skills.

We are proud of how many of our employees have grown with us. The average length of service is approximately six and a half years.

Diversity

The Group is committed to providing employment practices and policies which recognise colleague diversity. We will not unfairly discriminate in our recruitment or employment practices on the basis of any factor which is not relevant to individuals' performance including sex, race, disability, age, sexual orientation or religious belief.

Human rights

The Group operates exclusively in the UK and, as such, is subject to the European Convention on Human Rights and the UK Human Rights Act 1998. We aspire to conduct business in a way that values and respects the human rights of our colleagues, Members, customers and those of the communities in which we operate.

Listening to colleagues

Our annual survey is an important way for us to listen to our colleagues, to find out how we are working together and to see how well we are building a service focused culture. With a high response rate of 89% (2012: 88%), we get a clear insight into how colleagues feel about working with us, especially through their individual comments.

Our recent survey showed that 83% of our colleagues are satisfied with the Group as their employer and 91% are proud to work for us. In addition, the survey revealed that:

- 93% of colleagues believe we are committed to customer satisfaction;
- 92% of colleagues believe fair treatment of customers is central to the way we do business; and
- 89% of our colleagues believe we place a genuine focus on serving the financial needs of our Members.

We value the individual differences and input that people can bring to the Group, and we consistently look for ways to improve how we take account of the views of our colleagues. We hold annual colleague road shows, hold regular colleague

meetings and Talkbacks, run "meet the executive" sessions, and circulate monthly newsletters and business briefings.

Rewarding performance

Managing performance plays a critical role in helping us to develop our colleagues to build long-term relationships with our Members as well as effective relationships internally.

Reflecting the regulatory environment, progress has been made in strengthening reward governance. We've revisited our incentive frameworks to ensure that we are rewarding colleagues for not just what they achieve, but how they achieve it. This is supported by the performance management process.

We have also looked to re-balance fixed and variable pay and remove reliance on individual sales targets to ensure that our colleagues are motivated to deliver good customer outcomes for our Members. This is core to maintaining and enhancing the strong culture that underpins our commitment to being Recommended Every Day.

Realising our potential

Learning and development helps our colleagues to develop their ability to help us to provide the best customer service for our Members. We aim to benefit from the potential of our colleagues, so promotion from within and internal recruitment are strong aspects of the Society's culture. We actively encourage secondments to enable people to experience other areas of the organisation and share their knowledge.

In 2009 we launched a suite of Leadership and Management training programmes to support business succession planning. Over the last four years, 58 colleagues have participated in these three programmes. This has resulted in 18 people being promoted within twelve months of completing the programmes. During the year 65 colleagues have received support towards gaining externally recognised qualifications. It is our commitment to continue to develop our colleagues to enable us to retain the skills and experience of our top talent. This has led to us being awarded the Investors in People accreditation for the 15th consecutive year.

Community

As Wales' largest building society, we are passionate about supporting the communities we serve. By embracing our mutual heritage, we work to actively involve our Members, colleagues and people from the local community to play their part in activities that really make a difference to the lives of those around us.

In 2013, we have done this in a number of ways, through supporting sustainable and affordable housing initiatives, funding and participating in events that celebrate our culture and heritage, raising money for our Charity of the Year, and giving our time to support local schools and community projects.

Getting to the heart of our communities

We are proud to be at the heart of our communities, and this year colleagues in our head office, 53 branches and 17 agencies across Wales and the borders have continued to be dedicated to causes in their local areas.

We encourage our colleagues to help their local community in the best way that they choose and this year we have supported a variety of causes from Denbigh under 15's rugby team to Cwmbran Park Bowling Club and the musical group Abbey Players in Swansea.

Members of our arrears team spruced up a hall at Rhoose Community Centre, bringing it back into use for toddler groups and fitness classes. Colleagues also helped to transform the garden at Penarth Community Centre and bring a pond back into use at Whitchurch Primary School to help pupils learn more about wildlife and conservation.

In addition we launched the Principality Community Vote in December, to help one community group or worthy cause win a gift of £5k to kick-start a project in 2014. The winning group will also be given a Christmas party in 2014 for their local community. We hope that this will make a real difference to a great number of people in one local Welsh community.

Supporting Welsh heritage and culture

Our sponsorship programme impacts on our communities and for a cost of just a few pence per Member, we are able to make a real difference to the lives of people in Wales, including future generations.

Principality's relationship with Wales Millennium Centre sees the coming together of two iconic Welsh brands and demonstrates our mutual support for the future of Welsh arts. Already we have seen thousands of young performers flourish on the stage and showcase some of the unique talents that Wales has to offer.

We have a long association with rugby in Wales, and we are passionate about developing young talent. As title sponsors of the Principality Premiership since 2005, our shared aim with the Welsh Rugby Union (WRU) is to increase the profile of grass roots rugby in Wales. This year we have seen dozens of former Principality Premiership players take to the international stage in the Six Nations winning team and the triumphant British and Irish Lions squad in Australia – a real demonstration of the talent that is coming through this league. Principality has also assisted the WRU in its Academy programme to enhance the skills of university students through interaction and training with the Principality Premiership clubs.

We have continued our sponsorship of the Principality Junior Wales Open, which hopes to foster the talent of future golf champions to follow in the footsteps of Welsh Ryder Cup heroes like Ian Woosnam and Phillip Price, as well as Solheim Cup star Becky Brewerton.

In supporting the National Eisteddfod we celebrate the cultural traditions, language and heritage of Wales. The National Eisteddfod is the largest festival of its kind in Europe and is Wales' premier Welsh language festival. In 2014 we will be celebrating our 35th year of sponsoring the National Eisteddfod, and we are pleased to be the only financial services provider on the festival field.

Our award winning sponsorship of Only Boys Aloud and the Only Boys Aloud Academi has reached even more boys this year as the search for the next generation of male choral singers

continues in the Valleys. This year new groups have been launched in Cardiff and Swansea to encourage boys in the city areas to take advantage of this opportunity which has helped break down social barriers and increase access to the arts.

We are also sponsors of two high profile farming awards: the NFU Cymru/Principality Welsh Rural Community Champion Award and the NFU Cymru/Principality Wales Woman Farmer of the Year. Both awards recognise the hard work farmers undertake away from the farm in order to help their local town or village community, and celebrate the often unheard contribution that women make to Welsh farming.

As proud supporters of North Wales communities, we have partnered with Conwy County Borough Council to bring Access all Eirias, a weekend of family entertainment, to people across the locality for the last two years. This major event has showcased some of the biggest acts in the country and has helped to support local businesses by attracting a much wider audience drawn from all parts of Wales and the North West.

Helping hearts with British Heart Foundation Cymru

We rely on the endless goodwill of our colleagues to organise fundraising activities in support of our Charity of the Year, so every year we ask them to nominate and then vote for the good cause that they would like to support. This year they selected British Heart Foundation (BHF) Cymru and have raised thousands of pounds with sponsored cycle rides, cake sales and walks in support of the charity. This year we raised a record £60k to support BHF Cymru.

The dedicated efforts of our colleagues will be invested back in to Wales through BHF Cymru's "No Time To Wait" appeal, helping to purchase more life-saving defibrillators and train even more people in emergency skills, ultimately leading to more lives saved in Wales.

Helping Welsh people buy their first home

We aim to help as many people as possible across Wales and the borders to own their own home. In January, we launched a new 95% Loan to Value (LTV) mortgage product to support first-time buyers in stepping onto the property ladder and encourage existing homeowners to move with a deposit of just 5%. As a five year fixed-rate mortgage, this product was designed for the long-term, to allow buyers to budget realistically. Since then more than 600 people have taken up this mortgage, giving Principality a 12% share of the first-time buyer market in Wales.

We have also been working with the Welsh Government to launch the Help to Buy - Wales scheme, a shared-equity scheme designed to boost the housing market by helping aspiring homeowners to buy new-build homes and support local builders.

Supporting the economy and affordable housing

Principality Commercial has played a key role in supporting the housing agenda in Wales through a range of projects with Welsh housing associations. This year saw the 10th anniversary of our partnership with Valleys to Coast in Bridgend, the first stock transfer of social housing in Wales, which has enabled thousands of families to be housed in good quality homes.

We have also supported hundreds of families in Wales in finding quality rented homes thanks to the Welsh Housing Partnership initiative. In 2011, our Commercial team and the Welsh Government supported four housing associations, which joined forces to deliver affordable homes to the people of Wales. Since then more than 400 properties have been purchased by the partnership in local authority areas across the whole of Wales, and we have recently announced further funding for the next phase of the scheme, which will support hundreds more families into homes.

We have also supported a number of other developments in Wales, including the Harbourside Business Park development in Port Talbot, which has been named as the most environmentally friendly commercial building in the UK, illustrating our commitment to not only affordable but also sustainable development in Wales.

Supporting future generations

In 2012 the Society partnered with two Cardiff High Schools, Llanishen and Glyn Derw. In 2013, that partnership went from strength to strength with dozens of students receiving reading support from our colleagues with financial education and leadership support provided for the teachers.

Colleagues also took part in a Dragons Den style workshop for pupils at Llanishen to help develop their entrepreneurial skills and provide guidance that we hope will improve their employment prospects. Additionally, branch colleagues took their expertise to local schools to talk to children about money, to help improve their numeracy skills and increase financial awareness.

Caring for the environment

We have introduced a number of measures to reduce emissions this year. There has been increased investment in LED (light-emitting diode) technology within our branch network to reduce inefficient lighting units. Electricity for Principality's head office is now purchased on a renewable sources contract, and the solar power installation at Peter Alan's head office now generates enough electricity to make the building self-sufficient.

At Peter Alan and Principality, we are also changing suppliers for our car fleets which meet with tighter CO_2 restrictions. Recycling of our confidential waste has saved the equivalent of over 26 metric tonnes of paper, the equivalent of 800 trees. We also recycle general waste and electrical items.

Board of directors

① **Dyfrig D. J. John**
CBE FCIB (Age 63)
Chairman

Appointed a non-executive director in July 2009, he became Chairman in April 2010. He is Chairman of the Nominations Committee and a member of the Remuneration Committee.

Other Directorships and Appointments
President of the HSBC Bank UK Pension Association and a member of the audit committee for the Welsh Rugby Union.

② **Langley Davies**
BSc (Hons) ACA (Age 54)
Deputy Chairman

Appointed a non-executive director in May 2007 and appointed to the role of Deputy Chairman in October 2013. He is Chairman of the Group Risk Committee, a member of the Audit, Nominations and Property Committees and a director of Peter Alan Limited.

Other Directorships and Appointments
Partner in Ruperra Properties LLP and Hensol Properties LLP. Director of Vansdirect Limited, St Lawrence Consultancy Limited, South Wales Land Developments Limited and Imperial Park Investments Limited.

③ **Graeme H. Yorston**
FCIB MBA (Age 56)
Group Chief Executive

Joined the Society as Chief Operating Officer in July 2006. He was appointed as a director in October 2007 and became Group Chief Executive in October 2012. He is Chairman of Nemo Personal Finance Limited and Loan Link Limited and a director of Peter Alan Limited.

He is Chairman of the Group Management Committee, and a member of the Asset and Liability, Group Risk, Customer and Conduct and Property Committees. He is a director of all the Society's subsidiary undertakings which have not carried on business throughout the year. These can be seen listed in Note 23 on page 73.

④ **William Guy Thomas**
BSc (Hons) ACA FCT C.Dir (Age 58)
Group Chief Operating Officer

Joined the Society as Finance Director in November 2003 and became Chief Operating Officer in February 2013. He is Chairman of Peter Alan Limited and a director of Nemo Personal Finance Limited, Loan Link Limited and Principality Covered Bond LLP. He is also Chairman of the Property Committee and a member of the Asset and Liability and Group Management Committees.

⑤ Gordon MacLean
BA FCA (Age 59)

Senior Independent Director

Appointed a non-executive director in April 2006 and appointed to the role of Senior Independent Director in October 2013. He is Chairman of the Audit Committee and a member of the Nominations Committee. He is also a director of Nemo Personal Finance Limited and Loan Link Limited.

Other Directorships and Appointments
Director of 9 Highcliffe Road Management Company Limited.

⑥ Joanne Kenrick
LLB (Age 47)

Non-Executive Director

Appointed a non-executive director in January 2009. She is a member of the Customer and Conduct and Nominations Committees.

Other Directorships and Appointments
Marketing director of Homebase Limited, Board member of the Marketing Society, and a director of 53 Rosslyn Hill Residents Association Limited.

⑦ Menna Richards
BA OBE (Age 60)

Non-Executive Director

Appointed a non-executive director in June 2012. She is also chair of the Customer and Conduct Committee and a member of the Nominations Committee.

Other Directorships and Appointments
Non-executive director of Glas Cymru and the Welsh National Opera, Pro-Chancellor of Cardiff University, Trustee of the ALOUD charity, and Vice-President of the Royal Welsh College of Music and Drama.

⑧ Natalie Elphicke
LLB (Age 43)

Non-Executive Director

Appointed a non-executive director in July 2012. She is a member of the Audit, Group Risk, and Nominations Committees.

Other Directorships and Appointments
Co-founder of Million Homes, Million Lives a not for profit organisation.

⑨ Robert Michael Jones
BA (Hons) MBA ACIB (Age 55)

Group Risk Director

Joined the Society in 1997 and appointed to the Society's Board in February 2013. He is a member of the Group Risk Committee and is chairman of the Group Credit Risk and Group Operational Risk Committees. He is also a member of the Group Management, Property, Model Governance and the Asset and Liability Committees.

⑩ Stephen Hughes
ACMA (Age 41)

Group Finance Director

Joined the Society in December 2011 as Group Deputy Finance Director. He was appointed to the Society's Board in March 2013. He is Chairman of the Society's Asset and Liability and Model Governance Committees and a member of the Group Management Committee and represents the Society on the Board of Arkose Limited.

⑪ Laurence Philip Adams
LLB (Age 57)

Non-Executive Director

Appointed a director of the Society in August 2013. He is a member of the Remuneration, Nominations and Group Risk Committees.

Other Directorships and Appointments
Non-executive director of Novae Group PLC and of Exane Limited and EBRD nominee on the supervisory council of Citadele Bank in Latvia.

⑫ Nigel Charles Annett
(Age 55)

Non-Executive Director

Appointed a director of the Society in October 2013. He is Chairman of the Remuneration Committee and a member of the Nominations and Customer and Conduct Committees.

Directors' report
for the year ended 31 December 2013

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 2013. 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. As part of this work the Committee has:

- Received extensive reports from the Group Finance Director which relate to the going concern assessment and the assumptions and uncertainties associated with accounting judgements and critical accounting estimates;
- Received regular reports from senior members of the Group Finance team on the progress with work being undertaken leading to the preparation of the Group's financial statements;
- Considered: whether the description of the Group's business model is apt; 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 considered the Group's projected solvency and liquidity positions over the next 24 months; and
- Received reasonable assurance from the external auditor that the Group's financial statements as a whole are free from material misstatement whether caused by error or fraud.

The Chairman of the Audit Committee reports the Committee's conclusions to the Board.

The directors confirm that, to the best of their knowledge, the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary to Members to assess the Group's performance, business model and strategy.

Business objectives and activities of the Society and its subsidiaries

The Society's business objective is to provide Members with the benefits of a mutual organisation through the design, manufacture and delivery of attractive mortgage and savings products. The Society's principal activity is the provision of housing finance funded mainly from Members' savings. It also offers commercial loans and a range of insurance and financial services.

The Society's trading subsidiaries engage in complementary activities including:

- Estate agency, lettings and property services; and
- The provision of secured personal loans.

The directors consider that no activities carried out during 2013 were outside the powers of the Society.

The Society has not acquired or established, or allowed a subsidiary undertaking to acquire or establish, a 'non-core' business to which Section 92A of the Building Societies Act 1986 applies.

Directors

The names of the directors at the date of this report, together with brief biographical details, are listed on pages 25 and 26.

Two non-executive directors, Christopher Jones and Keith Brooks, resigned from the Board with effect from 19 April 2013 and 30 September 2013 respectively. During the year Laurence Adams and Nigel Annett joined the Board on 28 August and 21 October respectively. Two new executive directors were appointed to the Board during the year. Michael Jones was appointed Group Risk Director with effect from 1 February 2013 and Stephen Hughes was appointed Group Finance Director with effect from 7 March 2013. To comply with the UK Corporate Governance Code, and as permitted by Rule 26(1), all of the directors retire and stand for annual election at the Annual General Meeting. With the exception of the Chairman, Dyfrig John, all are eligible and willing to continue serving on the Board and there have been no other nominations.

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

Principal risks and uncertainties

The principal risks and uncertainties for the Group are outlined on pages 15 to 20.

Profits and capital

Profit before tax was £28.7m (2012: £25.7m restated). The profit after tax transferred to the general reserve was £22.2m (2012: £19.0m restated).

Total Group general reserves at 31 December 2013 were £357.7m (2012: £339.4m restated).

Gross capital at 31 December 2013 was £517.2m (2012: £511.4m restated), including £92.3m of subordinated debt and £70.2m of Permanent Interest-Bearing Shares (PIBS).

The ratio of gross capital as a percentage of shares and borrowings at 31 December 2013 was 8.00% (2012: 8.28% restated) and the free capital ratio was 8.12% (2012: 8.57% restated). The Annual Business Statement on page 100 contains an explanation of these ratios.

Mortgage arrears

At 31 December 2013 there were 788 (2012: 832) mortgage accounts across the Group on which payments were more than 12 months in arrears. Within these accounts, the total

amount of principal outstanding was £35.7m (2012: £36.8m) and the total amount of arrears was £9.0m (2012: £9.0m), for which provision has been made where appropriate.

Corporate social responsibility

Employees

The Society recognises the importance of effective communication with staff. Communication includes an intranet site, in-house publications, conferences and regular team cascade meetings. Employee feedback is welcomed and encouraged through a variety of methods such as a joint staff and Management forum and participation in staff surveys. In addition, there is regular consultation with union representatives.

Great importance is placed on the recruitment, training and retention of high-calibre employees. Competitive remuneration packages and individual performance plans, clearly linked to corporate objectives through balanced business scorecards, are key elements in the reward strategy.

It is the Society's policy to ensure that all employees and applicants for employment are afforded equal opportunity regardless of gender, sexual orientation, ethnic origin, age or disability. Wherever practical, arrangements will be made for continuing the employment of, and arranging appropriate training for, employees who become disabled during their employment with the Society.

The Society's business objective is to provide Members with the benefits of a mutual organisation

Auditor

At the Annual General Meeting on 19 April 2013 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 41 to 43, is made by the directors to explain their responsibilities in relation to the preparation of the Annual Accounts, the Report of the Remuneration Committee, the Annual Business Statement and the Directors' Report.

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

- Select appropriate accounting policies and apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed; and
- Prepare the Annual Accounts on the going concern basis, unless it is inappropriate to presume that the Society will continue in business.

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

Directors' responsibilities for accounting records and internal controls

The directors are responsible for ensuring that the Group:

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

The directors have general responsibility for safeguarding the assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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.

Going concern

The Chairman's statement and Group Chief Executive's review on pages 1 to 5, together with the Business Review on pages 7 to 13, set out a review of the Group's business for the year and the Society's future plans. In addition, Note 40 to the financial statements on pages 83 to 98 gives details of the Group's financial instruments and hedging activities and its exposures to credit, liquidity and market risk. The principal risks and uncertainties faced by the Society and the Group, financial risk management objectives and policies, and the way in which the Group uses financial derivatives, are summarised in the Risk management report on pages 14 to 20 and in Note 40 on pages 83 to 98.

Gareth Wyn Jones, winner of the NFU Cymru/Principality Rural Community Champion Award, at the Royal Welsh Show.

As presented in the consolidated statement of financial position, the Group continues to meet its funding requirements, which include the need to maintain a sufficient liquidity buffer, mainly from retail sources. The current economic conditions create some uncertainty over the availability of wholesale funding in the foreseeable future.

The Group's forecasts and projections include scenario testing as carried out in accordance with the Internal Capital Adequacy Assessment Process (ICAAP) and Individual Liquidity Adequacy Assessment (ILAA), which are processes required by the Prudential Regulation Authority to demonstrate appropriate levels of capital and liquidity respectively under stressed scenarios reflecting the directors' views of different risks that might arise under varying economic conditions. These scenarios take account of reasonably possible changes in trading performance and show that the Group will be able to operate within the sources of funding currently available to it, even under stressed scenarios. In addition to these sources, contingency funding plans are in place.

The assets held for liquidity purposes are assessed and regularly reviewed for counterparty risks, and the directors consider that the Group is not exposed to losses on those assets that would affect the decision to adopt the basis of going concern. The directors consider that the overall level of capital, including Tier 1 capital of £412.7m (18.73% as a percentage of risk-weighted assets) and a solvency ratio of 20.20% are adequate.

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 on the Group's ability to continue in business for the foreseeable future. Accordingly, the financial statements continue to be prepared on a going concern basis.

The future

We fully expect the strained economic conditions to continue for some time, with increased pressures due to reductions in public spending. There is no doubt that against that backdrop, and as the impact of the ever tightening regulatory environment within which the Society operates is felt, there will be further consolidation within the sector. Public and political interest in financial services will not diminish, and we continue to work closely with our regulators, the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA).

Despite the difficult environment, the Board remains confident of Principality's continued position as a key player in the Welsh economy, well placed to weather the challenges that lie ahead.

On behalf of the Board of Directors

Dyfrig D. J. John
Chairman
4 February 2014

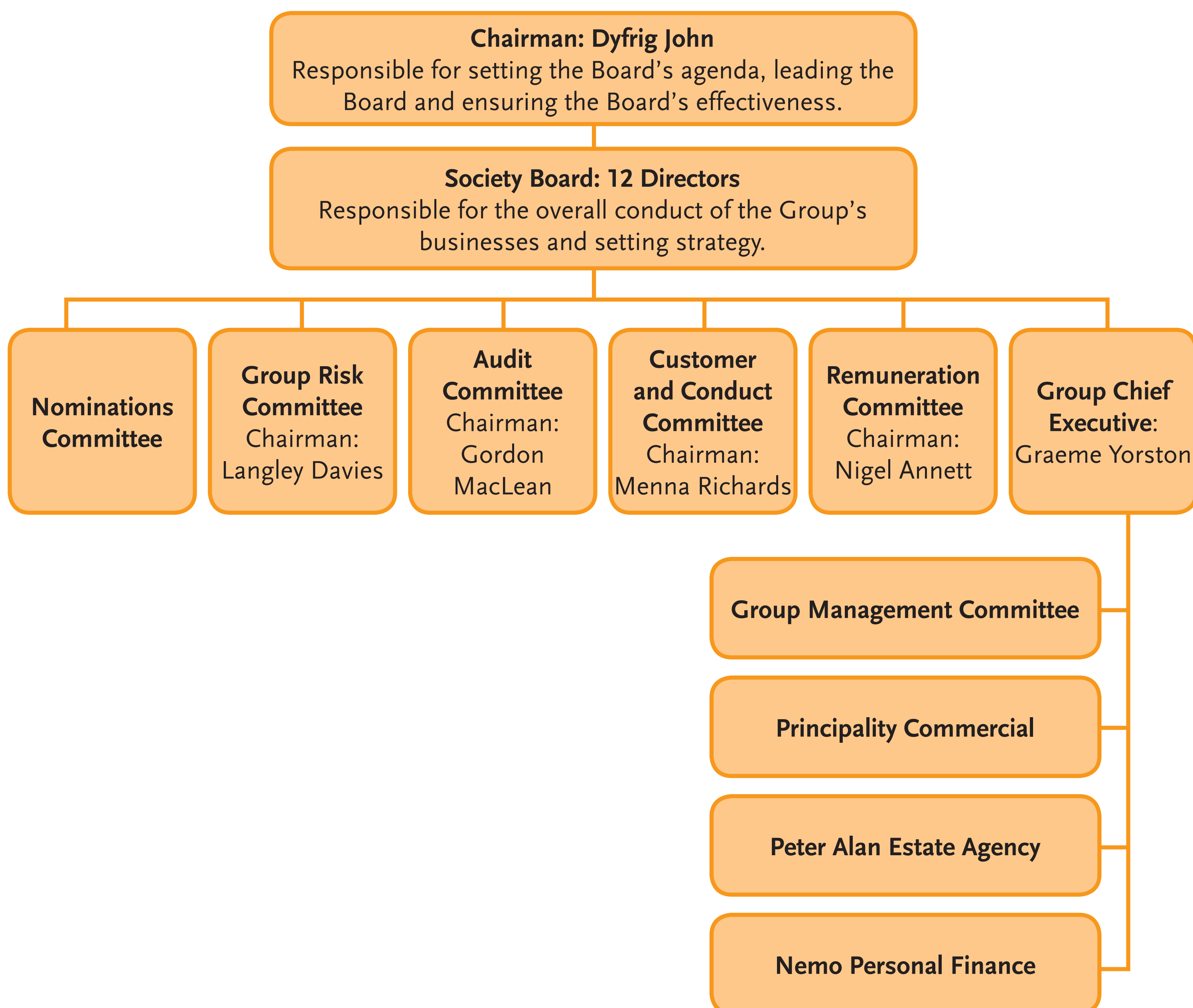
Corporate governance report

for the year ended 31 December 2013

The Society complies with the UK Corporate Governance Code (the Code) issued by the Financial Reporting Council in so far as its provisions are relevant to building societies. The Code is designed primarily to apply to listed companies and sets out standards of good practice in relation to board leadership and effectiveness, remuneration, and accountability amongst other matters. The new edition of the Code is effective for reporting periods beginning on or after 1 October 2012. The Code also provides guidance in relation to audit committees, risk, nominations and remuneration committees. This report summarises the Society's approach to corporate governance.

Corporate governance framework

The Board is responsible for ensuring that a strong and effective governance system and appropriate culture is in place throughout the Group. The work of the Board is supplemented by the work performed by a number of Board sub-committees.



How the Board operates

At 31 December 2013, the Board comprised four executive directors and eight non-executive directors. The offices of Chairman and Group Chief Executive are separate and held by different individuals. In accordance with the Code, all directors who were willing stood for re-election in 2013 and were duly re-elected. All directors willing to stand for re-election will again do so at the 2014 Annual General Meeting.

The Chairman leads the Board and is not involved in the day-to-day management of the Society. The Chairman's role profile has been approved by the Board and is reviewed annually. The Group Chief Executive's responsibilities are set out in a role profile approved by the Board.

The Board is responsible for the overall conduct of the Building Society and its subsidiary businesses and is accountable to the Society's Members for the proper conduct of those businesses. It focuses on the Group's strategy, the integrity of financial information and controls, operational and management performance, oversight of subsidiary companies and maintaining a system of effective corporate governance. The Board has a formal schedule of matters reserved for its decisions including the following matters:

- Responsibility for the overall strategic management of the Group;
- Approval of the Group's long term strategic objectives;
- Prescription of minimum capital limits/ratios, changes relating to the Group's capital structure;
- Approval of the Annual Report and Accounts including the corporate governance statement and remuneration report;
- Approval of the Group's Risk Appetite Statement; and
- Approval of any changes affecting the Group's risk management/governance frameworks.

A framework of delegated authority is in place, which extends to the Society's officers, management and various subsidiary company boards and management committees. This is reviewed annually by the Board. No political donations were made by the Society in the year.

Board composition

The Board consists of 12 directors including the Chairman, seven additional independent non-executive directors (including Langley Davies, Deputy Chairman and Gordon MacLean, Senior Independent Director) and four executive directors.

Executive and non-executive directors are equal members of the Board and are collectively responsible for setting the Group's strategy. In particular non-executive directors are required to have a wide range of skills and experience and exercise independent judgement on strategy, performance and risk management. In addition their role is to:

- Constructively challenge strategy proposals presented by the Group Chief Executive and executive directors;
- Scrutinise and challenge performance across the Group;
- Assess the integrity of the financial information and controls;
- Assess the adequacy of the Group's risk and conduct management framework;
- Determine the broad policy for executive remuneration and the remuneration packages for executive directors and the Chairman; and
- Be satisfied that an appropriate culture is in place across all Group businesses.

During the year Christopher Jones and Keith Brooks stepped down as non-executive directors. Early in the year Michael Jones, Group Risk Director and Stephen Hughes, Group Finance Director joined the Board as executive directors and in the second half of the year Nigel Annett and Laurence Adams were appointed to the Board. All four will stand for election for the first time in accordance with the Society's Rules at the 2014 Annual General Meeting.

Women directors constitute 25% of the Board and 43% of the non-executive directors. The Board gives consideration to all aspects of diversity, including gender. It has adopted the principle that all appointments should be made on merit.

Tenure of Non-Executive Directors

The UK Corporate Governance Code recognises that length of tenure is an important factor which should be considered when determining the independence of non-executive directors. The table below shows the tenure and independence of each non-executive director.

	Date first elected	Years from first election to 2013 AGM	Considered to be independent by the Board
Dyfrig John	April 2010	3	Yes
Gordon MacLean	April 2007	6	Yes
Langley Davies	April 2008	5	Yes
Joanne Kenrick	April 2010	3	Yes
Menna Richards	April 2013	Not applicable	Yes
Natalie Elphicke	April 2013	Not applicable	Yes
Laurence Adams	Not applicable	Not applicable	Yes
Nigel Annett	Not applicable	Not applicable	Yes

Conflicts of interest

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

- Changes to the commitments of all directors are reported to the Board;
- Directors are responsible for notifying the Group Secretary if they become aware of an actual or potential conflict situation;
- Actual or potential conflicts of interest are noted in the minutes of Board meetings as appropriate; and
- The Group Secretary maintains a register of potential conflicts of interest which is reviewed periodically.

No conflicts of interest were reported to the Board during the year except by Mrs Elphicke whose relationship with the law firm Stephenson Harwood continued through to April 2013. The directors considered the potential conflict and were satisfied that no issues arose.

All the Society's non-executive directors are considered by the Board to be independent in judgement and free of any relationships likely to affect his or her judgement having regard to the information in this report.

The Board operates through its regular monthly meetings and five committees – Audit, Remuneration, Nominations, Group Risk, and Customer and Conduct. All committees have written terms of reference. The terms of reference of all Board committees are reviewed annually together with the membership of those committees.

Group Management Committee

The Group Management Committee is chaired by the Group Chief Executive. It is the principal management committee of the Society and its subsidiary businesses. It is responsible for:

- Making recommendations to the Board concerning strategy, policies and budgets;
- Making recommendations to the Board in connection with new business initiatives and submitting investment appraisals to the Board;
- Ensuring that strategic, prudential, conduct and operational risks arising in connection with the Group's activities are managed effectively within the Board approved appetite for risk; and
- Monitoring the performance of the Society and its subsidiary businesses.

Board and Committee membership and attendance record

	Board	Audit	Customer and Conduct	Group Risk	Nominations	Remuneration	Property
Dyfrig John	14/14	-	-	-	3/3	3/3	-
Graeme Yorston	14/14	-	8/8	6/6	3/4	-	4/4
William Guy Thomas	14/14	-	-	-	-	-	4/4
Gordon MacLean	14/14	7/7	-	-	4/4	-	-
Langley Davies	13/14	6/7	-	6/6	1/1	-	3/3
Christopher Jones	3/4	-	-	-	-	2/2	-
Joanne Kenrick	11/14	-	7/8	-	-	-	-
Menna Richards	13/14	-	6/8	-	2/2	-	-
Keith Brooks	9/10	-	6/6	4/4	1/1	2/2	2/2
Natalie Elphicke	13/14	5/6	-	6/6	1/1	-	-
Robert Michael Jones	13/13	-	-	5/5	-	-	3/4
Stephen Hughes	12/12	-	-	-	-	-	-
Laurence Adams	4/5	-	-	1/2	1/1	1/1	-
Nigel Annett	4/4	-	2/2	-	1/1	1/1	-

Nominations Committee

The Nominations Committee is responsible for making recommendations for appointments to the Board. The Committee consists of three non-executive directors and the Group Chief Executive. It is chaired by Dyfrig John, the Society's Chairman, and meets as and when required to consider and recommend new appointments to the Board.

Non-executive candidates are sought in various ways, including through press advertisements and with the assistance of external search consultants. Candidates must meet the tests of fitness and propriety as prescribed by the FCA and must receive approval from the FCA as an Approved Person before taking up their role. In addition, the Society's Rules require that new directors must stand for election at the Annual General Meeting in the year following the year in which they are appointed.

When assessing new appointments to the Board, the combined skills and experience of the existing Board members is reviewed to determine what characteristics are required from a new director. Each member of the Board must have the skills, experience and character that will enable each director to contribute both individually, and as part of a team, to the effectiveness of the Board and the success of the Society. The Society believes that diversity amongst Board members is of great value but that diversity is a far wider subject than just gender. Careful consideration is given to issues of overall Board balance and diversity in making new appointments to the Board.

The Committee has written terms of reference which are reviewed annually. The Committee is responsible for succession planning and acts as a nomination committee for all new Board appointments. The terms upon which directors are appointed are available from the Group Secretary on request. The Committee reports on its activities to the Board.

A copy of the letter of appointment for a non-executive director can be obtained on request from the Group Secretary.

Audit Committee

The Committee is chaired by Gordon MacLean with Langley Davies and Natalie Elphicke as its other members, all of whom are independent non-executive directors. Gordon MacLean and Langley Davies have recent and relevant financial experience. The Group Chief Executive, the Group Finance Director, the Group Secretary, the Head of Group Audit, and representatives of Deloitte, the external auditor, attend each meeting. The Assistant Secretary acts as secretary to the Committee. The Committee acts as an Audit Committee for the Society and its subsidiary companies.

The Committee's responsibilities include:

- Monitoring the integrity of the Group's financial reporting;
- Reviewing the Group's internal control and risk management systems;
- Monitoring and reviewing the effectiveness of the Group's internal audit function;
- Ensuring that the system and controls for regulatory compliance are effective;
- Monitoring the effectiveness of the Group's Financial Crime Prevention function; and
- Monitoring the relationship between the Group and the external auditor.

During the year the Committee met on seven occasions. It monitored the integrity of the financial statements and formal announcements relating to the Group's financial performance and reviewed relevant accounting policies and any significant financial judgements.

The Committee has conducted detailed reviews of the interim and year-end financial statements, which have included consideration of the narrative reports, description of the Society's business model, strategy and risks faced by the Group, and recommended them to the Board for approval. Following discussion with both management and the external auditor, the Audit 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 assessment;
- Impairment provisions on loans and advances;
- Provisions for regulatory and customer complaints;
- Financial Services Compensation Scheme levy;
- Revenue recognition under IAS 39 using the effective interest rate method;
- Hedge accounting;
- Fair value measurements;
- Carrying value of investments in subsidiaries;
- Financing and funding transactions;
- Retirement benefit obligations; and
- Eurozone exposures.

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

The auditor has reported on both the interim and year-end financial statements, and those reports were considered by the Committee prior to recommending approval of the financial statements to the Board. In particular the auditor reported on the work carried out on the most significant areas of audit risk and where accounting assumptions and estimates have been applied and on how they satisfied itself that these were reasonable. Management confirmed to the Committee that they were not aware of any material misstatements or immaterial misstatements made intentionally to achieve a particular presentation. The auditor provided the Committee with a summary of misstatements identified during the course of the testing and no material amounts remain unadjusted.

During the year the Audit Committee also approved the Pillar 3 disclosures made in accordance with the FSA's Handbook BIPRU Chapter 11.

Dylan the dragon, Principality's mascot, takes in the sights and sounds of The Royal Welsh Show

The Committee is responsible for making recommendations to the Board on the appointment, reappointment, remuneration and removal of the external auditor and for the maintenance of an appropriate relationship with the Society's external auditor. During the year the Committee has reviewed and approved the external auditor's overall work plan and considered in detail the results of the audit, the performance and independence and the effectiveness of the overall audit process.

The Committee receives regular reports on the effectiveness of the Group's systems and controls framework including financial controls, internal control and risk management systems and controls. It has approved the Group Internal Audit plan and regularly reviewed the progress being made by the Internal Audit department, the adequacy of the resources available to that department, and Management's implementation of its recommendations. The Head of Group Internal Audit has direct access to the Committee Chairman and the Society's Chairman. The Committee has held private meetings with the Head of Group Internal Audit and Deloitte during the year. The Committee has held four private meetings in the absence of Management during the year.

The Committee has received regular reports from the Head of Group Financial Crime Prevention on financial crime matters, the progress of the Financial Crime team and adequacy of the resources available to that team. It has also reviewed the Group's 'whistleblowing' procedures and has been satisfied that arrangements are in place to enable individual employees to raise concerns about possible improprieties on a confidential basis. The Group maintains a financial crime policy, and the Audit Committee receives an update at each meeting in relation to any material fraud and associated action taken.

Immediately following each Audit Committee meeting, the Chairman of the Audit Committee provides a verbal update to the Society's Board of Directors on matters considered by the Committee. In addition, the Board receives the agenda and minutes of meetings of the Committee.

The Committee conducts an annual review of its own effectiveness. This process involves a collective review by members of the Committee of: its own procedures; resources available to the Committee; the means by which the Committee performs its role; review of its relationship with the Board; and arrangements for reporting to Members on the work of the Committee.

Auditor independence

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

In order to safeguard auditor objectivity and independence, the Audit Committee maintains a formal policy which governs the engagement of the external auditor (presently Deloitte LLP) 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. It identifies engagements that can only be undertaken with appropriate authority from the Committee Chairman or the Committee where non-audit fees will exceed pre-set thresholds. The Committee receives a schedule of fees for non-audit work paid to the audit firm at each meeting and 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 £140k. Non-audit fees, mainly in relation to the provision of taxation services, were £185k.

The Audit Committee assesses annually the qualification, expertise, resources and independence of the external auditors. The Committee conducts a formal review of the effectiveness of the annual audit. Members of the Committee and senior members of the Group Finance team consider a number of relevant questions. The Committee conducts this evaluation without the auditors being present. There is regular rotation of the audit partner responsible for the audit engagement (the present audit partner has been in place since 2012), and each year the external audit firm confirms to the Audit Committee that it considers itself to be independent as defined by the then current rules of the Institute of Chartered Accountants in England and Wales.

In considering the re-appointment of the audit firm, the Audit Committee has discussed the length of tenure of Deloitte LLP and the circumstances under which a re-tender for the provision of external audit services would be appropriate. Deloitte LLP took up their role as the Society's auditor in 2007 following the completion of a tender process in that year. As a consequence of the fact that the existing auditor has served for longer than five years and in accordance with the existing policy framework, the Audit Committee considers annually whether to commence the competitive tender process for the audit. In 2013 the Committee concluded that the external auditor continued to meet the test for independence and agreed that it was not necessary to commence the competitive tender process in 2013. Taking account of these factors the Audit Committee recommended the re-appointment as auditor to the Board and this resolution will be put to Members at the 2014 Annual General Meeting.

Remuneration Committee

This Committee of non-executive directors is chaired by Nigel Annett. Until April 2013 it was chaired by Christopher Jones. The other members during the year were Keith Brooks until October 2013, Laurence Adams from November 2013 and Dyfrig John. It considers remuneration policy, and the Board delegates to this Committee decisions on executives' remuneration and compensation packages. The Committee monitors changing trends in directors' remuneration in the marketplace including consideration of the FCA Code on Remuneration Practice. The Committee is responsible for maintaining the Group's Remuneration Policy. In performing its duties the Committee draws on the advice of independent consultants who have no other connection with the Society. No individual is present at a meeting when his or her own pay is decided. Fees payable to the Chairman and other non-executive directors are determined by the Board on recommendations from the executive directors. Details of directors' remuneration are set out on page 40.

The Committee reports on its activities to the Board.

Group Risk Committee

The Group Risk Committee is chaired by Langley Davies. During the year the other members of the Committee have been Keith Brooks, Natalie Elphicke, Laurence Adams, the Group Chief Executive and the Group Risk Director. A number of other senior managers from across the Group also regularly attend meetings of the Committee. The Committee is responsible for considering and recommending the Group's risk appetite, capital and liquidity adequacy to the Board and maintaining an appropriate risk governance structure.

The Committee reports on its activities to the Board.

A fuller report on risk management can be found on page 14.

Customer and Conduct Committee

During the year Nigel Annett joined the Committee and Menna Richards took over from Keith Brooks as Chairman of the Customer and Conduct Committee. Other members of the Committee are Joanne Kenrick, the Group Chief Executive and the Customer Director. The Group Risk Director, Group Human Resources Director, Group Secretary and a number of other senior managers from across the Group also attend meetings of the Committee regularly. The Committee is responsible for maintaining an appropriate Business Conduct Strategy and setting standards leading to good outcomes for customers across the Group. The Committee monitors the work undertaken by its subsidiary committee – the Customer Experience Forum. Amongst other activities, the Committee ensures that appropriate measures are in place to moderate the conduct-related risks inherent in the Group's activities, that the Group adheres to the principles underpinning the Retail Conduct Strategy, that the needs of customers are central to the Group's operations and that a customer-focused culture is maintained.

The Committee reports on its activities to the Board.

Copies of the Terms of Reference for each Board Committee are available on request from the Group Secretary. They can also be found on the Society's website: www.principality.co.uk.

Information and training

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.

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

The Society has a programme for meeting directors' training requirements. Newly appointed non-executive directors are provided with appropriate training on their role and responsibilities. Subsequent training is provided on an ongoing basis to meet particular needs.

Performance evaluation

The Chairman conducts an annual performance evaluation interview with each non-executive director and the Group Chief Executive. The Group Chief Executive carries out an annual performance appraisal with each of the other executive directors.

During 2013 the Board undertook an evaluation of the performance of the Chairman and an evaluation of its own performance. The Audit, Remuneration, Customer and Conduct Committee and Group Risk Committees each undertake annual reviews of their own effectiveness.

Branch Manager, Ceri Thomas with Cwmbran Park Bowling Club. Our Cwmbran branch provided new kit for 30 people at the club.

Communication with Members and the Annual General Meeting

The Society encourages all eligible Members to participate in the Annual General Meeting, either by attending in person or by voting by proxy. A resolution on the Report on Directors' Remuneration is included on the agenda. Voting is encouraged through a donation to charity for each voting paper received. All proxy votes are returned to independent scrutineers, who also attend the Meeting to count votes cast by Members in person. In accordance with the Society's Rules, all eligible Members are sent the Notice of the Annual General Meeting at least 21 days prior to the meeting.

Risk management and internal control

The Board has overall responsibility for maintaining sound risk management and internal control systems and for reviewing their effectiveness. It includes financial, operational and compliance controls as well as risk management. The processes used to assess the effectiveness of the internal control system, and which have been in place throughout the year, include the following:

- Regular operational and financial reviews of performance against budgets and forecasts by Management and the Board;
- Regular reviews by Management and the Audit Committee of the scope and results of internal audit work across the Group. The scope of the work covers all key activities of the Group and concentrates on higher risk areas;
- Reviews by the Audit Committee of the scope of the work of the external auditor and any significant issues arising;
- Reviews by the Audit Committee and the Board of accounting policies and delegated authority levels; and
- Consideration by the Group Risk Committee and the Board of the major risks facing the Group and procedures to manage them.

There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Group. The process currently consists of:

- Formal identification by management across the Group through a self-assessment process of the key risks to achieving its business objectives and the controls in place to manage them. The likelihood and potential impact of each risk is evaluated;
- Independent review by Group Internal Audit as to the existence and effectiveness of the risk management activities; and
- Regular review by the Board, the Group Risk Committee and the Customer and Conduct Committee of perceived strategic and conduct risks.

This process has been in place throughout the year. The Group Risk Committee receives reports on the status of these risks. The Committee reports on this to the Board which in addition carries out regular exercises to validate Management's conclusions on the major strategic risks facing the Group.

Dyfrig D. J. John
Chairman
4 February 2014

Report of the Remuneration Committee
for the year ended 31 December 2013

The report has been divided into separate sections for audited and unaudited information.

Unaudited information

Introduction

I am pleased to present the Remuneration Committee's 2013 Report which sets out the Remuneration Policy and provides details of the remuneration paid to executive and non-executive directors for the year to 31 December 2013.

The Remuneration Policy aims to align executive remuneration with the delivery of the Board's strategy.

The leadership team has delivered another good performance this year. Sound management and the benefits of strategies put in place in previous years have meant that the Group has a secure financial position which is key to ensuring that Members' savings are safe and our products and services are competitive and offer real value for our Members. The Committee believes that having appropriate remuneration policies in place, as summarised in this Report, has contributed to this positive result.

We keep the Remuneration Policy under review to ensure that it continues to support what we aim to achieve for the Society and its Members. In respect of 2013 the Committee implemented an important change to the calculation of pay for the executive directors by establishing a single, annual variable pay scheme, with deferral. This scheme significantly reduces the maximum variable pay award that can be achieved. The effect of this change has been to reduce both the "on target" and the potential maximum remuneration payable to executive directors by over 20%.

This important change follows other changes that the Committee has made in recent years to the application of its Policy including increasing the importance of achieving good outcomes for Members and customers in the calculation of variable pay. While it is appropriate that the remuneration of the leadership team reflects financial and service performance, we do not want Members to have any concern that too much weight is being placed on variable pay, or on only a small number of key performance measures. Alongside the overall level of remuneration we offer, getting the balance right between base salary and variable pay is an important judgement that has to be made by the Committee on behalf of the Society and Members. This judgement is informed by best practice elsewhere as well as regulatory guidance. The variable pay policy is also important in signalling to colleagues and to Members what the Board's priorities are with regard to the outcomes it aims to achieve, in particular the management of risk.

Principality is committed to best practice in corporate governance, and as such we provide full details of directors' remuneration and ask Members to approve the Remuneration Report through an advisory Member vote at the Annual General Meeting. The Report includes the key disclosure requirements of the UK Corporate Governance Code relevant to the Society and follows sector best practice as well as complying with regulatory requirements, including the PRA Remuneration Code. On behalf of the Remuneration Committee of the Board, I am happy to recommend this Report to Members for approval at the Annual General Meeting.

Nigel Annett
4 February 2014

Remuneration Policy

We are proud to be a mutual building society owned by our Members. Our purpose is to deliver good outcomes for Members and customers, looking after Members' funds and helping other Members to own their own homes. This means we must keep Members' savings safe, and we must offer good and competitive products and services to Members and customers that meet their needs. To do all of this, we must generate sufficient profits to ensure that we maintain a strong capital base and secure financial position. We must also run the Group efficiently, keeping costs under control and always taking a prudent and cautious approach to managing risks. This thinking underpins the Remuneration Policy which is designed to ensure that the Group is run safely and successfully for Members.

The Remuneration Policy aims to:

- Attract, motivate, reward and retain high quality people who can ensure that Principality continues to deliver value to Members and to be profitable in a competitive and often uncertain marketplace by positioning basic salaries and benefits, both in terms of total amount and structure (i.e. the balance of fixed and variable pay), at around market levels for similar roles within the UK mutual building society sector, as well as more broadly where this is appropriate;
- Incentivise performance by having a competitive variable pay scheme which rewards executive directors for meeting or exceeding challenging objectives set by the Board each year where performance is judged against a basket of financial and customer service measures; and
- Encourage sound risk management practices, in particular by setting capital and liquidity hurdles that must be met before any variable payment can be made and by deferring an element of variable pay which allows the Remuneration Committee to reduce or withhold the deferred element if it turns out that the basis on which the variable pay award was made was wrong or that financial performance has deteriorated materially before the deferred payment is made.

We do not anticipate any changes to the Remuneration Policy in 2014.

The work of the Remuneration Committee

The members of the Remuneration Committee during 2013 were Christopher Jones (as Chairman until he retired from the Board in April 2013), Keith Brooks (until he retired from the Board in September 2013), Dyfrig John, Nigel Annett and Laurence Adams. In October Nigel Annett was appointed Chairman of the Remuneration Committee, and at the same time he was joined by Laurence Adams as a member. All members of the Remuneration Committee are independent non-executive directors.

The Committee is responsible for determining, on behalf of the Board, the overall remuneration practices and policies for all colleagues and, in particular, the level of remuneration of the four executive directors as well as nine other senior "Code Staff", who are key individuals who have been identified by the Committee as having a potential material impact on the Society's risk profile (as defined by the PRA Remuneration Code). The Terms of Reference for the Remuneration Committee can be found on the Principality website.

The Committee met formally on three occasions during the year (2012: nine), and a number of remuneration matters during the year were considered by the Board rather than at a meeting of the Remuneration Committee. Activities during the year included:

- The implementation of the new executive variable pay scheme;
- Agreeing the performance targets for awards to be made under the 2013 executive variable pay scheme and reviewing the outcomes which were paid in respect of the year;
- Ongoing work in relation to sales incentive schemes in the light of the FCA guidance paper on "Risks to Customers from Financial Incentives";
- Agreeing the arrangements for auto-enrolment into the pension scheme for the Group. Under government legislation employers must automatically enrol their employees into a pension scheme with a minimum level of contributions. Colleagues across the Group who are not in the pension scheme will be automatically enrolled in the Society's pension scheme effective from 1 January 2014; and
- Approval of the annual pay review.

The Committee draws on the advice of independent external advisors as necessary. This year KPMG has provided advice on auto-enrolment as well as the future pension strategy following the completion of the annuity purchase in 2012.

Elaine Morris, Group Secretary, acts as secretary to the Committee. The Group HR Director and the Group Risk Director attend most Committee meetings and provide specialist advice as required. The Group Chief Executive and the Group Finance Director are also asked to attend the Committee's meetings when their input is required on specific issues. Executives are not involved in any Remuneration Committee discussions concerning their own pay.

Implementation of the Remuneration Policy

Executive director remuneration comprises base salary plus benefits (car allowance, pension and medical cover) plus variable pay which rewards performance against challenging targets set by the Board and personal objectives for each executive director.

Base salary

Base salary determined by the Committee reflects the individual's skills, experience and performance as well as the responsibilities associated with the role. The Committee considers salary levels for similar roles within a comparator group of the largest building societies. When determining executive salaries the Committee has regard to economic factors, remuneration trends and the general level of pay across the Group.

R Michael Jones, Group Risk Director, and Stephen Hughes, Group Finance Director, were appointed to the Board in February and March 2013 respectively. Their base salaries and total remuneration were benchmarked and set prior to appointment. Guy Thomas was appointed as Group Chief Operating Officer in February 2013. His salary and total remuneration were benchmarked, and while his base salary was increased the total potential earnings was reduced by around 20% because of the Committee's decision to reduce the maximum variable pay level.

Graeme Yorston, Group Chief Executive, having been appointed in October 2012, did not receive a pay increment in 2013; indeed, the total remuneration package of the Chief Executive in 2013 was 19% lower than that of the previous Chief Executive. Michael Jones and Stephen Hughes, following their appointments to the Board, also did not receive a pay increment in 2013. Guy Thomas did receive an annual salary review in 2013 and was awarded an increment of 2.25%, equal to the average increase for all colleagues in 2013.

At the end of 2013 Michael Jones took on more responsibility and so his remuneration will be benchmarked and reviewed in 2014. All the other executive directors have been awarded a pay increment of 2.25% for 2014 which is the same as the average pay increase for all colleagues in 2014. In formulating and applying the Remuneration Policy including increments to base salary, the Committee considers remuneration arrangements across the Group and indeed more generally.

Variable pay

The reduction in variable pay for executive directors – reducing the maximum that can be achieved from 100% to 40% and reducing "on target" variable pay to 20% of base salary – is an important change in the application of the Remuneration Policy and signals a general shift in the structure of remuneration practices across the Group. In particular in the Society, the variable pay of customer service colleagues is now much more limited and is based on team performance and customer satisfaction as well as behaviours and personal objectives rather than sales volumes.

Variable pay for executive directors is calculated on the basis of performance against targets set by the Board for the following four measures, two of which are financial and two of which capture customer satisfaction with the service we give Members. In addition, each executive director has personal objectives which if not achieved can reduce the variable pay award. The Committee reviews and approves actual variable pay awards having considered what has been achieved by the Group and by each executive director.

Basket of financial and customer satisfaction measures					
Metric	**Note**	**Weighting**	**On target**	**Maximum**	**Actual results**
Return on assets ratio compared with our peers	1	25%	10 basis points better than the average result	20 basis points better than the average result	Will not be available until June 2014
Group profit before tax		25%	£25.7m	£30.8m	£28.7m
Customer satisfaction index	2	25%	Score of 85%	Score of 87%	Score of 86%
Customer net promoter score	3	25%	6th best	3rd best or above	1st

Notes:

1 Return on assets ratio is the Society's post-tax profit expressed as a percentage of the average value assets held during the year. This ratio is used by the sector as a comparator of financial performance.

2 Customer satisfaction index is independently collected by a firm measuring customer satisfaction over the 12 month period.

3 The net promoter score is compiled by an independent company which carries out research across the financial services sector with customers to gauge the standing of each firm by asking customers if they would recommend to others the firm they have their savings with; this allows us to judge where we rank against other firms in the financial services sector.

Certain additional conditions must be satisfied before any variable pay can be awarded. In particular, the variable pay scheme specifies capital and liquidity hurdles, set above minimum regulatory requirements, which the Society must meet before any variable pay award can be made. These capital and liquidity hurdles relate to the capital and cash or cash equivalents we must hold to support lending activities. At the end of 2013 capital and liquidity levels were materially above the minimum regulatory requirements.

In accordance with the variable pay scheme rules, half of the scheme's award for 2013 will be paid in two tranches, in February and in June 2014 when we will know how the return on assets ratio compares with peers. Under the scheme rules, the remaining half of the award will be deferred and paid in February 2015. The deferred award is subject to annual review, and may be reduced or withdrawn at the discretion of the Committee in the event that the original assessment of performance was misleading or if performance declines substantially prior to the payment of the deferred award.

In respect of 2013, the variable pay awards to the executive directors are as follows:

Graeme Yorston, Guy Thomas and Stephen Hughes are eligible for an award of 24.4% in respect of performance for 2013 against the targets for group profit before tax, customer satisfaction index and customer net promoter score (see table above). R Michael Jones, Group Risk Director, does not participate in any variable pay scheme as we believe it is inappropriate for the executive responsible for Risk to do so.

The Committee does not anticipate any changes to the executive variable pay scheme in 2014 although it will be kept under review against the test of ensuring that our Remuneration Policy and its implementation align with our aim of delivering the best outcomes for our Members.

Service contracts

Executive directors' terms and conditions of employment are detailed in their individual contracts which include a notice period of 12 months. Each contract includes a provision for a termination payment in lieu of notice up to a maximum of 12 months' salary and benefits. In addition a discretionary payment may be made in respect of a variable pay award depending on the circumstances and according to the rules of the executive variable pay scheme.

	Date of contract
Graeme Yorston	31/12/07
Guy Thomas	14/11/06
Stephen Hughes	07/03/13
R Michael Jones	01/02/13

Pension arrangements

All executive directors receive pension contributions of 15% of base salary payable into a defined contribution scheme or elected to be paid as a cash allowance. These pension contributions are recorded in the directors' remuneration table below. Life assurance of four-times basic salary in the event of death in service is provided.

Non-executive directors' remuneration

The Chairman, Deputy Chairman, Senior Independent Director and non-executive directors do not have service contracts and are subject to re-election at each year's Annual General Meeting.

Non-executive directors are paid a basic fee for participation on the Board. The non-executive directors receive additional fees payable for providing services on Board Committees and for their membership of subsidiary company boards. The fees for the Chairman, Deputy Chairman, Senior Independent Director and non-executive directors are set by the Board, based on recommendations from the executive directors and external benchmarking from time to time.

In 2013 the Chairman, Deputy Chairman, Senior Independent Director and non-executive director basic fees were increased by 2.25%, equal to the average increase for all colleagues, while the fees for services on Board Committees and subsidiary company boards were not increased.

In October 2013 Langley Davies was appointed as Deputy Chairman, Gordon MacLean as Senior Independent Director and Menna Richards as Chair of the Customer and Conduct Committee, and their fees in 2013 reflect these additional responsibilities. Details of non-executive directors' remuneration are set out below. The Chairman, Deputy Chairman, Senior Independent Director and non-executive directors do not participate in any variable pay schemes or any pension arrangements.

Audited information

Directors' remuneration in respect of the year to 31 December 2013

The following disclosure in this report (and the following section concerning executive directors' pension arrangements) contains information which is audited.

	Salary & fees	Benefits	Annual bonus	Sub-total	Pension	Total
	£000	£000	£000	£000	£000	£000
Executive 2013						
Graeme Yorston	310	14	77	401	47	448
Guy Thomas	256	14	64	334	38	372
R Michael Jones (from 1 February 2013)	170	7	-	177	26	203
Stephen Hughes (from 7 March 2013)	176	9	59	244	26	270
Total	**912**	**44**	**200**	**1,156**	**137**	**1,293**
Executive 2012						
Peter Griffiths (to 30 September 2012)	232	10	139	381	35	416
Guy Thomas	216	13	130	359	32	391
Graeme Yorston	231	11	111	353	35	388
Total	**679**	**34**	**380**	**1,093**	**102**	**1,195**

	Fees	
	2013*	2012
	£000	£000
Non-executive directors		
Dyfrig John	91	87
Christopher Jones (to 18 April 2013)	15	43
Gordon MacLean	61	58
Langley Davies	63	68
Keith Brooks (to 29 September 2013)	50	65
Joanne Kenrick	45	44
Menna Richards (from 1 June 2012)	45	21
Natalie Elphicke (from 23 July 2012)	49	18
Laurence Adams (from 28 August 2013)	12	-
Nigel Annett (from 21 October 2013)	12	-
Sub-total	**443**	**404**
Executive remuneration total	**1,293**	**1,195**
Total	**1,736**	**1,599**

*Includes the impact of changes to non-executive committee appointments made in 2012.

1 The 2012 variable pay scheme contained a return on assets measure against the average performance of a comparator group of mutual building societies. This was recalculated in June 2013 once the full set of comparator information was available. This resulted in an additional variable pay award of £6k earned by executive directors. This sum is payable over three years.

2 The 2013 variable pay scheme contains a return on assets measure against the average performance of a comparator group of mutual building societies. Since all the results of other societies are not available until May 2014 an assumption has been made in respect of Principality's on-target performance relative to the comparator group (i.e. 5% of base salary). This figure will be adjusted upwards or downwards to reflect actual performance once the 2013 results for the comparator group are published.

3 50% of the variable pay award is paid in 2014 and 50% is paid in 2015 subject to review and confirmation by Committee.

4 The figures under benefits include company car/car allowance, fuel allowance and personal medical insurance.

5 Awards under the variable pay scheme are non-pensionable.

Executive directors' pension arrangements

In addition to the current pension arrangements noted on page 39, Guy Thomas is a member of the Society's defined benefit pension scheme which closed to future accrual in 2010. The scheme is a "career average" scheme whereby members earn a pension of 1/60th of their salary each year, index linked to the Retail Prices Index, up to retirement age.

Guy Thomas' accrued annual pension entitlement at 31 December 2013 was £21k (2012: £21k). His normal retirement date is 5 November 2015. Michael Jones' accrued annual pension entitlement at 31 December 2013 was £18k (2012: £17k). His normal retirement date is 19 June 2018.

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

In our opinion the financial statements:

- Give a true and fair view, in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31 December 2013 and of the Group's and the Society's income and expenditure for the year then ended; and
- Have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the group financial statements, Article 4 of the IAS Regulation.

The financial statements comprise Group and Society Income Statements, Group and Society Statements of Comprehensive Income, Group and Society Statements of Financial Position, Group and Society Cash Flow Statements, the Accounting Policies and the related Notes 1 to 41. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

Going concern

We have reviewed the directors' statement contained on page 29 that the Group is a going concern. We confirm that:

- We have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- We have not identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.

Assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team:

Risk	How the scope of our audit responded to the risk
Loan loss provisions Determining provisions for bad and doubtful debts against loans to customers is judgemental requiring an estimate to be made of the likely loss within the residential mortgage, commercial and secured personal lending portfolios. This requires estimation of future customer default rates, house price movements, sales costs, forced sale discounts and likelihood of repossession which may be sensitive to changes in the economic environment.	We challenged the appropriateness of Management's key assumptions used in the impairment calculations for loans and receivables, including the estimation of house prices, sales costs, forced sale discounts and likelihood of repossession by benchmarking against internal and external data and testing the underlying controls to the provisioning process. We also tested the accuracy and completeness of the provision calculation by testing an extraction of source data from the core lending systems and recalculating the provision in accordance with the approved provisioning policy and the identification of impaired accounts.
Provisions for regulatory and customer complaints The assessment of the Group's calculation of provisions for conduct remediation is judgemental due to inherent uncertainty around complaint volumes, uphold rates and redress costs.	We challenged the appropriateness of Management's key assumptions used in the provision by assessing estimated future cash flows and volumes of complaints against historical analysis of critical data inputs including complaint volumes, uphold rates and redress costs and also by performing internal benchmarking.
Financial Services Compensation Scheme levy Accounting for the Financial Services Compensation Scheme (FSCS) is reliant on data extracted from the core savings system and involves making assumptions regarding the Group's share of industry protected deposits. There is also uncertainty regarding the extent to which additional levies will be raised to cover future capital shortfalls on the loans to HM Treasury and therefore the extent of any contingent liabilities to be disclosed in the financial statements.	We challenged the accuracy of the provision for the FSCS levy by performing an independent calculation of the amount based on information published by the FSCS and internal data from the core savings system. In respect of the deposit balances guaranteed by the FSCS we have tested the extraction of the data from the core savings system and by testing the identification of the underlying accuracy of the system data and the associated key controls.
Revenue recognition The recognition of revenue on loans using an effective interest rate method requires significant judgement by Management to determine key assumptions related to the expected life of each loan and the cash flows relating thereto. Such assumptions are also sensitive to changes in the economic environment.	We challenged the appropriateness of Management's key assumptions used in the recognition of revenue using the effective interest rate method as described in Note 1 by comparison against historical customer behaviour and performing analytical procedures to assess the sensitivity of key assumptions. We also performed focused testing of Management's controls over appropriate cut-off of fees and commissions as well as testing a sample of fees and commissions recognised pre and post year end.

Risk	How the scope of our audit responded to the risk
Hedge accounting The hedge accounting requirements are complex and require significant skilled input and oversight by Management as well as robust systems and controls particularly due to the number of both micro and macro hedge arrangements in the Society.	We tested Management's application of hedge accounting by testing hedge documentation and independently reperforming a sample of hedge effectiveness tests conducted during the year.
Carrying value of investments in subsidiary The carrying value of the Group's investment in, and loan to its subsidiary, Nemo, is material and requires significant judgement to determine the net present value of future cash flows into the Group including application of an appropriate discount factor.	We challenged the appropriateness of Management's key assumptions used to calculate the recoverability of the Group's investment in and loan to its subsidiary, Nemo, by comparing estimated future cash flows against historical performance and the latest corporate business plan. We benchmarked the discount factor applied and undertook analytical procedures to assess the sensitivity of key assumptions.
Financing transactions The accounting treatment for some of the Group's complex financing transactions requires a significant skilled input and oversight by Management and thorough understanding of the terms of each transaction to ensure appropriate recognition, derecognition and fair value measurement of associated assets and liabilities. Such complex transactions include: • The issue of Residential Mortgage Backed Securities; • Participation in the Funding for Lending Scheme; and • The sale, and origination and sale of secured personal loans and receivables by a subsidary of the Group, Nemo.	We challenged Management's accounting treatment of financing transactions including verification to supporting documentation including original contracts and cash receipts. We also reviewed the disclosure of such transactions in the annual report including disclosed levels of encumbrance.
Retirement benefit obligations The calculation of the present value of the retirement benefit obligations requires significant judgement in the selection of key assumptions and is highly sensitive to such assumptions. Management make significant judgements in respect of mortality, price inflation, discount rates, pension increases and earnings growth. Of these inputs, discount rate, general price inflation and mortality rates all have a significant impact on the pension liability balance sheet value.	We evaluated the appropriateness of Management's assumptions in deriving the defined benefit pension balance by benchmarking the assumptions in respect of the discount rate, inflation and mortality assumptions to those used in the market at 31 December 2013 and consulting with our pension specialists.

The Audit Committee's consideration of these risks is set out on page 33.

Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the financial statements is not modified with respect to any of the risks described above, and we do not express an opinion on these individual matters.

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.

We determined materiality for the Group to be £2.1m, which is 7.5% of pre-tax profit or 0.03% of total assets.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £42k, 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.

Opinion on other matters prescribed by the Building Societies Act 1986

In our opinion:

- 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 accounting records and 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.

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:

- Proper accounting records have not been kept by the Society; or
- The Group 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.

Our duty to read other information in the Annual Report
Under International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

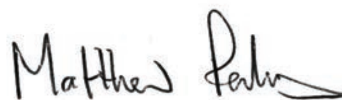
- Materially inconsistent with the information in the audited financial statements; or
- Apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- Otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed. We confirm that we have not identified any such inconsistencies or misleading statements.

Respective responsibilities of directors and auditor
As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of financial statements which give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

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 or the Society's Members as a body, for our audit work, for this report, or for the opinions we have formed.

Scope of the audit of the financial statements
An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Society's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.



Matthew Perkins
Senior Statutory Auditor
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Cardiff, United Kingdom
4 February 2014

Ben Davies, Lloyd Davies, Andrew Lee and Darren Timothy walked 22 miles around our nine city branches to raise money for the British Heart Foundation Cymru

Consolidated income statement

for the year ended 31 December 2013

	Notes	2013 £m	2012 (restated*) £m
Interest receivable and similar income	4	261.6	253.3
Interest payable and similar charges	5	(145.2)	(154.2)
Net interest income		116.4	99.1
Fees and commission receivable	6	24.1	24.5
Fees and commission payable	7	(1.0)	(1.2)
Net fee and commission income		23.1	23.3
Other operating income		0.9	1.0
Other fair value (losses)/gains	8	(1.2)	0.2
Net operating income		139.2	123.6
Administrative expenses	9	(68.7)	(64.8)
Depreciation and amortisation	24 & 25	(6.9)	(6.4)
Operating expenses		(75.6)	(71.2)
Impairment provision for losses on loans and advances	21	(22.4)	(16.3)
Provision for other liabilities and charges	22	(12.5)	(11.9)
Operating profit		28.7	24.2
Other gains	35	-	1.5
Profit before taxation		28.7	25.7
Taxation expense	13	(6.5)	(6.7)
Profit for the year		**22.2**	**19.0**

Consolidated statement of other comprehensive income

	Notes	2013 £m	2012 (restated*) £m
Profit for the year		22.2	19.0
Actuarial loss on retirement benefit obligations	12	(4.3)	(7.6)
(Loss)/gain on available-for-sale assets		(8.2)	1.8
Taxation expense	13	2.2	1.3
Total comprehensive income for the year	**37 & 38**	**11.9**	**14.5**

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

The accounting policies and notes on pages 51 to 99 form part of these accounts.

*Further information can be found in Note 1.

Income statement of the Society

for the year ended 31 December 2013

	Notes	2013 £m	2012 (restated*) £m
Interest receivable and similar income	4	224.9	216.3
Interest payable and similar charges	5	(145.2)	(153.8)
Net interest income		79.7	62.5
Fees and commission receivable	6	10.0	11.8
Fees and commission payable	7	(0.6)	(0.6)
Net fee and commission income		9.4	11.2
Other operating income		3.0	1.2
Other fair value (losses)/gains	8	(1.2)	0.2
Net operating income		90.9	75.1
Administrative expenses	9	(52.4)	(48.4)
Depreciation and amortisation	24 & 25	(5.6)	(5.1)
Operating expenses		(58.0)	(53.5)
Impairment provision for losses on loans and advances	21	(17.1)	(12.8)
Provision for other liabilities and charges	22	(4.5)	(2.6)
Operating profit		11.3	6.2
Other gains	35	-	1.5
Profit before taxation		11.3	7.7
Taxation expense	13	(2.6)	(2.1)
Profit for the year		**8.7**	**5.6**

Statement of other comprehensive income of the Society

	Notes	2013 £m	2012 (restated*) £m
Profit for the year		8.7	5.6
Actuarial loss on retirement benefit obligations	12	(4.3)	(7.6)
(Loss)/gain on available-for-sale assets		(8.2)	1.8
Taxation expense	13	2.2	1.3
Total recognised (expense)/income for the year	**37 & 38**	**(1.6)**	**1.1**

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

The accounting policies and notes on pages 51 to 99 form part of these accounts.

*Further information can be found in Note 1.

Consolidated statement of financial position

at 31 December 2013

	Notes	2013 £m	2012 (restated*) £m	2011 (restated*) £m
Assets				
Liquid assets:				
Cash in hand and balances with the Bank of England		355.6	498.2	532.9
Loans and advances to credit institutions	14	120.5	128.5	172.1
Debt securities	15	566.0	447.6	409.7
		1,042.1	1,074.3	1,114.7
Derivative financial instruments	16	37.6	43.6	45.5
Loans and advances to customers:				
Loans fully secured on residential property	18	5,409.0	5,039.2	4,644.9
Other loans fully secured on land	19	446.5	507.3	530.0
Other loans	18	49.1	45.2	45.2
	20	5,904.6	5,591.7	5,220.1
Intangible fixed assets	24	4.4	2.6	2.5
Property, plant and equipment	25	47.8	46.3	43.7
Deferred tax assets	34	4.3	4.3	3.3
Other assets	26	6.3	6.2	4.9
Prepayments and accrued income	27	11.0	15.3	15.0
Total assets		**7,058.1**	**6,784.3**	**6,449.7**

Liabilities				
Shares	28	5,562.6	5,467.0	5,013.8
Deposits and debt securities:				
Amounts owed to credit institutions	29	499.7	95.8	115.4
Amounts owed to other customers	30	225.1	345.7	306.9
Debt securities in issue	31	178.0	269.0	386.3
		902.8	710.5	808.6
Derivative financial instruments	16	26.2	49.4	57.4
Current tax liabilities		1.9	3.7	3.6
Other liabilities	32	8.4	8.5	8.6
Provisions for liabilities	22	12.7	9.9	24.7
Accruals and deferred income	33	8.7	9.8	9.9
Deferred tax liabilities	34	0.5	0.8	1.0
Retirement benefit obligations	12	17.1	13.2	11.5
Subordinated liabilities	35	92.3	92.3	107.0
Subscribed capital	36	70.2	76.4	75.4
Total liabilities		6,703.4	6,441.5	6,121.5
General reserve	37	357.7	339.4	326.2
Other reserves	38	(3.0)	3.4	2.0
Total equity and liabilities		**7,058.1**	**6,784.3**	**6,449.7**

The accounting policies and notes on pages 51 to 99 form part of these accounts.

These accounts were approved by the Board on 4 February 2014.

Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Graeme H. Yorston Group Chief Executive

Stephen Hughes Group Finance Director

*Further information can be found in Note 1.

Statement of financial position of the Society

at 31 December 2013

	Notes	2013 £m	2012 (restated*) £m	2011 (restated*) £m
Assets				
Liquid assets:				
Cash in hand and balances with the Bank of England		355.6	498.2	532.9
Loans and advances to credit institutions	14	49.8	50.3	72.3
Debt securities	15	566.0	447.6	409.7
		971.4	996.1	1,014.9
Derivative financial instruments	16	37.6	43.6	45.5
Loans and advances to customers:				
Loans fully secured on residential property	18	4,892.2	4,507.5	4,068.5
Other loans fully secured on land	19	446.5	507.3	530.0
	20	5,338.7	5,014.8	4,598.5
Investments in subsidiary undertakings	23	523.2	545.6	587.5
Intangible fixed assets	24	2.0	1.9	1.8
Property, plant and equipment	25	43.1	42.0	39.3
Deferred tax assets	34	4.1	4.2	3.3
Other assets	26	3.0	3.7	2.9
Prepayments and accrued income	27	9.9	14.4	14.0
Total assets		**6,933.0**	**6,666.3**	**6,307.7**

	Notes	2013 £m	2012 (restated*) £m	2011 (restated*) £m
Liabilities				
Shares	28	5,562.6	5,467.0	5,013.8
Deposits and debt securities:				
Amounts owed to credit institutions	29	582.4	252.1	317.5
Amounts owed to other customers	30	225.1	345.7	306.9
Debt securities in issue	31	26.2	34.4	83.8
		833.7	632.2	708.2
Derivative financial instruments	16	26.2	49.4	57.4
Current tax liabilities		0.6	1.5	1.1
Other liabilities	32	5.2	6.0	6.4
Provisions for liabilities	22	3.6	3.6	3.1
Accruals and deferred income	33	7.6	8.8	8.9
Deferred tax liabilities	34	0.5	0.9	1.1
Retirement benefit obligations	12	17.1	13.2	11.5
Subordinated liabilities	35	92.3	92.3	107.0
Subscribed capital	36	70.2	76.4	75.4
Total liabilities		6,619.6	6,351.3	5,993.9
General reserve	37	316.4	311.6	311.8
Other reserves	38	(3.0)	3.4	2.0
Total equity and liabilities		**6,933.0**	**6,666.3**	**6,307.7**

The accounting policies and notes on pages 51 to 99 form part of these accounts.

These accounts were approved by the Board on 4 February 2014.

Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Graeme H. Yorston Group Chief Executive

Stephen Hughes Group Finance Director

*Further information can be found in Note 1.

Consolidated statement of cash flows

for the year ended 31 December 2013

	2013 £m	2012 (restated*) £m
Net cash (outflow)/inflow from operating activities (see below)	(0.9)	10.3
Cash flows from investing activities		
Purchase of companies	(1.3)	-
Purchase of intangible assets and property, plant and equipment	(8.7)	(9.1)
Purchase of investment securities	(476.2)	(694.8)
Proceeds from sale and maturity of investment securities	349.5	658.7
Cash flows from financing activities		
Subordinated debt repurchase	-	(13.2)
(Decrease) in cash and cash equivalents	(137.6)	(48.1)
Cash and cash equivalents at beginning of year	603.6	651.7
Cash and cash equivalents at end of year	466.0	603.6
Represented by:		
Cash and balances with the Bank of England	355.6	498.2
Loans and advances to credit institutions repayable on demand	110.4	105.4
	466.0	603.6
Net cash inflow from operating activities		
Profit before taxation	28.7	25.7
Adjusted for:		
Depreciation and amortisation	6.9	6.3
Increase in impairment losses on loans and advances to customers	22.4	16.3
Change in fair values	18.0	9.5
Other non-cash movements	0.3	(1.4)
Changes in net operating assets		
Decrease in loans and advances to credit institutions	13.1	30.2
(Increase) in loans and advances to customers	(372.9)	(395.6)
(Increase) in other assets	(0.1)	(1.2)
Decrease/(increase) in prepayments and accrued income	4.4	(0.3)
(Decrease) in derivative financial instruments	(17.2)	(6.1)
Increase in shares	108.7	455.3
Increase/(decrease) in deposits and debt securities	192.5	(100.9)
(Decrease) in other liabilities	(0.6)	(0.1)
Increase/(decrease) in provisions for liabilities	2.8	(14.8)
(Decrease) in accruals and deferred income	(1.1)	(0.1)
(Decrease) in pension fund obligations	(0.3)	(6.0)
Taxation	(6.5)	(6.5)
	(0.9)	**10.3**

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2013 amounted to £10.4m (2012: £6.1m).

*Further information can be found in Note 1.

Statement of cash flows of the Society

for the year ended 31 December 2013

	2013 £m	2012 (restated*) £m
Net cash outflow from operating activities (see below)	(6.6)	(9.1)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(6.9)	(8.0)
Purchase of investment securities	(476.2)	(694.8)
Proceeds from sale and maturity of investment securities	349.5	658.7
Cash flows from financing activities		
Subordinated debt repurchase	-	(13.2)
(Decrease) in cash and cash equivalents	(140.2)	(66.4)
Cash and cash equivalents at beginning of year	535.5	601.9
Cash and cash equivalents at end of year	**395.3**	**535.5**
Represented by:		
Cash and balances with the Bank of England	355.6	498.2
Loans and advances to credit institutions repayable on demand	39.7	37.3
	395.3	535.5
Net cash inflow from operating activities		
Profit before taxation	11.3	7.7
Adjusted for:		
Depreciation and amortisation	5.6	5.1
Increase in impairment losses on loans and advances to customers	17.1	12.8
Change in fair values	18.0	9.5
Other non-cash movements	(0.1)	(1.4)
Changes in net operating assets		
Decrease/(increase) in loans and advances to credit institutions	3.1	(9.8)
(Increase) in loans and advances to customers	(378.6)	(436.7)
Decrease in loans to subsidiary companies	22.4	41.9
Decrease/(increase) in other assets	0.7	(0.5)
Decrease/(increase) in prepayments and accrued income	4.5	(0.4)
(Decrease) in derivative financial instruments	(17.2)	(6.1)
Increase in shares	108.7	455.3
Increase/(decrease) in deposits and debt securities	201.8	(79.0)
(Decrease) in other liabilities	(0.8)	(0.4)
(Decrease)/increase in provisions for liabilities	(0.1)	0.5
(Decrease) in accruals and deferred income	(1.2)	(0.1)
(Decrease) in pension fund obligations	(0.3)	(6.0)
Taxation	(1.5)	(1.5)
	(6.6)	**(9.1)**

*Further information can be found in Note 1.

Notes to the accounts
for the year ended 31 December 2013

1. Accounting policies

Basis of preparation
The Group and Society's financial statements for the year ended 31 December 2013 have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) 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 Group has taken early adoption of IFRIC 21Levies which has led to the restatement of prior year comparatives. Two restated comparative periods have been disclosed in the statement of financial position and Note 22. The IFRIC amends the trigger for recognition from the year end to the start of the FSCS scheme year in April.

The restatement has an impact on the prior year profit figures. The charge for 2012 has decreased from £3.2m to £2.2m, and the charge for 2011 has increased from £1.5m to £1.8m. The tax charge has also been restated to take account of this. The impact on the statement of financial position has been described in Note 22.

The revision of IAS 19 Employee Benefits became effective for accounting periods on or after 1 January 2013. The main impact for the Group is to change the recognition of the rate of return on assets to the income statement and to increase disclosures required for the defined benefit pension scheme in the Society. The prior year comparatives have been restated with an additional charge of £0.4m recognised in the income statement for 2012. The impact for 2013 was a charge of £0.6m. Note 12 includes new disclosures required under the revised standard.

The financial statements have been prepared on a going concern basis. This is discussed in the Directors' Report on page 28, under the heading "Going concern". At the date of authorisation of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue but not yet effective:

Pronouncement	Nature of Change	Effective Date
IFRS 10 Consolidated Financial Statements, IFRS 12 Disclosures of Interests in Other Entities, IAS 27 Consolidated and Separate Financial Statements	The amendments provide definitions for determining whether an entity is an investment entity and introduce an exception for consolidating certain subsidiaries in an investment entity. The amendments to IFRS 12 and IAS 27 also require new disclosures by investment entities. As the Group does not include an investment entity as defined by the amendments, this will not impact the Group's accounts.	Accounting periods beginning on or after 1 January 2014
IAS 32 Financial Instruments: Presentation	The amendments relate to offsetting of financial assets and liabilities, clarifying the meaning of "currently has a legally enforceable right to offset" and "simultaneous realisation of settlements". The amendment is not expected to have a significant impact on the Group's accounts.	Accounting periods beginning on or after 1 January 2014
IAS 36 Impairment of Assets	The amendments change the required disclosures for recoverable amounts on non-financial assets and were made as a consequence of issuing IFRS 13 Fair Value Measurements. The impact on the Group is expected to be limited to changes to wording on valuation techniques and key assumptions in the "Assets measured at fair value" note.	Accounting periods beginning on or after 1 January 2014
IAS 39 Financial Instruments: Recognition and Measurement	The amendments add a limited exception to the general rule of discontinuing hedge accounting when a novation occurs. Although no significant impact is expected as a result of these amendments, anticipated changes to the Group's method of entering into and settling interest rate swaps may have an impact on the determination of the accounting treatment for a limited number of previously existing swaps.	Accounting periods beginning on or after 1 January 2014
IFRS 2 Share-based Payment	The amendments clarify the definition of "vesting condition" by separately defining "performance condition" and "service condition". No impact on the Group is expected as it does not typically offer share-based compensation.	Accounting periods beginning on or after 1 July 2014

1. Accounting policies (continued)

Basis of preparation (continued)

Pronouncement	Nature of Change	Effective Date
IFRS 3 Business Combinations	The amendments clarify the classification and measurement of contingent consideration in a business combination. Entities will be required to treat contingent consideration according to IAS 32 Financial Instruments: Presentation when the consideration is a financial instrument. Further, the consideration must always be measured at fair value when it is classified as an asset or a liability. The amendment is not expected to have a significant impact on the Group's accounts.	Accounting periods beginning on or after 1 July 2014
IFRS 8 Operating Segments	The amendments require the explicit disclosure of judgements made by Management in applying criteria for the aggregation of operating segments. As the Group's operating segments are quite clear-cut, the extent of the impact to the Group is expected to be limited to the possible addition of wording to the Business segments note describing how the operating segments are determined.	Accounting periods beginning on or after 1 July 2014
IFRS 13 Fair Value Measurement	The amendments clarify that the standard does not intend to prevent entities from measuring short-term receivables and payables with no stated interest rate at their invoiced amounts without discounting if the effect of the discounting is immaterial. They also clarify that the exception whereby entities are allowed to measure the fair value of a group of financial assets and financial liabilities with offsetting risk positions on a net basis if certain conditions are met applies to contracts in the scope of IAS 39 and IFRS 9 without regard to whether they meet the definition of a financial asset or liability under IAS 32. These amendments are not expected to have any significant impact on the Group's accounts.	Accounting periods beginning on or after 1 July 2014
IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets	The amendments clarify that upon revaluing relevant assets, the amount by which accumulated depreciation or amortisation is adjusted need not be proportionate to the change in the gross carrying amount of the asset. These amendments are not expected to have any significant impact on the Group's accounts.	Accounting periods beginning on or after 1 July 2014
IAS 24 Related Party Disclosures	The amendment has extended the definition of related parties to include a management entity that provides key management personnel services to the reporting entity. This amendment is not expected to have any impact on the Group's accounts.	Accounting periods beginning on or after 1 July 2014
IAS 40 Investment Property	The amendments clarify that an entity should assess acquired properties to determine whether they are investment properties under IAS 40 or new businesses as defined by IFRS 3. This amendment is not expected to a have any significant impact on the Group's accounts.	Accounting periods beginning on or after 1 July 2014
IFRS 9 Financial Instruments	This standard has been proposed as a replacement for IFRS 7 Financial Instruments: Disclosures and IAS 39 Financial Instruments: Recognition and Measurement. The new standard addresses phase 1 of the IASB's project to replace IAS 39 and requires financial assets to be classified at amortised cost or fair value. The available-for-sale (AFS) category currently used by the Group will not be available. Early adoption is permitted. The impact of IFRS 9 on the Group is currently being considered. Whilst the proposed standard would bring in a number of changes related to categorisation and accounting treatment of financial instruments and related disclosures, only the proposals set out in the Expected Credit Losses exposure draft would have a material impact on the Group's accounts. These proposals would require entities to recognise 12 months' of expected losses on loans and receivables without regard to whether any specific impairment event has occurred, whereas the current standard (IAS 39) requires that expected losses only be recognised when a triggering event has occurred. Furthermore, when the credit risk of the counterparty is deemed to be impaired, lifetime expected credit losses are to be recognised in full. The standard will also introduce a significant number of new disclosures that could require adjustments to current transaction recording and reporting methods.	At its November 2013 meeting, the IASB tentatively chose a "placeholder" for the mandatory effective date as no earlier than annual periods beginning on or after 1 January 2017.

The directors anticipate that the adoption of these standards and interpretations in future periods, with the exception of IFRS 9, will not have a material impact on the financial statements of the Group. The impact of IFRS 9 is being considered but any impact cannot be quantified as this standard has not been finalised nor formally adopted by the EU.

The accounting policies set out on pages 51 to 58 have been applied consistently to all periods presented in these consolidated financial statements.

Notes to the accounts
for the year ended 31 December 2013

1. Accounting policies (continued)

Accounting convention
The Group prepares its accounts under the historical cost convention, except for the revaluation of debt securities - available-for-sale, certain financial assets and liabilities held at fair value and all derivative contracts.

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).

Subsidiaries
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.

Securitisation transactions
The Group has securitised certain mortgage loans by the transfer of the loans to a special purpose entity (SPE) controlled by the Group. The securitisation enables a subsequent issuance of debt by the SPE to investors who gain the security of the underlying assets as collateral. The SPE is fully consolidated into the Group's accounts under IFRS 10 Consolidated Financial Statements. The transfer of the mortgage loans to the SPE 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 SPE. In the accounts of the Society, the proceeds received from the transfer are accounted for as a deemed loan repayable to the SPE. To manage interest rate risk, the Society enters into derivative transactions with the SPE, receiving a rate of interest based on the securitised mortgages and paying a rate inherent in the debt issuance. In accordance with IAS 39, these internal derivatives are treated as part of the deemed loan and not separately fair valued because the relevant mortgage loans are not derecognised. Cash flows arising from these internal derivatives are accounted for on an accruals basis.

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 available-for-sale investments, derivatives and other financial assets accounted at fair value through the statement of other comprehensive income 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 commissions
Loan origination fees are reflected in the calculation of the effective interest rate on the loan.

Fees received under loan servicing and other business process outsourcing is reflected in the income statement in the period that the servicing is carried out. Other than at the point of loan de-recognition, all service contracts provide for charging clients on a monthly basis by reference to the portfolio size.

The Group receives trail commission based on the performance of previous sales of Payment Protection Insurance at the discretion of the life assurance company. The commission is recognised when payment is received.

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

Measurement of financial assets and liabilities
Financial assets
Financial assets are classified as:

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

1. Accounting policies (continued)

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

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

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

v) Financial assets held for trading
The Group does not hold any financial assets classified as held for trading.

Financial liabilities
Financial liabilities are measured at:

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

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

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

ii) Fair Value Through Profit and Loss (FVTPL)
Financial liabilities are classified as at FVTPL when the financial liability is designated as at FVTPL.

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

Financial liabilities at FVTPL are stated at fair value, with any gains or losses arising on remeasurement recognised in profit or loss. The net gain or loss recognised in profit or loss incorporates any interest paid on the financial liability and is included in the "other gains and losses" line item in the income statement. Fair value is determined in the manner described in Note 40.

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

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

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the

1. Accounting policies (continued)

difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions have been deducted from the appropriate asset values in the statement of financial position.

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

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

In the case of commercial loans that are not considered individually significant, cash flows are estimated based on past experience taking into account the total exposure to the customer, the likelihood that the loan will progress through the various stages of delinquency, including being written off and the amount and timing of expected receipts and recoveries.

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

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

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

Loans are assessed separately for impairment where they have been subject to previous forbearance activity and there is evidence that forbearance will have an impact on the future performance of the loan. For assessment purposes, loans are collectively assessed by forbearance type, taking into account historical performance. Definitions of forbearance are considered in Note 40 and in relation to the FSA's paper titled "Forbearance and Impairment Provisions – Mortgages" issued in October 2011. The Arrears Management Department maintains forbearance information which is reported regularly to Group Risk Committee.

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

Derivative financial instruments and hedge accounting

The Group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, interest rate caps, forward rate agreements, options 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, then 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".

1. Accounting policies (continued)

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.

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.

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.

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

Foreign currency translation
The consolidated financial statements are presented in Sterling which is the functional currency of the parent undertaking. Foreign currency transactions are translated into Sterling using the exchange rates prevailing at the dates of the transactions. Monetary items denominated in foreign currencies are translated at the rate prevailing at the date of the statement of financial position.

Intangible assets
i) Goodwill
Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisition of subsidiaries is included as an intangible asset. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. The impairment test compares the carrying value of goodwill to the underlying associated asset value in use. If the carrying value exceeds the value in use, goodwill is considered impaired and recognised in the income statement immediately.

Goodwill written off to reserves under UK GAAP prior to the introduction of FRS 10 Goodwill and Intangible Assets in 1998 has not been reinstated and will not be included in determining any subsequent profit or loss on disposal.

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

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

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

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

Taxation
The tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable 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 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, and is accounted for using the statement of financial position liability method. Deferred tax liabilities are

1. Accounting policies (continued)

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.

Deferred tax related to fair value re-measurement of available-for-sale investments, which is charged or credited directly to the available-for-sale reserve, is also credited or charged directly to the available-for-sale reserve and is subsequently recognised in the income statement together with the deferred gain or loss.

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

Property, plant and equipment

Freehold and long leasehold properties comprise mainly branches and office buildings. Valuations are completed annually by independent surveyors.

Property, plant and equipment are stated at cost less accumulated depreciation and provision for impairment, as appropriate. Additions and subsequent expenditure are included in the asset's carrying value or are recognised as a separate asset only when they improve the expected future economic benefits to be derived from the asset.

All other repairs and maintenance are charged to the income statement in the period in which they are incurred.

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

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

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

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

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. Pension scheme assets are measured using closing market values. Pension 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 increase in the present value of the liabilities of the defined benefit scheme expected to arise from employee service in the period is charged to the income statement. 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.

1. Accounting policies (continued)

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

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

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

Debt securities in issue, subordinated liabilities and Permanent Interest-Bearing Shares
Premiums and discounts, together with costs associated with the issue of debt securities, subordinated liabilities and Permanent Interest-Bearing Shares, are accounted for as an adjustment to the amount of the liability and amortised using the effective interest method.

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

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

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.

Government grants
Government grants are recognised at their fair value where there is a reasonable assurance that the grant will be received and the Group will comply with all the attached conditions.

Government grants are recognised as income in the income statement over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis.

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.

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for the year ended 31 December 2013

2. Judgements in applying accounting policies and critical accounting estimates

The Group has to make judgements in applying its accounting policies which affect the amounts recognised in the financial statements. In addition, 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 judgements and estimates are made are as follows:

Impairment provision on loans and advances

In accordance with the accounting policy on the impairment of financial assets carried at amortised cost where objective evidence exists that a loss has been incurred, the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate.

Key assumptions included in the measurement of the incurred loss include data regarding the probability of any account going into default, the probability of defaulted accounts progressing to possession and the eventual loss incurred in the event of forced sale or write-off. The House Price Index (HPI) and the discount applied on forced sale are key assumptions on the residential mortgage books. To the extent the HPI movements were to differ from current observations by 1%, the impact on provisions would be £1.0m. The impact of a 1% change in the forced sale discounts currently being experienced would impact provisions by £1.0m.

The loan loss provision against the Commercial lending portfolio is sensitive to a number of factors including: Commercial real estate values at the expected date of sale; the customer's business model and their capacity to trade successfully out of financial difficulties; and the likely funds available on liquidation or bankruptcy, including any guarantees.

These assumptions are based on observed historical data and updated as management considers appropriate to reflect current and future conditions. The accuracy of the impairment provision would therefore be affected by unexpected changes in the above assumptions.

Collateral values are updated at the date of each statement of financial position based on the best information publicly available. Land Registry data is used in the retail financial services sector with Hometrack being used in the secured personal lending sector. External valuations are used to estimate commercial security values and future cash flows.

Impairment provision on investment securities

Based on the best information available, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, it has been concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

Fair value of derivatives and available-for-sale assets

Derivative financial instruments and available-for-sale assets are stated at fair value. Derivative financial instruments are valued by discounted cash flow models using yield curves that are based on observable market data. Available-for-sale assets are, in the majority of cases, valued using market prices or prices obtained from counterparties. In cases where market prices are not available, discounted cash flow models are used. Changes in the assumptions used in the models could affect the reported fair value of available-for-sale assets.

The Group applies fair value hedge accounting which relies on a number of assumptions, the most significant of which relates to estimates in respect of loan prepayments.

Retirement benefit obligations

The Group has to make assumptions on the expected return on pension plan assets, mortality inflation and future salary rises when valuing its pension liability and the cost of benefits provided. Changes in assumptions could affect the reported liability, service cost and expected return on pension plan assets.

The impact of a 0.1% increase in the inflation assumptions would be to increase the carrying value of the pension obligations by approximately £0.9m. The impact of a 0.1% increase in the discount rate would be to reduce the value of pension obligations by approximately £0.9m.

Further details on the assumptions used in valuing retirement benefit obligations and other sensitivity analysis can be found in Note 12.

Effective interest rate (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.

The impact of a 10% change in the expected lives of financial instruments would result in an increase/decrease in the value of the loans in the statement of financial position by £0.5m/(£0.5m) respectively. The impact of a 10% change in the anticipated level of early redemption would result in an increase/decrease in the value of the loans in the statement of financial position by £0.7m/(£0.5m) respectively.

2. Judgements in applying accounting policies and critical accounting estimates (continued)

Other provisions for liabilities and charges

i) Customer and regulatory complaints

The Group holds provisions for customer and regulatory complaints.

The Group is undertaking a detailed and comprehensive review of processes and documentation in relation to compliance with consumer credit legislation which commenced in the second half of 2013 and is planned to be completed during the first half of 2014. To date a number of areas, which require further review have been identified and a charge of £8.0m has been recognised in respect of potential costs which will require remediation over the next 12 months. The provision assumes almost all customers will be contactable. For each 10% decrease in customers being contactable, the provision required would decrease by £0.8m.

Provisions have been made in respect of claims in relation to previous sales of Payment Protection Insurance (PPI) which, in the Group's case, relate to secured personal lending PPI products. The PPI remediation process is nearing completion. At 31 December 2013, the Group holds a provision of £1.1m (2012: £6.3m), which it expects to be sufficient to meet obligations in relation to previous sales of PPI. The level of provision is calculated based upon estimates of complaint volumes, the rate at which these claims are upheld and the level of redress paid on each complaint.

ii) Financial Services Compensation Scheme (FSCS) levy

Along with other deposit-taking institutions, the Group has a provision for liabilities under the FSCS. During the year, the IASB issued IFRIC 21 Levies which is effective for periods beginning on or after 1 January 2014. The IFRIC is an interpretation of IAS 37 Provisions, Contingent Liabilities and Contingent Assets. The IFRIC clarifies when a liability should be recognised for a levy, defining when the obliging event occurs. The IFRIC changes how the industry has recognised FSCS for both the capital and interest, changing the trigger date for recognition from 31 December to 1 April of the subsequent year, in line with the start of the scheme year. The Group has taken early adoption of IFRIC 21 and has restated two comparative periods in the statement of financial position and the impacted notes as per IAS 1 Presentation of Financial Statements. Details of the restatement are disclosed in Note 22.

As at 31 December 2013, the Group holds a provision of £2.3m in respect of levies payable in September 2014. The principal assumption underlying the provision relates to the interest charged on the loans funding the scheme by HM Treasury. A 1% increase in the expected level of interest would increase the value of the required provision by £1.2m.

The Group's ultimate liability for levies payable to the FSCS in respect of failed financial institutions remains uncertain. The provided amount is dependent upon the following factors:

- Future interest rates;
- Capital shortfalls from insufficient recoveries to fully repay loans from HM Treasury;
- The Group's share of industry protected deposits as at 31 December 2013; and
- The future structure of any replacement scheme.

Further detail of the FSCS and the provision held are included in Note 39.

Taxation

Significant estimates are required in determining the provision for corporation tax. There are a number of transactions for which the final tax determination is uncertain at the date of the statement of financial position.

3. Business segments

The Group operates four main business segments, retail financial services, secured personal lending, property services including estate agency and commercial lending. These segments are used for internal reporting to the Board which is responsible for all significant decisions. Transactions between the business segments are on normal commercial terms and conditions.

	2013					
	Retail financial services	Commercial lending	Secured personal lending	Property services	Adjustment for Group transactions	Total
	£m	£m	£m	£m	£m	£m
Net interest income	68.6	11.0	36.8	-	-	116.4
Other income and charges	6.3	2.0	4.0	13.3	(2.8)	22.8
Net operating income	74.9	13.0	40.8	13.3	(2.8)	139.2
Administrative expenses	(52.6)	(4.2)	(10.7)	(11.0)	2.9	(75.6)
Impairment provision for losses on loans and advances	(0.4)	(16.7)	(5.3)	-	-	(22.4)
Provision for other liabilities and charges	(3.4)	(0.6)	(8.4)	(0.1)	-	(12.5)
Operating profit/(loss)	**18.5**	**(8.5)**	**16.4**	**2.2**	**0.1**	**28.7**
Other gains	-	-	-	-	-	-
Profit/(loss) before taxation	**18.5**	**(8.5)**	**16.4**	**2.2**	**0.1**	**28.7**

	2012 (restated)					
	Retail financial services	Commercial lending	Secured personal lending	Property services	Adjustment for Group transactions	Total
	£m	£m	£m	£m	£m	£m
Net interest income	53.7	8.8	36.6	-	-	99.1
Other income and charges	9.5	2.0	3.8	11.8	(2.6)	24.5
Net operating income	63.2	10.8	40.4	11.8	(2.6)	123.6
Administrative expenses	(47.0)	(4.8)	(11.6)	(10.4)	2.6	(71.2)
Impairment provision for losses on loans and advances	(1.8)	(11.0)	(3.5)	-	-	(16.3)
Provision for other liabilities and charges	(2.2)	-	(9.3)	(0.4)	-	(11.9)
Operating profit/(loss)	**12.2**	**(5.0)**	**16.0**	**1.0**	**0.0**	**24.2**
Other gains	1.5	-	-	-	-	1.5
Profit/(loss) before taxation	**13.7**	**(5.0)**	**16.0**	**1.0**	**0.0**	**25.7**

During 2013 Group transactions have been recharged to the relevant business segment. The net adjustment for Group transactions of £4.6m for 31 December 2012 has been restated to reflect this change. In addition, 2012 has been restated on account of IFRIC 21 Levies and the revised IAS19 Employee Benefits.

3. Business segments (continued)

	Group	
	2013	2012
	£m	£m
Total assets by business segment		
Retail financial services	5,653.2	5,298.1
Secured personal lending	572.9	582.9
Commercial lending	822.9	897.8
Property services	9.1	5.5
Total assets	**7,058.1**	**6,784.3**
Total liabilities by business segment		
Retail financial services	6,478.3	6,197.6
Secured personal lending	570.7	581.2
Commercial lending	-	-
Property services	9.1	5.5
Total liabilities	**7,058.1**	**6,784.3**

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

4. Interest receivable and similar income

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
On loans fully secured on residential property	252.1	243.2	201.8	190.9
On other loans fully secured on land	20.0	23.1	20.0	23.1
On other loans to subsidiaries	-	-	13.6	15.7
On debt securities	5.4	6.2	5.4	5.8
Profit on realisation of investments	0.6	3.2	0.6	3.2
On other liquid assets	2.1	2.3	2.1	2.3
On derivative financial instruments	(18.6)	(24.7)	(18.6)	(24.7)
	261.6	**253.3**	**224.9**	**216.3**

5. Interest payable and similar charges

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
On shares held by individuals	137.0	142.4	137.0	142.4
On deposits and debt securities	11.1	16.2	11.1	15.8
On subscribed capital	4.2	4.2	4.2	4.2
On subordinated liabilities	1.4	2.0	1.4	2.0
On derivative financial instruments	(8.5)	(10.6)	(8.5)	(10.6)
	145.2	**154.2**	**145.2**	**153.8**

6. Fees and commission receivable

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Insurance and related financial service products	5.9	7.8	3.6	5.5
Estate agency	5.8	5.2	-	-
Mortgage related fees	5.1	5.1	5.1	5.1
Other fees and commission	7.3	6.4	1.3	1.2
	24.1	**24.5**	**10.0**	**11.8**

7. Fees and commission payable

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Mortgage related fees	0.6	0.8	0.2	0.2
Bank charges	0.4	0.4	0.4	0.4
	1.0	**1.2**	**0.6**	**0.6**

8. Other fair value gains and losses

	Group and Society	
	2013	2012
	£m	£m
Gains on derivatives	17.3	6.0
Losses on hedged items attributable to the hedged risk	(18.5)	(5.8)
	(1.2)	**0.2**

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.

Notes to the accounts
for the year ended 31 December 2013

9. Administrative expenses

	Group		Society	
	2013	2012 (restated)	2013	2012 (restated)
	£m	£m	£m	£m
Wages and salaries	37.6	35.0	28.1	25.4
Social security costs	3.7	3.4	2.8	2.5
Other pension costs	1.8	1.7	1.7	1.6
	43.1	40.1	32.6	29.5
Other administrative expenses	25.6	24.7	19.8	18.9
	68.7	**64.8**	**52.4**	**48.4**

		£000	£000	£000	£000
Other administrative expenses include:					
Auditor's remuneration:					
For audit of the Society's Annual Accounts		122	118	122	118
For audit of the Society's subsidiaries		8	8	-	-
Total		**130**	**126**	**122**	**118**
For other services:					
Tax advisory		174	56	174	53
Specialist consultancy		11	16	11	-
Further assurance services		16	-	-	-
All other services		-	27	-	23
Total other services		**201**	**99**	**185**	**76**
Operating lease charges	- motor vehicles	261	262	232	227
	- land and buildings	1,640	1,715	935	921

10. Employees

The average number employed including executive directors was:

	Full-time		Part-time	
	2013	2012	2013	2012
	Number	Number	Number	Number
Society's Customer Contact Centre	559	508	75	70
Society branch offices	194	200	145	137
Employed by the Society	753	708	220	207
Subsidiaries	280	268	64	59
Employed by the Group	1,033	976	284	266

11. Emoluments of the Society's directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on page 40 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 £1.8m (2012: £1.6m).

In addition, ex-gratia pensions amounting to £25k (2012: £24k) were paid to former directors.

12. 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 fixed contributions, without any further 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 2013 was £1.1m (2012: £1.0m). There were no contributions outstanding or prepaid at the end of the year.

From 1 January 2014 employees not currently in the pension scheme will be auto-enrolled into the defined contribution scheme. The cost to the Group of employer's contributions is expected to increase going forward with an estimated cost in 2014 of £1.6m.

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 will be subject to a triennial valuation by the scheme's independent actuary on 30 September 2013.

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

During 2012, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the scheme with Legal and General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal and General assumed full responsibility for the benefits payable to the scheme's current pensioners. The buy-in took effect from September 2012. The pensioner liability and the matching annuity policy remain within the scheme. The premium paid for the annuity policy was £30.8m which the scheme settled with a combination of cash and assets including an additional Group contribution of £5.4m. This additional contribution is recognised in the statement of other comprehensive income.

A further £0.9m was paid in to the pension scheme from the Society during 2013.

Scheme management consists of a Board of Trustees, comprising five individuals, two of whom were elected by the members to the Board of Trustees as Member Nominated Trustees. The power of appointment and removal of the Trustees is vested in the Society in accordance with the Trust Deed.

The Trustees have continued to act in accordance with the Statement of Investment Principles adopted on 1 November 2007 as required by Section 35 of the Pensions Act 1995. Assets supporting the Scheme are managed by Royal London Asset Management, Baring Asset Management and Standard Life Investments. In addition the Trustees may hold cash from time to time. The assets managed by Standard Life Investments and Baring Asset Management during the year were invested to target a long-term rate of return well in excess of inflation.

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.

Updated calculations prepared by the scheme actuary on the IAS 19 basis at 31 December 2013, including the unfunded liability referred to above, reflected a deficit amounting to £17.1m (2012: £13.2m). The use of the RPI and CPI in valuing the scheme will be reviewed in 2014.

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRS is £19.7m (2012 Restated: £15.4m).

Pension obligation risk is discussed in the Risk management report on pages 19 to 20.

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

	At 31 December				
	2013	2012	2011	2010	2009
	%	%	%	%	%
Rate of increase in pensionable salaries	3.50	3.00	3.05	3.55	3.60
Rate of increase of pensions in payment and deferred pensions	3.50	3.00	3.05	3.55	3.60
Discount rate	4.50	4.60	4.70	5.40	5.65
Inflation assumption (RPI)	3.50	3.00	3.05	3.55	3.60
Inflation assumption (CPI)	2.70	2.60	2.25	3.05	n/a

12. Retirement benefit obligations (continued)

The assumptions on mortality are determined by the following tables:

	2013	2012
Retired and non-retired members	SAPS CMI2013 LTR1.5%	SAPS LC1%B
The assumptions are illustrated by the following year of life expectancy at age 65:		
Retired members		
Males currently aged 65	22.4	23.0
Females currently aged 65	24.9	25.8
Non-retired members		
Males currently aged 45	24.5	25.0
Females currently aged 45	27.2	27.8

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

	At 31 December				
	2013	2012	2011	2010	2009
	£m	£m	£m	£m	£m
Target return funds	25.0	24.2	22.6	22.4	18.6
Debt securities	-	-	22.6	20.4	21.4
Annuities	23.4	22.7	-	-	-
Bonds and cash	1.3	0.5	0.9	0.4	0.4
Total fair value of plan assets	49.7	47.4	46.1	43.2	40.4
Present value of funded obligations	(66.3)	(60.1)	(57.1)	(52.0)	(49.8)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net deficit recognised in the statement of financial position	**(17.1)**	**(13.2)**	**(11.5)**	**(9.3)**	**(9.9)**

The actual return on plan assets was £1.5m (2012: £4.2m).

The amounts recognised in the income statement are as follows:

	Group and Society	
	2013	2012 (restated)
	£m	£m
Analysis of the amounts recognised in the income statement		
Interest on pension scheme assets	(1.2)	(2.2)
Interest on pension scheme liabilities	1.7	2.7
Net interest expense	**0.5**	**0.5**
Analysis of amount recognised in statement of other comprehensive income		
Gain/(loss) on scheme assets in excess of interest	0.4	(5.7)
Experience (losses) on liabilities	(0.6)	-
Gains from changes to demographic assumptions	0.8	-
Losses from changes to financial assumptions	(4.9)	(1.9)
Total remeasurement	(4.3)	(7.6)
Analysis of the movement in the statement of financial position deficit		
Deficit in schemes at beginning of year	(13.2)	(11.5)
Movement in year:		
Net interest expense	(0.5)	(0.5)
Remeasurements	(4.3)	(7.6)
Contributions paid and accrued	0.9	6.4
Deficit in schemes at end of year	**(17.1)**	**(13.2)**

12. Retirement benefit obligations (continued)

Analysis of the movement in the fair value of pension scheme assets

	Group and Society	
	2013	2012 (restated)
	£m	£m
Fair value of assets at the beginning of the year	47.4	46.1
Interest on assets	1.1	2.2
Society contributions	0.9	6.4
Scheme member contributions	-	-
Benefits paid	(0.5)	(1.5)
Return on plan assets less interest	0.4	(5.8)
Change in fair value of the annuity policy	0.4	-
Fair value of assets at the end of the year	**49.7**	**47.4**

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 in to 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.

	Increase 0.5%	Decrease 0.5%
	£m	£m
Discount rate	(4.4)	5.1
Inflation	4.5	(4.4)
Life expectancy	0.9	(0.9)

The sensitivity analysis presented 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 as some of the assumptions may be correlated.

13. Taxation

	Group		Society	
	2013	2012 (restated)	2013	2012 (restated)
	£m	£m	£m	£m
Current tax				
UK corporation tax charge for the year	7.8	7.1	3.4	2.4
Adjustments in respect of prior years	(1.0)	(0.1)	(0.6)	-
	6.8	7.0	2.8	2.4
Deferred tax				
Deferred tax charge for year	(0.8)	(0.5)	(0.7)	(0.5)
Adjustments in respect of prior years	0.5	0.2	0.5	0.2
	(0.3)	(0.3)	(0.2)	(0.3)
Taxation on profit on ordinary activities	**6.5**	**6.7**	**2.6**	**2.1**

13. Taxation (continued)

The statutory rate of corporation tax was reduced to 23.0% from 1 April 2013. The Group was subject to corporation tax at a rate of 24.0% for the period 1 January to 31 March 2013, and 23.0% for the period 1 April to 31 December 2013, resulting in an effective rate of corporation tax of 23.3% for the full year in 2013.

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	
	2013	2012 (restated)	2013	2012 (restated)
	£m	£m	£m	£m
Profit before taxation	28.7	25.7	11.3	7.7
Profit multiplied by the standard rate of corporation tax at 23.3% (2012: 24.5%)	6.7	6.3	2.6	1.9
Effects of:				
Expenses not deductible for tax purposes	0.3	0.3	0.3	0.2
Adjustments to prior years	(0.5)	0.1	(0.1)	0.2
Other	-	-	(0.2)	(0.2)
Total taxation for the year	**6.5**	**6.7**	**2.6**	**2.1**

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	
	2013	2012 (restated)	2013	2012 (restated)
	£m	£m	£m	£m
Current tax				
Relating to retirement benefit obligations	(0.3)	(0.9)	(0.3)	(0.9)
Revaluations of available-for-sale financial assets	(1.8)	0.4	(1.8)	0.4
	(2.1)	(0.5)	(2.1)	(0.5)
Deferred tax				
Relating to retirement benefit obligations	(0.1)	(0.9)	(0.1)	(0.9)
	(0.1)	(0.9)	(0.1)	(0.9)
Total charged to other comprehensive income	**(2.2)**	**(1.3)**	**(2.2)**	**(1.3)**

14. Loans and advances to credit institutions

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Accrued interest	-	0.1	-	0.1
On demand	87.6	79.4	16.9	11.2
Less than three months	5.0	18.0	5.0	8.0
Between three months and one year	5.0	5.0	5.0	5.0
Credit Support Annex (CSA) assets	22.9	26.0	22.9	26.0
	120.5	**128.5**	**49.8**	**50.3**

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. £22.9m has been pledged at the statement of financial position date (2012: £26.0m).

15. Debt securities

	Group and Society	
	2013	2012
	£m	£m
Issued by UK Government	347.0	195.0
Issued by Supranational entities	116.0	107.4
Issued by other borrowers and unlisted	103.0	145.2
	566.0	**447.6**

Debt securities are held as available-for-sale assets and carried at their fair value.

Other than the Supranational entities, all liquid assets are obtained from sources within the UK.

The debt securities set out above are repayable from the date of the statement of financial position in the ordinary course of business as follows:

	Group and Society	
	2013	2012
	£m	£m
Accrued interest	3.7	2.7
Less than three months	60.0	90.0
Between three months and one year	63.6	22.5
Between one year and five years	415.8	303.2
Greater than five years	22.9	29.2
	566.0	**447.6**

The movement in available-for-sale debt securities is summarised as follows:

	Group and Society	
	2013	2012
	£m	£m
At 1 January	447.6	409.7
Additions	476.2	694.8
Disposals and maturities	(350.5)	(659.1)
(Losses)/gains from changes in fair value	(8.2)	1.8
Increase in accrued interest	0.9	0.4
At 31 December	**566.0**	**447.6**

16. Derivative financial instruments

Currency and interest rate swaps are used by the Group for hedging purposes. These are commitments to exchange one set of cash flows for another. No exchange of principal takes place.

	Group and Society			
	Contract/notional amount		Fair value	
	2013	2012	2013	2012
	£m	£m	£m	£m
Derivative assets held for hedging purposes and designated fair value hedges:				
Interest rate swaps	1,736.3	1,463.4	30.8	37.5
Cross currency interest rate swaps	16.6	16.2	3.1	2.7
Equity and RPI index linked interest rate swaps	48.2	48.7	3.7	3.4
Total recognised derivative assets	**1,801.1**	**1,528.3**	**37.6**	**43.6**
Interest rate swaps	1,205.9	1,301.8	(25.5)	(49.1)
Equity & RPI index linked interest rate swaps	14.2	7.9	(0.7)	(0.3)
Total recognised derivative assets/(liabilities)	**1,220.1**	**1,309.7**	**(26.2)**	**(49.4)**

17. Assets measured at fair value

	Group and Society		
	2013	Level 1	Level 2
	£m	£m	£m
Financial assets at fair value through profit or loss:			
Derivative financial instruments	37.6	-	37.6
Available-for-sale financial assets:			
Debt securities	566.0	566.0	-
Total	**603.6**	**566.0**	**37.6**

	Group and Society		
	2012	Level 1	Level 2
	£m	£m	£m
Financial assets at fair value through profit or loss:			
Derivative financial instruments	43.6	-	43.6
Available-for-sale financial assets:			
Debt securities	447.6	447.6	-
Total	**491.2**	**447.6**	**43.6**

The tables above provide an analysis of financial instruments that are measured subsequent to initial recognition at fair value, grouped into levels 1 to 3 based on the degree to which the fair value is observable.

Level	Hierarchy for fair value disclosures
1	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
2	Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices).
3	Inputs for the asset or liability that are not based on observable market data. There are no instruments classified as level 3 in 2013 (2012: none).

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18. Loans fully secured on residential property

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Gross balances	5,489.7	5,081.4	4,913.6	4,496.5
Provision for impairment losses	(59.9)	(67.1)	(32.7)	(36.1)
Unamortised loan origination fees	18.4	22.6	1.4	(0.4)
Fair value adjustment for hedged risk	9.9	47.5	9.9	47.5
	5,458.1	**5,084.4**	**4,892.2**	**4,507.5**

Within the Group totals above there was £49.1m partially secured against residential property (2012: £45.2m).

19. Other loans fully secured on land

	Group and Society	
	2013	2012
	£m	£m
Other loans	446.5	507.3

20. Loans and advances to customers

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Maturity analysis of loans and advances to customers from the date of the statement of financial position:				
Less than three months	157.7	163.4	146.9	153.6
Between three months and one year	245.6	316.2	214.7	287.9
Between one year and five years	1,036.3	952.2	865.7	788.2
More than five years	4,496.6	4,157.0	4,132.8	3,774.1
	5,936.2	**5,588.8**	**5,360.1**	**5,003.8**
Provision for impairment losses	(59.9)	(67.1)	(32.7)	(36.1)
Unamortised loan origination fees	18.4	22.5	1.4	(0.4)
Fair value adjustment for hedged risk	9.9	47.5	9.9	47.5
	5,904.6	**5,591.7**	**5,338.7**	**5,014.8**

The amortised value of the residential mortgage backed security is £510.4m (2012: £657.0m). The Group holds £358.9m of the notes (2012: £422.8m).

In October 2012, the Group became a member of the FLS and during 2013 drew down additional funding of £350.0m to support mortgage growth. The maximum funding available to the Group under the Scheme was £756.4m.

Asset encumbrance is 16.8% (2012: 10.6%) of total assets. The Board has set an encumbrance limit of 30.0%.

21. Provision for impairment losses

	Fully secured on residential property		Fully secured on land	
	Specific	Collective	Specific	Collective
	£m	£m	£m	£m
2013				
Group				
At 1 January 2013	38.7	20.9	7.5	-
Amounts written off during the year	(14.9)	-	(14.7)	-
Charge/(release) for loan impairment	4.5	(5.1)	23.0	-
At 31 December 2013	**28.3**	**15.8**	**15.8**	**-**
Society				
At 1 January 2013	8.2	20.4	7.5	-
Amounts written off during the year	(5.8)	-	(14.7)	-
Charge/(release) for loan impairment	(0.1)	(5.8)	23.0	-
At 31 December 2013	**2.3**	**14.6**	**15.8**	**-**
2012				
Group				
At 1 January 2012	44.1	15.1	4.0	-
Amounts written off during the year	(12.4)	-	-	-
Charge for loan impairment	7.0	5.8	3.5	-
At 31 December 2012	**38.7**	**20.9**	**7.5**	**-**
Society				
At 1 January 2012	8.3	15.1	4.0	-
Amounts written off during the year	(4.1)	-	-	-
Charge for loan impairment	4.0	5.3	3.5	-
At 31 December 2012	**8.2**	**20.4**	**7.5**	**-**

22. Provisions for liabilities

	Group			Society		
	2013	2012 (restated)	2011 (restated)	2013	2012 (restated)	2011 (restated)
	£m	£m	£m	£m	£m	£m
At 1 January	9.9	24.7	22.6	3.6	3.1	2.7
Additions	12.5	11.9	11.5	4.5	2.6	2.2
Utilisation	(9.7)	(26.7)	(9.4)	(4.5)	(2.1)	(1.8)
At 31 December	**12.7**	**9.9**	**24.7**	**3.6**	**3.6**	**3.1**

Included in provisions is the FSCS levy of £2.3m which is the expected interest charge for scheme year April 2013 to March 2014. The Group has adopted IFRIC 21 Levies which has led to a change in the trigger for recognition. The FSCS provision as at 31 December 2012 has been restated from £5.2m to £2.2m. The provision as at 31 December 2011 has been restated from £3.8m to £1.8m. 2009 and 2010 provisions were also restated with a reduction in the provision of £2.2m.

Other provisions of £10.4m are held in respect of various customer and regulatory complaints.

The contingent aspect of such provisions is described in Note 39.

23. Investments in subsidiary undertakings

	Society	
	2013	2012
	£m	£m
Shares in subsidiary undertakings:		
At cost	1.1	1.1
Loans to subsidiary undertakings	522.1	544.5
	523.2	**545.6**

	Subsidiary undertakings	
	Shares	Loans
	£m	£m
Movement in investments in subsidiary undertakings:		
At 1 January 2013	1.1	544.5
Loan repayment	-	(22.4)
At 31 December 2013	**1.1**	**522.1**

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

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
Peter Alan Limited	England and Wales	Estate agency and financial services	Ordinary and preference	100%	Direct
Nemo Personal Finance Limited	England and Wales	Secured personal lending	Ordinary	100%	Direct
Loan Link Limited	England and Wales	Loan broking	Ordinary	100%	Indirect
Principality Mortgage and Insurance Services Limited	England and Wales	Provision of advisory and administration services	Ordinary	100%	Direct
Principality Covered Bond LLP	England and Wales	Mortgage acquisition and guarantor of covered bonds	Ordinary	100%	Direct
Friary Two Limited	England and Wales	Special purpose entity	Ordinary	100%	Direct

During the year the Group purchased 100% of the ordinary shares of Mead Property Management Limited and Thomas George Cardiff Limited, both incorporated in England and Wales. Their principal activity is letting agents.

During the year, the Society participated in designing a scheme to assist the housing agenda in Wales. The scheme aims to deliver a 700 house development on a brownfield site in Cardiff being a mix of affordable, social and private dwellings ultimately funded by the capital markets. This resulted in the creation of Ely Bridge Development Company Limited which 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 which have not carried on business during the year. These were all incorporated in the United Kingdom.

Brokerpoint Limited
Energy Assess Wales Limited
Home Information Pack Wales Limited
Nemo Loans Limited
Nemo Financial Limited
Nemo Financial Services Limited
Nemo Home Loans Limited
Nemo Secured Loans Limited
Nemo Insurance Services Limited
Peter Alan Black Limited
Peter Alan Property Services Limited
Peter Alan Surveyors Limited
Peter Alan Property Development Services Limited
Principality Limited
Principality Asset Management Limited
Principality Bank Limited
Principality Direct Limited
Principality Estate Agency Limited
Principality Financial Management Limited
Principality Homes Limited
Principality (IFA Services) Limited
Principality Independent Financial Advisers Limited
Principality Life Assurance Services Limited
Principality (Life and Pensions) Limited
Principality Mortgage Corporation Limited
Principality Personal Loans Limited
Principality Property Development Services Limited
Principality Property Sales Limited
Principality Property Services Limited
Principality Property Solutions Limited
Principality Surveyors Home Condition Report Limited
Principality Syndicated Loans Limited
Roderick Price Limited
The Principality Home Information Pack Limited

24. Intangible assets

	Goodwill		Computer software		Total	
	Group	Society	Group	Society	Group	Society
	£m	£m	£m	£m	£m	£m
2013						
Cost:						
At 1 January 2013	0.7	-	6.7	6.7	7.4	6.7
Additions	1.8	-	0.7	0.7	2.5	0.7
Disposals	-	-	(0.1)	(0.1)	(0.1)	(0.1)
At 31 December 2013	**2.5**	**-**	**7.3**	**7.3**	**9.8**	**7.3**
Impairment/amortisation:						
At 1 January 2013	-	-	4.8	4.8	4.8	4.8
Charge for the year	0.1	-	0.6	0.6	0.7	0.6
Disposals	-	-	(0.1)	(0.1)	(0.1)	(0.1)
At 31 December 2013	**0.1**	**-**	**5.3**	**5.3**	**5.4**	**5.3**
Net book value:						
At 31 December 2013	**2.4**	**-**	**2.0**	**2.0**	**4.4**	**2.0**
At 31 December 2012	0.7	-	1.9	1.9	2.6	1.9

	Goodwill		Computer software		Total	
	Group	Society	Group	Society	Group	Society
	£m	£m	£m	£m	£m	£m
2012						
Cost:						
At 1 January 2012	0.7	-	5.9	5.9	6.6	5.9
Additions	-	-	0.8	0.8	0.8	0.8
Disposals	-	-	-	-	-	-
At 31 December 2012	**0.7**	**-**	**6.7**	**6.7**	**7.4**	**6.7**
Impairment/amortisation:						
At 1 January 2012	-	-	4.1	4.1	4.1	4.1
Charge for the year	-	-	0.7	0.7	0.7	0.7
Disposals	-	-	-	-	-	-
At 31 December 2012	**-**	**-**	**4.8**	**4.8**	**4.8**	**4.8**
Net book value:						
At 31 December 2012	**0.7**	**-**	**1.9**	**1.9**	**2.6**	**1.9**
At 31 December 2011	0.7	-	1.8	1.8	2.5	1.8

The goodwill at the beginning of the year relates to the acquisition of 100% of the ordinary share capital of Loan Link Limited on 1 December 2004. The goodwill addition in the year relates to the acquisition of 100% of the ordinary shares of Mead Property Management Limited and Thomas George Cardiff Limited, both lettings agents.

In accordance with the requirements of IAS 36, the Group completed an impairment review of the carrying value for goodwill as
at 31 December 2013 to ensure that the carrying value is stated at no more than its recoverable amount.

A review of the recoverability of the goodwill in relation to Loan Link Limited has been completed, taking into account the present value of future profits of Loan Link Limited, based on the 2013 outturn and a discount rate of 4.25%. No impairment provision is required as a result of this review.

The recoverable amount of goodwill from the acquisition of Mead Property Management Limited and Thomas George Cardiff Limited is determined by the proportion of the acquired letting book still managed at the year end. As a result of the review an impairment allowance of £0.1m has been recognised in the year.

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25. Property, plant and equipment

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group	Society	Group	Society	Group	Society
	£m	£m	£m	£m	£m	£m
Cost:						
At 1 January 2013	58.2	54.1	35.7	24.7	93.9	78.8
Additions	4.0	3.1	3.7	3.1	7.7	6.2
Disposals	-	-	(0.2)	(0.2)	(0.2)	(0.2)
At 31 December 2013	**62.2**	**57.2**	**39.2**	**27.6**	**101.4**	**84.8**
Depreciation:						
At 1 January 2013	22.7	20.7	24.9	16.1	47.6	36.8
Charge for the year	1.9	1.8	4.3	3.2	6.2	5.0
Disposals	-	-	(0.2)	(0.1)	(0.2)	(0.1)
At 31 December 2013	**24.6**	**22.5**	**29.0**	**19.2**	**53.6**	**41.7**
Net book value:						
At 31 December 2013	**37.6**	**34.7**	**10.2**	**8.4**	**47.8**	**43.1**
At 31 December 2012	35.5	33.4	10.8	8.6	46.3	42.0

Included within land and buildings additions is £0.8m (2012: £0.3m) on account of assets in the course of construction.

The value of assets subject to operating leases where the Group acts as lessor is £26.0m (2012: £21.9m).

	2013		2012	
	Group	Society	Group	Society
	£m	£m	£m	£m
Land and buildings:				
Freehold	34.6	32.0	21.0	20.0
Long leasehold	0.5	0.4	0.4	0.2
Short leasehold	2.5	2.3	1.9	1.7
	37.6	**34.7**	**23.3**	**21.9**
Occupied by the Society and subsidiary undertakings	26.2	26.2	25.5	24.6

25. Property, plant and equipment (continued)

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group	Society	Group	Society	Group	Society
	£m	£m	£m	£m	£m	£m
Cost:						
At 1 January 2012	54.1	50.2	31.9	21.7	86.0	71.9
Additions	4.1	3.9	4.2	3.3	8.3	7.2
Disposals	-	-	(0.4)	(0.3)	(0.4)	(0.3)
At 31 December 2012	**58.2**	**54.1**	**35.7**	**24.7**	**93.9**	**78.8**
Depreciation:						
At 1 January 2012	21.1	19.2	21.2	13.4	42.3	32.6
Charge for the year	1.6	1.5	4.1	2.9	5.7	4.4
Disposals	-	-	(0.4)	(0.2)	(0.4)	(0.2)
At 31 December 2012	**22.7**	**20.7**	**24.9**	**16.1**	**47.6**	**36.8**
Net book value:						
At 31 December 2012	**35.5**	**33.4**	**10.8**	**8.6**	**46.3**	**42.0**
At 31 December 2011	33.0	31.0	10.7	8.3	43.7	39.3

26. Other assets

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Due within one year:				
Other	6.3	6.2	3.0	3.7

27. Prepayments and accrued income

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Accrued interest on derivative financial instruments	6.9	10.9	6.9	10.9
Other	4.1	4.4	3.0	3.5
	11.0	**15.3**	**9.9**	**14.4**

28. Shares

	Group and Society	
	2013	2012
	£m	£m
Held by individuals	5,551.0	5,442.3
Other shares	4.3	4.3
Fair value adjustment for hedged risk	7.3	20.4
	5,562.6	**5,467.0**

The repayment of the above balances from the date of the statement of financial position in the ordinary course of business is as follows:

	Group and Society	
	2013	2012
	£m	£m
Fair value adjustment for hedged risk	7.3	20.4
Accrued interest	79.4	73.9
On demand	1,106.1	1,633.2
Less than three months	2,097.0	1,197.0
Between three months and one year	1,061.8	1,080.7
Between one year and five years	1,211.0	1,461.8
	5,562.6	**5,467.0**

29. Amounts owed to credit institutions

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Accrued interest	0.1	-	0.1	-
Credit Support Annex (CSA) liabilities	13.8	13.3	13.8	13.3
On demand	2.2	2.5	-	-
Less than three months	180.9	18.5	187.6	36.8
Between three months and one year	65.4	5.0	83.7	57.1
Between one year and five years	230.9	42.0	290.8	130.4
Greater than five years	6.4	14.5	6.4	14.5
	499.7	**95.8**	**582.4**	**252.1**

30. Amounts owed to other customers

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Accrued interest	2.6	4.3	2.6	4.3
On demand and less than three months	94.2	125.8	94.2	125.8
Between three months and one year	119.0	170.9	119.0	170.9
Between one year and five years	9.3	44.7	9.3	44.7
	225.1	**345.7**	**225.1**	**345.7**

31. Debt securities in issue

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Certificates of deposit	6.5	14.8	6.5	14.8
Fixed and floating rate notes	16.6	16.3	16.6	16.3
Other debt securities	151.8	234.6	-	-
Fair value adjustment for hedged risk	3.1	3.3	3.1	3.3
	178.0	**269.0**	**26.2**	**34.4**

The repayment from the date of the statement of financial position in the ordinary course of business is as follows:

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Fair value adjustment for hedged risk	3.1	3.3	3.1	3.3
Accrued interest	-	0.1	-	0.1
Less than three months	11.1	17.1	2.5	4.0
Between three months and one year	28.6	47.9	4.0	10.7
Between one year and five years	135.2	200.6	16.6	16.3
	178.0	**269.0**	**26.2**	**34.4**

The effective interest rates at the date of the statement of financial position were as follows:

Certificates of deposit	0.88%	1.75%
Fixed and floating rate notes	0.70%	0.71%

32. Other liabilities

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Due within one year:				
Income tax	0.8	0.9	0.8	0.9
Other taxation and social security	1.4	1.2	0.9	0.9
Other creditors	6.2	6.4	3.5	4.2
	8.4	**8.5**	**5.2**	**6.0**

33. Accruals and deferred income

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Interest accrued on subordinated liabilities	0.3	0.4	0.3	0.4
Interest accrued on subscribed capital	0.4	0.4	0.4	0.4
Other	8.0	9.0	6.9	8.0
	8.7	**9.8**	**7.6**	**8.8**

34. Deferred tax

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
At 1 January	(3.5)	(2.3)	(3.3)	(2.2)
Credited to the income statement	(0.2)	(0.3)	(0.2)	(0.2)
Credited to statement of other comprehensive income on actuarial losses	(0.1)	(0.9)	(0.1)	(0.9)
At 31 December	**(3.8)**	**(3.5)**	**(3.6)**	**(3.3)**

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

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Deferred tax liabilities				
Accelerated tax depreciation	-	-	0.1	0.2
Other	0.5	0.8	0.4	0.7
	0.5	**0.8**	**0.5**	**0.9**
Deferred tax assets				
Accelerated tax depreciation	(0.2)	(0.1)	-	-
Retirement benefit obligation	(3.8)	(3.8)	(3.8)	(3.8)
Other	(0.3)	(0.4)	(0.3)	(0.4)
	(4.3)	**(4.3)**	**(4.1)**	**(4.2)**

The reduction of the UK Corporation tax rate to 20% from 1 April 2015 has resulted in a deferred tax charge arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the asset is expected to reverse. The statement of other comprehensive income includes a charge of £0.4m arising from the actuarial loss on retirement benefit obligations. The charge reflected in the income statement is not material.

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within 17 years. More information on the triennial valuation can be found in Note 12.

35. Subordinated liabilities

	Group and Society	
	2013	2012
	£m	£m
5⅜% Subordinated Notes due 2016	92.3	92.3

The Society's subordinated liabilities are unsecured. The subordinated liabilities rank pari passu with each other and behind the claims against the Society of all depositors, creditors and investing Members of the Society.

The Society did not exercise its option to call the subordinated liabilities on 8 July 2011. The Society has the option of calling these notes on a quarterly basis until financial maturity on 8 July 2016. From 8 July 2011, the rate of interest became LIBOR plus 1.005% reset quarterly.

With the permission of the Financial Services Authority, in 2012, the Society repurchased £14.7m of subordinated liabilities at a discount. The Group has benefited from a one-off gain of £1.5m. There have been no repurchases during 2013.

Repaying the subordinated liabilities requires the prior consent of the Prudential Regulation Authority.

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36. Subscribed capital

	Group and Society	
	2013	2012
	£m	£m
7.00% Permanent Interest-Bearing Shares	60.0	60.0
Unamortised issue costs	(0.5)	(0.7)
Fair value adjustment for hedged risk	10.7	17.1
	70.2	**76.4**

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.

37. Analysis of general reserve

	Group			Society		
	2013	2012 (restated)	2011 (restated)	2013	2012 (restated)	2011 (restated)
	£m	£m	£m	£m	£m	£m
Balance at 1 January	339.4	326.2	312.3	311.6	311.8	307.0
Profit for the financial year	22.2	19.0	17.2	8.7	5.6	8.1
Actuarial loss on retirement benefit obligations	(4.3)	(7.6)	(4.2)	(4.3)	(7.6)	(4.2)
Movement in deferred tax relating to retirement benefit obligations	0.4	1.8	0.9	0.4	1.8	0.9
Total recognised income for the year	18.3	13.2	13.9	4.8	(0.2)	4.8
Balance at 31 December	**357.7**	**339.4**	**326.2**	**316.4**	**311.6**	**311.8**
Reserves excluding pension liability	374.8	352.6	337.7	333.5	324.8	323.3
Pension liability	(17.1)	(13.2)	(11.5)	(17.1)	(13.2)	(11.5)
	357.7	**339.4**	**326.2**	**316.4**	**311.6**	**311.8**

38. Other reserves

	Group and Society	
	2013	2012
	£m	£m
Other reserves comprise		
Revaluation reserve – available-for-sale investments	(3.0)	3.4
Movement in other reserves		
Balance at 1 January	3.4	2.0
Net (losses)/gains from changes in fair value, net of taxation	(6.4)	1.4
Balance at 31 December	**(3.0)**	**3.4**
Balance at 1 January	3.4	2.0
(Losses)/gains transferred to equity	(7.6)	5.0
Gains recycled to profit and loss on sales	(0.6)	(3.2)
Taxation	1.8	(0.4)
Balance at 31 December	**(3.0)**	**3.4**

39. Financial commitments and contingent liabilities

a) Financial Services Compensation Scheme levy

Based on its share of protected deposits, the Society pays levies to the Financial Services Compensation Scheme (FSCS) to enable the FSCS to meet claims against it. Since 2008 a number of institutions have been declared in default by the PRA (formerly the "FSA"). The FSCS has met the claims by way of loans received from HM Treasury. The terms of these loans are interest-only and the FSCS will seek to recover the interest cost, together with ongoing management expenses, by way of annual levies on member firms over this period.

During the year, the IASB issued IFRIC 21 Levies which is effective for periods beginning on or after 1 January 2014. The IFRIC is an interpretation of IAS 37 Provisions, Contingent Liabilities and Contingent Assets. The IFRIC clarifies when a liability should be recognised for a levy, defining when the obliging event occurs. The change to the PRA handbook combined with the IFRIC changes how the industry has recognised FSCS for both the capital and interest, changing the trigger for recognition, from the year end to 1 April of the subsequent year in line with the start of the FSCS scheme year. The Group has taken early adoption of IFRIC 21, and IAS 1 Presentation of Financial Statements requires the disclosure of two comparative restated periods in the statement of financial position and the impacted notes.

During the year, the Group has recognised an FSCS interest charge of £2.3m in respect of scheme year April 2013 to March 2014 which is held as a provision at the year end and payable during 2014. During the year a payment was made in respect of interest in relation to scheme year April 2012 to March 2013 of £2.2m. It is expected that further interest payments will be made in future years with interest relating to scheme year April 2014 to March 2015 being recognised in 2014. Based on the latest information available, the Group's share is expected to be £2.4m.

The Group has also recognised in 2013 an FSCS charge of £1.9m in respect of the first instalment of the capital repayment. This amount was paid during the year. It is expected that two further instalments will be made in 2014 and 2015 in relation to the capital shortfall. Based on the latest information which is subject to change, the Group's share is expected to be £3.8m. A provision will be made in 2014 and 2015 for this liability.

The Group also has a potential exposure to future levies resulting from the failure of the Dunfermline Building Society along with potential capital shortfalls arising from the sale of assets in relation to Bradford and Bingley. The quantification and timing of such losses have yet to be determined and hence, although the Group's share could be material, no provision has been recognised.

b) Customer and Regulatory Complaints

The Group is undertaking a detailed and comprehensive review of processes and documentation in relation to compliance with consumer credit legislation which commenced in the second half of 2013 and is planned to be completed during the first half of 2014. To date a number of areas which require further review have been identified, and a charge of £8.0m has been recognised in respect of potential costs which will require remediation over the next 12 months.

Other provisions of £0.3m (2012: £9.7m) have been made in respect of various customer claims. No provisions have been made during the period in relation to previous sales of payment protection insurance. At 31 December 2013, provisions of £1.1m are held in relation to PPI with utilisation of £5.2m of the provision during the year. The PPI remediation process is in its final stages.

Provisions are only made where the Group has responsibility for the original sale of the product. No provision has been made for sales by third parties as external legal advice has concluded that it is unlikely that the Group would be liable for redress in respect of such sales.

c) Defined benefit pension scheme

The defined benefit scheme is subject to a triennial valuation by the scheme's independent actuary on 30 September 2013. The Group has a potential exposure to future payments into the scheme arising from any deficit at that date. The quantification of any deficit is yet to be determined and hence, although the contributions into the scheme could be significant, no provision has been recognised.

Notes to the accounts

for the year ended 31 December 2013

39. Financial commitments and contingent liabilities (continued)

d) Commitments under non-cancellable operating leases

	2013		2012	
	Property	Vehicles, plant and equipment	Property	Vehicles, plant and equipment
	£m	£m	£m	£m
Group commitments in respect of operating lease rentals:				
Due within one year	1.8	0.2	1.8	0.3
Due between two and five years	6.4	0.1	7.1	0.3
Due after five years	4.7	-	6.5	-
	12.9	**0.3**	**15.4**	**0.6**
Society commitments in respect of operating lease rentals:				
Due within one year	1.0	0.1	1.0	0.3
Due between two and five years	3.6	0.1	3.9	0.2
Due after five years	3.0	-	4.0	-
	7.6	**0.2**	**8.9**	**0.5**

e) Income receivable under non-cancellable operating leases

Property rental income earned during the year was £0.8m (2012:£0.8m).

At the statement of financial position date, the Society had contracted with tenants for the following future minimum lease payments:

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Receivable within one year	0.8	0.8	1.0	1.0
Receivable between two and five years	2.7	2.8	3.4	3.3
Receivable after five years	8.1	8.6	9.6	10.6
	11.6	**12.2**	**14.0**	**14.9**

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

f) Capital commitments

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Capital expenditure contracted for but not provided for	0.9	1.3	0.9	1.3

g) Loan commitments

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
Loan commitments contracted but not paid	48.5	52.1	48.5	52.1

40. Financial instruments

a) 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 2013	At amortised cost	Loans and receivables	Available-for-sale	Designated at fair value	Total
	£m	£m	£m	£m	£m
Group assets					
Cash in hand and balances with Bank of England	355.6	-	-	-	355.6
Loans and advances to credit institutions	-	120.5	-	-	120.5
Debt securities	-	-	566.0	-	566.0
Derivative financial instruments	-	-	-	37.6	37.6
Loans and advances to customers	-	5,904.6	-	-	5,904.6
Total financial assets	**355.6**	**6,025.1**	**566.0**	**37.6**	**6,984.3**
Total non-financial assets					73.8
Total Group assets					**7,058.1**
Group liabilities					
Shares	5,562.6	-	-	-	5,562.6
Amounts owed to credit institutions	434.3	-	-	65.4	499.7
Amounts owed to other customers	225.1	-	-	-	225.1
Debt securities in issue	178.0	-	-	-	178.0
Derivative financial instruments	-	-	-	26.2	26.2
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	70.2	-	-	-	70.2
Total financial liabilities	**6,562.5**	**-**	**-**	**91.6**	**6,654.1**
Total non-financial liabilities					49.3
General reserve and other reserves					354.7
Total Group reserves and liabilities					**7,058.1**

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Society As at 31 December 2013	At amortised cost	Loans and receivables	Available-for-sale	Designated at fair value	Total
	£m	£m	£m	£m	£m
Society assets					
Cash in hand and balances with Bank of England	355.6	-	-	-	355.6
Loans and advances to credit institutions	-	49.8	-	-	49.8
Debt securities	-	-	566.0	-	566.0
Derivative financial instruments	-	-	-	37.6	37.6
Loans and advances to customers	-	5,338.7	-	-	5,338.7
Loans to and investments in subsidiaries	1.1	522.1	-	-	523.2
Total financial assets	**356.7**	**5,910.6**	**566.0**	**37.6**	**6,870.9**
Total non-financial assets					62.1
Total Society assets					**6,933.0**
Society liabilities					
Shares	5,562.6	-	-	-	5,562.6
Amounts owed to credit institutions	517.0	-	-	65.4	582.4
Amounts owed to other customers	225.1	-	-	-	225.1
Debt securities in issue	26.2	-	-	-	26.2
Derivative financial instruments	-	-	-	26.2	26.2
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	70.2	-	-	-	70.2
Total financial liabilities	**6,493.4**	**-**	**-**	**91.6**	**6,585.0**
Total non-financial liabilities					34.6
General reserve and other reserves					313.4
Total Society reserves and liabilities					**6,933.0**

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Group As at 31 December 2012	At amortised cost	Loans and receivables	Available-for-sale	Designated at fair value	Total
	£m	£m	£m	£m	£m
Group assets					
Cash in hand and balances with Bank of England	498.2	-	-	-	498.2
Loans and advances to credit institutions	-	128.5	-	-	128.5
Debt securities	-	-	447.6	-	447.6
Derivative financial instruments	-	-	-	43.6	43.6
Loans and advances to customers	-	5,591.7	-	-	5,591.7
Total financial assets	**498.2**	**5,720.2**	**447.6**	**43.6**	**6,709.6**
Total non-financial assets					74.7
Total Group assets					**6,784.3**
Group liabilities					
Shares	5,467.0	-	-	-	5,467.0
Amounts owed to credit institutions	39.3	-	-	56.5	95.8
Amounts owed to other customers	345.7	-	-	-	345.7
Debt securities in issue	269.0	-	-	-	269.0
Derivative financial instruments	-	-	-	49.4	49.4
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	76.4	-	-	-	76.4
Total financial liabilities	**6,289.7**	**-**	**-**	**105.9**	**6,395.6**
Total non-financial liabilities					45.9
General reserve and other reserves					342.8
Total Group reserves and liabilities					**6,784.3**

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Society As at 31 December 2012	At amortised cost	Loans and receivables	Available-for-sale	Designated at fair value	Total
	£m	£m	£m	£m	£m
Society assets					
Cash in hand and balances with Bank of England	498.2	-	-	-	498.2
Loans and advances to credit institutions	-	50.3	-	-	50.3
Debt securities	-	-	447.6	-	447.6
Derivative financial instruments	-	-	-	43.6	43.6
Loans and advances to customers	-	5,014.8	-	-	5,014.8
Loans to and investments in subsidiaries	1.1	544.5	-	-	545.6
Total financial assets	**499.3**	**5,609.6**	**447.6**	**43.6**	**6,600.1**
Total non-financial assets					66.2
Total Society assets					**6,666.3**
Society liabilities					
Shares	5,467.0	-	-	-	5,467.0
Amounts owed to credit institutions	195.6	-	-	56.5	252.1
Amounts owed to other customers	345.7	-	-	-	345.7
Debt securities in issue	34.4	-	-	-	34.4
Derivative financial instruments	-	-	-	49.4	49.4
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	76.4	-	-	-	76.4
Total financial liabilities	**6,211.4**	**-**	**-**	**105.9**	**6,317.3**
Total non-financial liabilities					34.0
General reserve and other reserves					315.0
Total Society reserves and liabilities					**6,666.3**

40. Financial instruments (continued)

b) Carrying values and fair values

The table below compares carrying values and fair values of the Group's and the Society's financial instruments by category. It is accompanied by an explanation of the methods used to determine fair value.

	Note	2013		2012	
		Carrying value	Fair value	Carrying value	Fair value
		£m	£m	£m	£m
Group assets					
Cash in hand and balances with Bank of England		355.6	355.6	498.2	498.2
Loans and advances to credit institutions	i.	120.5	120.5	128.5	128.5
Debt securities	ii.	566.0	566.0	447.6	447.6
Derivative financial instruments	iii.	37.6	37.6	43.6	43.6
Loans and advances to customers	iv.	5,904.6	5,886.1	5,591.7	5,569.2
		6,984.3	**6,965.8**	**6,709.6**	**6,687.1**
Group liabilities					
Shares	vi.	5,562.6	5,562.6	5,467.0	5,467.0
Amounts owed to credit institutions	vii.	499.7	499.7	95.8	95.8
Amounts owed to other customers	vii.	225.1	225.1	345.7	345.7
Debt securities in issue	vii.	178.0	181.7	269.0	271.2
Derivative financial instruments	iii.	26.2	26.2	49.4	49.4
Subordinated liabilities	viii.	92.3	81.1	92.3	75.9
Subscribed capital	viii.	70.2	48.5	76.4	48.5
		6,654.1	**6,624.9**	**6,395.6**	**6,353.5**

	Note	2013		2012	
		Carrying value	Fair value	Carrying value	Fair value
		£m	£m	£m	£m
Society assets					
Cash in hand and balances with Bank of England		355.6	355.6	498.2	498.2
Loans and advances to credit institutions	i.	49.8	49.8	50.3	50.3
Debt securities	ii.	566.0	566.0	447.6	447.6
Derivative financial instruments	iii.	37.6	37.6	43.6	43.6
Loans and advances to customers	iv.	5,338.7	5,337.3	5,014.8	5,014.4
Loans and advances to subsidiaries	v.	523.2	523.2	545.6	545.6
		6,870.9	**6,869.5**	**6,600.1**	**6,599.7**
Society liabilities					
Shares	vi.	5,562.6	5,562.6	5,467.0	5,467.0
Amounts owed to credit institutions	vii.	582.4	582.4	252.1	252.1
Amounts owed to other customers	vii.	225.1	225.1	345.7	345.7
Debt securities in issue	vii.	26.2	26.1	34.4	34.4
Derivative financial instruments	iii.	26.2	26.2	49.4	49.4
Subordinated liabilities	viii.	92.3	81.1	92.3	75.9
Subscribed capital	viii.	70.2	48.5	76.4	48.5
		6,585.0	**6,552.0**	**6,317.3**	**6,273.0**

40. Financial instruments (continued)

b) Carrying values and fair values (continued)

The gross amount of foreign currency swaps held was €20.0m (2012: €20.0m).

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 loans and advances to credit institutions with a maturity of under 12 months is assumed to equate to their fair value.
ii) Debt securities classified as available-for-sale are measured at fair value by reference to market prices.
iii) All derivatives are held for economic hedging purposes. The fair value of interest rate swaps is calculated by utilising discounted cash flow valuation models. The fair value of cross currency interest rate swaps is obtained from external counterparties.
iv) The fair value of loans and advances to customers at a variable rate is assumed to approximate to their carrying amounts. The fair value of loans and advances to customers at a fixed rate of interest represents the discounted amount of estimated future cash flows expected to be received after taking account of incurred (not expected) loss provisions, expected levels of early repayment and discounting at current market rates.
v) The fair value of loans and advances to subsidiaries at a variable rate is assumed to approximate to their carrying amounts.
vi) The fair value of customer accounts is assumed to approximate to the amount payable at the date of the statement of financial position.
vii) The fair values of amounts owed to credit institutions, amounts owed to other customers and debt securities in issue are established by using discounted cash flow valuation models or are assumed to approximate to the amount payable at the date of the statement of financial position.
viii) The fair values of subordinated liabilities and subscribed capital are obtained from market prices.

The credit risk which the Group is exposed to is described in the Risk management report on pages 15 to 16. 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 c) on page 89 to 94. Credit risk in relation to treasury financial instruments is described in section d).

40. Financial instruments (continued)

c) Credit risk: 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	
	2013		2013	
	£m	%	£m	%
In respect of loans and advances to customers:				
Fully secured by a first charge on residential property	4,882.3	82.7	4,882.3	91.5
Fully secured by a first charge on land	446.5	7.5	446.5	8.3
Fully secured by a second charge on residential property	516.8	8.8	-	-
Partially secured by a second charge on residential property	49.1	0.8	-	-
Fair value adjustments	9.9	0.2	9.9	0.2
	5,904.6	**100.0**	**5,338.7**	**100.0**

	Group		Society	
	2012		2012	
	£m	%	£m	%
In respect of loans and advances to customers:				
Fully secured by a first charge on residential property	4,488.9	80.3	4,488.9	89.6
Fully secured by a first charge on land	478.4	8.6	478.4	9.5
Fully secured by a second charge on residential property	531.7	9.5	-	-
Partially secured by a second charge on residential property	45.2	0.8	-	-
Fair value adjustments	47.5	0.8	47.5	0.9
	5,591.7	**100.0**	**5,014.8**	**100.0**

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	
	2013		2013	
	£m	%	£m	%
Retail financial services	4,505.9	76.3	4,505.9	84.4
Commercial lending	822.9	13.9	822.9	15.4
Secured personal lending	565.9	9.6	-	-
Fair value adjustments	9.9	0.2	9.9	0.2
	5,904.6	**100.0**	**5,338.7**	**100.0**

	Group		Society	
	2012		2012	
	£m	%	£m	%
Retail financial services	4,069.6	72.8	4,069.6	81.2
Commercial lending	897.7	16.1	897.7	17.9
Secured personal lending	576.9	10.3	-	-
Fair value adjustments	47.5	0.8	47.5	0.9
	5,591.7	**100.0**	**5,014.8**	**100.0**

40. Financial instruments (continued)

c) Credit risk: loans and advances to customers (continued)

ci) First and second charge retail credit risk

Retail credit risk can be categorised as first or second charge, where first charge consists of first time buyers, remortgage, buy-to-let and other, and second charge consisting of activities from Nemo.

Further detail of the Group's risk management strategy in relation to first and second charge retail credit risk is described in the Risk management report on pages 15 to 16.

First and second charge retail: 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.

As at 31 December 2013, approximately 31.9% (2012: 33.5%) of first and second charge retail loans by account and 29.6% (2012: 31.6%) by value were concentrated in Wales.

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 63.2% (2012: 63.7%). Index-linked LTV banding is shown below:

	Group		Society	
	2013	2012	2013	2012
	%	%	%	%
Less than 70%	59.8	58.4	62.0	62.7
More than 70% but less than 80%	19.0	16.7	19.0	16.3
More than 80% but less than 90%	10.9	13.1	10.5	12.5
More than 90% but less than 100%	5.8	5.9	5.0	4.8
More than 100%	4.5	5.9	3.5	3.7
	100.0	**100.0**	**100.0**	**100.0**

First and second charge retail: Performance

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.78% (2012: 0.75%) which compares favourably with the industry average of 1.33% (CML arrears and possession data at 30 September 2013). Total arrears balances on residential lending fully secured by a first charge was £1.6m (2012: £1.5m) and there are 146 (2012: 143) residential cases six months or more in arrears.

The percentage of secured personal loans currently in arrears by number is 8.74% (2012: 9.25%), which by value is 11.68% (2012: 12.38%).

40. Financial instruments (continued)

c) Credit risk: loans and advances to customers (continued)

ci) First and second charge retail credit risk (continued)

First and second charge retail: Performance (continued)

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

	Group		Group	
	2013		2012	
	£m	%	£m	%
Current	4,895.7	96.5	4,469.3	96.1
Past due up to 3 months	114.0	2.2	116.3	2.5
Past due 3 months up to 6 months	23.0	0.5	23.2	0.5
Past due 6 months up to 12 months	17.5	0.3	16.5	0.4
Past due over 12 months	17.8	0.4	17.3	0.4
Possessions	3.8	0.1	3.9	0.1
	5,071.8	**100.0**	**4,646.5**	**100.0**

	Society		Society	
	2013		2012	
	£m	%	£m	%
Current	4,385.5	97.3	3,949.9	97.1
Past due up to 3 months	88.2	2.0	88.8	2.2
Past due 3 months up to 6 months	15.3	0.3	16.5	0.4
Past due 6 months up to 12 months	10.5	0.2	9.5	0.2
Past due over 12 months	2.6	0.1	0.9	-
Possessions	3.8	0.1	3.9	0.1
	4,505.9	**100.0**	**4,069.5**	**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 sector with Hometrack being used in the Secured Personal Lending business. Both indices take account of the geographical location of the collateral.

Based on indexed valuations the total collateral held against lending secured against residential property is estimated to be £11,349.0m (2012: £10,401.3m). 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. The percentage of the book with a collateral shortfall is reflected in the table on page 90.

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £4.7m (2012: £5.2m) 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.

Provisions are held against loans and advances to customers in line with the accounting policy which is outlined in Note 1. Provisions on retail loans and mortgages by business segment are broken down as follows:

	2013	2012
	£m	£m
Retail financial services	5.8	7.1
Secured personal loans	27.2	31.0
	33.0	**38.1**

40. Financial instruments (continued)

c) Credit risk: loans and advances to customers (continued)

ci) First and second charge retail credit risk (continued)

First and second charge retail: Forbearance

Whilst easing to some extent, difficult economic conditions have continued throughout 2013. We continue to uphold our mutual values, exploring all reasonable and appropriate account management and forbearance options for borrowers experiencing financial difficulty.

The Group offers a range of account management and forbearance options for borrowers. In the event of short-term difficulty the Group operates temporary reductions in payments and "rehabilitation" tools for borrowers in arrears or pre-delinquency. Actions may include granting a revised payment schedule, a temporary transfer to interest-only, arrangements for the borrower to underpay and changing the payment date or payment method.

Longer-term forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. During the year 18 accounts (2012: 36) have been capitalised with balances of £0.5m (2012: £1.5m). Capitalisation of arrears requires a qualifying period, typically six months, or a number of qualifying payments being met prior to the restructure. Any restructure will result in cases being classified and reported as up to date. We extended the term of 186 mortgages (2012: 485) and loans during the year with balances of £9.6m (2012: £26.9m).

Where suitable, the secured personal lending business will agree to release the legal charge on properties which fall into negative equity, thereby facilitating a vendor controlled sale and the achievement of their most advantageous selling price. The business may subsequently seek to reach agreement for payment of the unsecured shortfall with the borrowers. There have been 20 (2012: 23) successful cases during the year with balances of £1.2m (2012: £0.9m). Reduced settlement figures have been accepted on eight (2012: six) secured accounts with balances of £0.3m (2012: £0.2m).

All account management and forbearance options are considered based on the borrower's financial circumstances, agreed subject to set criteria and reviewed on a case-by-case basis. We will seek to agree a course of action following a comprehensive financial fact find. This may include establishing that a borrower is seeking or has received independent advice or guidance from one of a number of Advice Agencies.

Repossession of a property is the last resort and will only take place once all alternatives have been reviewed and there are no other solutions available. 70 properties were taken into possession during 2013 (2012: 62) with balances of £7.2m (2012: £6.2m).

22 (2012: 13) borrowers with balances of £1.1m (2012: £0.4m) were able to remain in their homes under a Mortgage Rescue Scheme and we continue to work with the Welsh Assembly Government, Local Authorities and debt advice agencies in Wales and England to ensure all options are available.

The underlying performance of previous capitalisations, interest-only concessions and arrangements to underpay are reflected in the provisioning methodology and are not individually or collectively material. Provisions of £1.2m (2012: £0.6m) are held in relation to accounts subject to previous forbearance.

cii) 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 development projects.

Further detail of the Group's risk management strategy in relation to commercial lending is described in the Risk management report on page 16.

Commercial Lending: Risk Concentrations

The Group's commercial loan portfolio on a gross basis comprises the following:

	Group and Society			
	2013		2012	
	£m	%	£m	%
Loans to Registered Social Landlords secured on residential property	158.9	18.7	173.9	18.7
Other loans secured on residential property	256.9	30.2	255.1	27.5
Loans secured on commercial property	435.7	51.1	499.6	53.8
	851.5	**100.0**	**928.6**	**100.0**

40. Financial instruments (continued)

c) Credit risk: loans and advances to customers (continued)

cii) Commercial Lending credit risk (continued)

Commercial Lending: Risk Concentrations (continued)

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			
	2013		2012	
	£m	%	£m	%
Office	155.9	35.8	166.8	33.4
Retail	141.1	32.4	153.8	30.8
Industrial	72.9	16.7	88.1	17.6
Leisure	10.8	2.5	12.2	2.4
Land	6.1	1.4	6.1	1.2
Other	48.9	11.2	72.6	14.6
	435.7	**100.0**	**499.6**	**100.0**

The average index-linked loan to value (LTV) in respect of the Group's commercial loans is estimated to be 78.5% (2012: 78.6%). 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.

£136.5m of exposures have an LTV of greater than 100%. Of these, £51.3m are already classified as Impaired and a further £53.9m are on the Watchlist, leaving £31.3m of exposures considered to be Satisfactory notwithstanding that they include an unsecured element. In these instances, Management are satisfied that the cashflows generated by the underlying assets will be sufficient to fully repay the debt over time.

The largest exposure to one counterparty is £29.9m (2012: £31.5m) or 3.5% (2012: 3.4%) of gross balances.

Commercial Lending: Performance

The commercial lending risk procedure for loans and advances to customers is described in the Risk management report on page 16.

Using the commercial credit risk grading system the commercial loan portfolio is distributed as follows (the figures are gross balances not including provision for loan impairment or unamortised loan origination fees):

	Group and Society			
	2013		2012	
	£m	%	£m	%
Satisfactory	711.2	83.5	738.8	79.6
Watchlist	78.1	9.2	162.7	17.5
Impaired (including past due up to 3 months)	62.2	7.3	27.1	2.9
	851.5	**100.0**	**928.6**	**100.0**

Watchlist 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 Watchlist are typically those which have had a material covenant breach, have persistent arrears (but are not presently past due) or where there are other concerns about the likelihood of eventual repayment. Defaulted accounts are described as impaired.

40. Financial instruments (continued)

c) Credit risk: loans and advances to customers (continued)

cii) Commercial Lending credit risk (continued)

Commercial Lending: Performance (continued)
The table below provides further information on commercial loans and advances by defaulted and delinquency status:

	Group and Society			
	2013		2012	
	£m	%	£m	%
Unimpaired				
Current	789.3	92.7	901.5	97.1
Past due up to 3 months	3.7	0.4	1.5	0.2
Impaired				
Past due 3 to 6 months	3.1	0.4	-	-
Past due 6 to 12 months	-	-	3.1	0.3
Past due over 12 months	-	-	0.4	-
Defaulted but not past due	52.3	6.1	14.3	1.6
Law of Property Act (LPA) Receivers appointed	3.1	0.4	7.7	0.8
	851.5	**100.0**	**928.5**	**100.0**

There are seven commercial cases (2012: 11) three months or more in arrears, of which three have LPA Receivers appointed. Total arrears balances are £86k (2012: £386k).

The total collateral held against commercial loans is estimated to be £1,325.8m (2012: £1,419.8m). Lending is classified by sector according to the property type held as collateral, as analysed in the table above. 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 will be sought. In the case of Watchlist exposures this will typically be at least annually.

Provisions are held against impaired loans as follows:

	Group and Society	
	2013	2012
	£m	£m
Collective Provisions	10.7	16.9
Specific Provisions	16.2	12.1
Total Provisions	**26.9**	**29.0**

Forbearance
In some cases of default or in order to avoid a default or maximise recoveries on defaulted exposures, 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. Management review all loans approaching refinancing six months in advance. Facilities due to be repaid which cannot be refinanced on current market terms may also be renewed on forbearance terms (such as an LTV covenant concession) to deal with the refinancing risk inherent in such situations. 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 2013, 20 (2012: 14) accounts with balances totalling £46.5m (2012: £68.6m) in value were granted forbearance concessions. The potential for losses on these accounts is assessed and considered in the level of overall provisions held against the Commercial Lending portfolio.

40. Financial instruments (continued)

d) Credit risk: Treasury financial instruments

The treasury credit risk strategy is described in the Risk management report on page 16.

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	
	2013	2012	2013	2012
	£m	£m	£m	£m
UK government securities and amounts held with central banks	347.0	195.0	347.0	195.0
Supranational securities	116.0	107.4	116.0	107.4
UK financial institutions	261.1	317.3	190.4	239.1
	724.1	**619.7**	**653.4**	**541.5**

None of these exposures was either past due or impaired, and there are no assets that would otherwise be past due or impaired whose terms have been renegotiated.

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £13.8m (2012: £13.3m) is held over derivative financial instruments.

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

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
AAA to AA-	528.9	393.5	528.9	383.5
A+ to A-	180.2	213.2	109.5	145.0
BBB+ to BBB-	-	-	-	-
Unrated	15.0	13.0	15.0	13.0
	724.1	**619.7**	**653.4**	**541.5**

The geographical distribution of these exposures is as follows:

	Group		Society	
	2013	2012	2013	2012
	£m	£m	£m	£m
UK	608.1	512.3	537.4	434.1
Other European countries	116.0	107.4	116.0	107.4
	724.1	**619.7**	**653.4**	**541.5**

The treasury risk function monitors exposure concentrations against a variety of criteria including counterparty and country limits, and all exposures are well spread across this risk assessment framework. An assessment has been made of the Society's key counterparties regarding the potential levels of direct or indirect exposure to distressed Eurozone economies. This assessment concludes that no impairment provisions are required.

40. Financial instruments (continued)

e) Liquidity risk

The following tables analyse the gross contractual principal cash flows payable under financial liabilities, excluding accrued interest and fair value adjustments. These balances will not agree directly to the balances in the consolidated statement of financial position as the table incorporates all cash flows on an undiscounted basis related to both principal as well as future interest payments based on rates prevailing at the date of the statement of financial position.

	2013					
	Total	Undefined maturity	Less than 3 months	Between 3 months and 1 year	Between 1 year and 5 years	More than 5 years
	£m	£m	£m	£m	£m	£m
Group						
Non-derivative liabilities						
Shares	5,475.9	-	3,203.1	1,061.8	1,211.0	-
Amounts owed to credit institutions	499.6	13.8	183.1	65.4	230.9	6.4
Other customers	222.5	-	94.2	119.0	9.3	-
Debt securities in issue	174.9	-	11.1	28.6	135.2	-
Subordinated liabilities	92.3	-	-	-	92.3	-
Subscribed capital	60.0	-	-	-	-	60.0
	6,525.2	**13.8**	**3,491.5**	**1,274.8**	**1,678.7**	**66.4**
Society						
Non-derivative liabilities						
Shares	5,475.9	-	3,203.1	1,061.8	1,211.0	-
Amounts owed to credit institutions	582.3	13.8	187.6	83.7	290.8	6.4
Other customers	222.5	-	94.2	119.0	9.3	-
Debt securities in issue	23.1	-	2.5	4.0	16.6	-
Subordinated liabilities	92.3	-	-	-	92.3	-
Subscribed capital	60.0	-	-	-	-	60.0
	6,456.1	**13.8**	**3,487.4**	**1,268.5**	**1,620.0**	**66.4**
Group and Society						
Derivative liabilities						
Interest rate swaps	25.5	-	0.5	1.0	11.5	12.5
Equity and RPI index linked interest rate swaps	0.7	-	-	-	-	0.7
	26.2	**-**	**0.5**	**1.0**	**11.5**	**13.2**

40. Financial instruments (continued)

e) Liquidity risk (continued)

	2012					
	Total	Undefined maturity	Less than 3 months	Between 3 months and 1 year	Between 1 year and 5 years	More than 5 years
	£m	£m	£m	£m	£m	£m
Group						
Non-derivative liabilities						
Shares	5,372.8	-	2,830.3	1,080.7	1,461.8	-
Amounts owed to credit institutions	95.8	13.3	21.0	5.0	42.0	14.5
Other customers	341.4	-	125.8	170.9	44.7	-
Debt securities in issue	265.6	-	17.1	47.9	200.6	-
Subordinated liabilities	92.3	-	-	-	92.3	-
Subscribed capital	60.0	-	-	-	-	60.0
	6,227.9	**13.3**	**2,994.2**	**1,304.5**	**1,841.4**	**74.5**
Society						
Non-derivative liabilities						
Shares	5,372.8	-	2,830.3	1,080.7	1,461.8	-
Amounts owed to credit institutions	252.1	13.3	36.8	57.1	130.4	14.5
Other customers	341.4	-	125.8	170.9	44.7	-
Debt securities in issue	31.0	-	4.0	10.7	16.3	-
Subordinated liabilities	92.3	-	-	-	92.3	-
Subscribed capital	60.0	-	-	-	-	60.0
	6,149.6	**13.3**	**2,996.9**	**1,319.4**	**1,745.5**	**74.5**
Group and Society						
Derivative liabilities						
Interest rate swaps	49.1	-	0.6	3.8	17.2	27.5
Equity and RPI index linked interest rate swaps	0.3	-	-	-	-	0.3
	49.4	**-**	**0.6**	**3.8**	**17.2**	**27.8**

Annual commitments under non-cancellable operating leases are outlined in Note 39.

40. Financial instruments (continued)

f) Market risk
Market risk can be sub-divided into interest rate risk and currency risk.

Interest rate risk
Interest rate risk refers to the sensitivity of net interest income to the periodic re-pricing of assets and liabilities and the imperfect correlation caused by basis risk. Interest rate risks generated by these activities are offset against each other, and the remaining net exposure to interest rate risk is managed on a continuous basis, within parameters set by ALCO, using a combination of derivatives and cash instruments (such as savings and deposits).

The Group's exposure to interest rate risk in terms of the net risk after taking account of Management's action to hedge inherent exposures is measured using interest rate gap analysis. In this method each of the Group's financial instruments including on and off the statement of financial position assets and liabilities is assigned to future time periods on the basis of their contractual maturity or contractual re-pricing arrangements. In calculating the net exposure for each future period, account is also taken of those assets and liabilities with embedded optionality, such as pipeline and prepayment risk on fixed rate mortgages. If there was a 2% parallel upward shift in interest rates the adverse impact on reserves would be £1.2m (2012: £6.9m).

Currency risk
After taking into account the effect of cross currency swaps the Group has no material exposure to foreign exchange rate fluctuations or changes in foreign currency interest rates.

41. Related party transactions

The remuneration of the directors (including non-executive directors), who are the key management personnel of the Group, is set out in the Report of the Remuneration Committee on page 40.

Loans to and shares held by directors

There was an aggregate of £0.4m (2012: £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 17 April 2014.

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 £0.2m (2012: £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 received from Society	Interest paid to Society	Fees received from Society	Fees paid to Society	Rent received from Society	Rent paid to Society
	£m	£m	£m	£m	£m	£m
Year ended 31 December 2013						
Nemo Personal Finance Limited	-	13.6	-	2.0	-	-
Peter Alan Limited	-	-	-	-	-	0.2
	-	**13.6**	**-**	**2.0**	**-**	**0.2**
Year ended 31 December 2012						
Nemo Personal Finance Limited	-	15.7	-	0.3	-	-
Peter Alan Limited	-	-	-	-	-	0.2
	-	**15.7**	**-**	**0.3**	**-**	**0.2**

At the year-end the following balances were outstanding:

	Loans owed to Society	Loans owed by Society	Loans owed to Society	Loans owed by Society
	2013	2013	2012	2012
	£m	£m	£m	£m
Nemo Personal Finance Limited	517.9	-	542.8	-
Peter Alan Limited	4.1	-	1.7	-
	522.0	**-**	**544.5**	**-**

Annual Business Statement
for the year ended 31 December 2013

1. Statutory percentages

	At 31 December 2013	At 31 December 2012	Statutory limit
	%	%	%
The lending limit	8.5	10.3	25.0
The funding limit	14.0	11.6	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.

The lending limit is the proportion of business assets not in the form of loans fully secured on residential property.

The funding limit is the proportion of shares and borrowings not in the form of customer accounts held by individuals.

Business assets are 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.

Loans fully secured on residential property are the amount of principal owed by borrowers and interest accrued not yet payable. This is the amount shown in the statement of financial position plus provision for loan impairment and minus unamortised loan origination fees.

2. Other percentages

	2013	2012
	%	% (restated)
As a percentage of shares and borrowings:		
Gross capital	8.0	8.3
Free capital	8.1	8.6
Liquid assets	16.1	17.4
As a percentage of mean total assets:		
Profit after taxation	0.32	0.29
Management expenses	1.09	1.08

Gross capital represents retained earnings, subscribed capital and subordinated liabilities as shown in the consolidated statement of financial position.

Free capital is gross capital plus provision for impairment losses less intangible assets and property, plant and equipment.

Liquid assets represent the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.

Mean total assets represent the average of the total assets in the consolidated statement of financial position at the beginning and end of the year.

Management expenses represent the aggregate of administrative expenses, depreciation and amortisation.

Annual Business Statement (continued)
for the year ended 31 December 2013

3. Directors

Details of directors are contained on pages 25 and 26.

Details of directors' service contracts are included in the Report of the Remuneration Committee on page 39.

Documents may be served on any of the directors c/o Eversheds LLP, Reference PDV, 1 Callaghan Square, Cardiff CF10 5BT.

Managers

David Cunningham-Jones
Peter Hughes
Susan Lane
Elaine Morris
Julie-Ann Haines

No director or other officer, including connected persons, has any right to subscribe for shares in, or debentures of, any connected undertaking of the Society.

Subsidiary companies

Peter Alan Limited
Managing Director:
Andrew Barry

Nemo Personal Finance Limited
Managing Director:
Phillip E. Jones

Glossary

ALCO
Asset and Liability Committee.

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 II
The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.

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. The standards will be phased in gradually from 2013.

BIPRU
The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive and was implemented in the UK via the FSA Handbook.

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.

Commercial lending
Loans secured on commercial property and loans to Registered Social Landlords.

Commercial Paper (CP)
An unsecured promissory note issued to finance short-term credit needs. It specifies the face amount paid to investors on the maturity date.

Commercial property
Includes office buildings, industrial property, medical centres, hotels, retail stores, shopping centres, multifamily housing buildings, warehouses, garages and industrial properties.

Contractual maturity
The final payment date of a loan or other financial instrument, at which point the entire remaining outstanding principal and interest is due to be repaid.

Core liquidity ratio
Buffer eligible liquid assets as a proportion of savings, deposits and loans.

Core Tier 1 capital
Tier 1 capital (see definition below) less Permanent Interest-Bearing Shares (PIBS).

Core Tier 1 capital ratio
Core 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.

Coverage ratio
Impairment allowances (provisions) as a percentage of the loans and advances to which they relate.

Covered bonds
Debt securities backed by a portfolio of mortgages that is segregated from the issuer's other assets solely for the benefit of the holders of the covered bonds.

Credit default swap
An arrangement where the credit risk of an asset (the reference asset) is transferred from the buyer to the seller of the protection. A credit default swap is a contract where the protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer upon a defined credit event. Credit events normally include bankruptcy, payment default on a reference asset or assets, or downgrades by a rating agency.

Credit risk
The risk that a borrower or counterparty fails to pay the interest or to repay the capital on a loan. Credit risk is the largest risk category to which the Group is exposed and sub-divided as follows: retail lending, commercial lending, and Treasury credit risks.

Credit risk mitigation
Techniques to reduce the potential loss in the event that a customer (borrower or counterparty) becomes unable to meet its obligations. This may include the taking of financial or physical security, the assignment of receivables or the use of credit derivatives, guarantees, credit insurance, set off or netting.

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 restructuring
The changing of the terms and provisions of outstanding debt agreements. Restructuring may be done in order to improve cash flow and the ability of the borrower to repay the debt. It can involve altering the repayment schedule as well as debt or interest charge alteration.

Debt securities
Assets representing certificates of indebtedness of credit institutions, public bodies or other undertakings excluding those issued by central banks.

Debt securities in issue
Transferable certificates of indebtedness of the Group to the bearer of the certificates. These are liabilities of the Group and include certificates of deposit.

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 further obligation to pay further contributions.

Delinquency
See Arrears.

ECAI
External Credit Assessment Institution. An ECAI (e.g. Moody's, Standard and Poor's and Fitch) is an institution that assigns credit ratings to issuers of certain types of debt obligations as well as the debt instruments themselves.

Glossary (continued)

Economic capital
An internal assessment of the amount of capital required to protect against potential unexpected future losses arising from business activities, across a defined time horizon and confidence interval.

Effective Interest Rate method (EIR)
The method used to measure the carrying value of a financial asset or a liability. EIR allocates associated interest income or expense to produce a level yield, either to maturity or to the next re-pricing date.

Euro Medium Term Notes (EMTN)
Euro notes issued by corporates across a range of maturities. EMTNs are frequently issued by corporates under EMTN programmes whereby notes are offered on a regular and continuous basis to investors.

Expected Loss (EL)
A Basel II 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, counterparty or group fails to meet their obligations or if assets and off-statement of financial positions have to be realised.

Exposure At Default (EAD)
A Basel II parameter used to estimate the amount outstanding at the time of default.

FSA
Financial Services Authority. The former financial services industry regulator in the UK, which was superseded by the Financial Conduct Authority and the Prudential Regulation Authority from 1 April 2013.

Final salary pension arrangements
A defined benefit pension arrangement where the pension payable to the employee is based on final pensionable salary prior to retirement.

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)
The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the UK regulators is obliged to pay an annual levy, which goes towards its running costs and compensation payments.

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.

Free capital
The aggregate of gross capital and provisions for collective impairment losses on loans and advances to customers less property, plant and equipment and intangible assets.

Funding limit
The proportion of shares and borrowings not in the form of customer accounts held by individuals.

GORC
Group Operational Risk Committee.

GRC
Group Risk Committee.

Gross capital
The aggregate of general reserve, revaluation reserve, available-for-sale reserve, subscribed capital and subordinated liabilities.

Guarantee
An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.

Individual Liquidity Adequacy Assessment (ILAA)
The Group's own assessment of the levels of liquidity that it needs to meet its current and expected financial obligations. These are assessed under normal and stressed conditions.

Impaired loans
A loan is impaired if there is objective evidence that an impairment event has occurred, and that the event has an impact on the estimated future cash flows of the loan which can be reliably estimated. Impairment may be caused by a single event, or a combination of events. Impairment events include redundancy or marital breakdown.

Impairment allowances
Provisions held against assets on the statement of financial position. The provisions represent management's best estimate of losses incurred in the loan portfolio at the statement of financial position date.

Indexed LTV (Loan to Value)
A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

Individually/collectively assessed impairment allowances
Impairment is measured individually for assets that are individually significant to the Group, 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 quantity of a firm's liquidity resources and the firm's funding profile.

Internal Capital Adequacy Assessment Process (ICAAP)
The Group's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.

International Swaps and Derivatives Association (ISDA) master agreement
A standardised contract developed by ISDA and used to enter into bilateral derivative 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.

IPD index
Measures the returns on property investments in the UK.

Internal Ratings Based (IRB)
This is a risk assessment approach for capital calculations which allows a financial services business to use its own internal information to estimate risk weightings, rather than standard risk weightings prescribed by the Prudential Regulation Authority (PRA).

Glossary (continued)

Lending limit
The proportion of business assets not in the form of loans fully secured on residential property.

Level 1 fair values
Fair value derived from unadjusted quoted prices in active markets for identical assets or liabilities, e.g. G10 government securities.

Level 2 fair values
Fair value derived from inputs other than quoted prices that are observable for the asset or liability, either directly (i.e. a price) or indirectly (i.e. derived from prices), e.g. most investment grade and liquid bonds, asset backed securities, certain collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and OTC derivatives.

Level 3 fair values
Fair value derived from inputs for the asset or liability that are not based on observable market data (unobservable inputs), e.g. private equity investments, derivatives including an equity element, deposits including an equity element, some CDOs and certain asset-backed securities and bonds.

Leverage ratio
As currently proposed under Basel III rules, it is a supplementary measure of risk-adjusted capital requirements, defined as the ratio of Tier 1 capital to total exposures. Total exposures include on and off statement of financial position items (after netting derivatives).

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)
As currently proposed under Basel III rules, this is 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 is not able to meet its financial obligations as they fall due or can secure them only at excessive cost.

Loan to deposit ratio
Represents loans and advances to customers divided by the aggregate of shares, other deposits and amounts due to customers.

Loan To Value ratio (LTV)
A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

Loans past due/past due loans
Loans are past due when a counterparty has failed to make a payment when contractually due.

Loss Given Default (LGD)
A Basel II parameter used to estimate the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.

Management expenses
The aggregate of administrative expenses, depreciation and amortisation.

Management expense ratio
Management expenses as a proportion of total average assets.

Market risk
The potential losses or decrease in value of the Group statement of financial position as a result of adverse market movements. Specific types of market risk include interest rate risk (banking book), swap spread risk and currency risk.

Maturity
The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.

Member
A person aged 18 or over who has a share investment or a mortgage loan with the Society over £100 during the year.

Negative equity mortgages
Negative equity occurs when the value of the property purchased using the mortgage is less than the balance outstanding on the loan. Negative equity is the difference between the current value of the property and the outstanding balance on the loan.

Net interest income
The sum of the amount earned on assets (a combination of retail lending, commercial lending and liquid assets) less liabilities (savings products and borrowings).

Net interest margin
Net interest income as a proportion of total average 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).

Non-standard lending
Consists of Buy-to-Let and other non-standard mortgages.

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 rates are also used to discount collateralised derivative future cash flows to calculate the fair value of collateralised swaps.

Over-The-Counter (OTC)
A bilateral transaction (e.g. derivatives) that is not exchange traded and valued using valuation models.

Own credit adjustment
Adjustment for the effect of the Group's credit standing on the fair value of its financial liabilities. This is sometimes referred to as a debit valuation adjustment.

Permanent Interest-Bearing Shares (PIBS)
Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, creditors and investing Members of the Group. Also known as subscribed capital.

Prime residential mortgages
Prime mortgages are mainstream residential loans, which typically have a higher credit quality and fit standard underwriting processes. As such, they are likely to have a good credit history, and pass a standard affordability assessment at the point of origination.

Probability of Default (PD)
A Basel II parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.

Glossary (continued)

Prudential Regulation Authority (PRA)
The statutory body responsible for the prudential supervision of banks, building societies, insurers and a small number of significant investment firms in the UK from 1 April 2013. The PRA is a subsidiary of the Bank of England. The PRA's role emphasises the statutory objective of promoting the safety and soundness of firms.

Regulatory capital
The capital held by the Group, determined in accordance with rules established by the PRA. The regulatory capital base comprises Tier 1 and Tier 2 capital (see below).

Renegotiated loans
Loans and advances may be renegotiated either as part of an ongoing customer relationship with a creditworthy customer or in response to a borrower's financial difficulties. In the latter case, the renegotiated loan may no longer be treated as past due or impaired if there is no change to the estimated future flows. Individually significant loans whose terms have been renegotiated are subject to ongoing review to determine if they remain past due or impaired.

Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)
A repurchase agreement that allows a borrower to use a financial security as collateral for a cash loan. In a repo, 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 and consumer banking.

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)
The value of assets, after adjustment, under the Basel II capital rules to reflect the degree of risk they represent.

Return on Capital (ROC)
Profit after tax as a percentage of average gross capital (general reserve, revaluation reserve, available-for-sale reserve, PIBS and subordinated liabilities). Profit after tax excludes the interest cost of PIBS and subordinated liabilities.

Securitisation
A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose 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.

Shares
Funds deposited by a person in a retail savings or current account with the Society. Such funds are recorded as liabilities for the Society.

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 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 SPEs set up under a securitisation programme. Where the Group has control of these entities or retains the risks and rewards relating to them, they are consolidated within the Group's results. This term is used interchangeably with SPV (Special Purpose Vehicle).

Standardised approach
The basic method used to calculate credit risk capital requirements under Basel II. 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).

Sub prime
Loans to borrowers that typically have weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and discharged bankruptcies. They may also display higher risk characteristics as measured by credit scores, or other criteria indicating heightened risk of default.

Standard Variable Rate (SVR)
The rate of interest on which mortgage pricing is based.

Tier 1 capital
A component of regulatory capital comprising general reserves from retained profits, Permanent Interest-Bearing Shares (PIBS), less goodwill, intangible assets and other regulatory adjustments.

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 and the collective impairment allowance (for exposures treated on a Basel II standardised basis), 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.

Branch Addresses

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BRIDGEND	28 Caroline Street CF31 1DQ	01656 655120
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CARDIFF (Birchgrove)	95 Caerphilly Road, Birchgrove CF14 4AE	029 2061 5928
CARDIFF (Canton)	174 Cowbridge Road East, Canton CF11 9NE	029 2037 3153
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CARDIFF (Whitchurch)	21 Merthyr Road, Whitchurch CF14 1DA	029 2062 4537
CARMARTHEN	13 Guildhall Square SA31 1PR	01267 235403
CHESTER	14 Bridge Street CH1 1NQ	01244 323039
COWBRIDGE	28 High Street CF71 7AG	01446 773954
CWMBRAN	Cwmbran Shopping Centre, Cwmbran NP41 1AH	01633 835000
DENBIGH	11 Vale Street LL16 3AD	01745 814549
EBBW VALE	2a The Walk NP23 6AY	01495 305569
FISHGUARD	29 West Street SA65 9AL	01348 873473
GORSEINON	86 High Street SA4 4BL	01792 896389
HAVERFORDWEST	5 Victoria Place SA61 2JX	01437 762147
HEREFORD	2 St Peter's Square HR1 2PG	01432 273039
LAMPETER	45 High Street SA48 7BB	01570 422844
LLANDEILO	40 Rhosmaen Street SA19 6HD	01558 822638
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MAESTEG	139 Commercial Street CF34 9DW	01656 737111
MERTHYR TYDFIL	Beacons Place CF47 8ED	01685 385421
MOLD	39 High Street CH7 1BQ	01352 756345
MONMOUTH	1 Monnow Street NP25 3EF	01600 717038
NEATH	1-3 Green Street SA11 1DR	01639 635316
NEWPORT	33 High Street NP20 1RU	01633 258206
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PORTHCAWL	23 John Street CF36 3AP	01656 788257
PORT TALBOT	7 Riverside Walk SA13 1NY	01639 884055
PRESTATYN	99 High Street LL19 9AP	01745 852531
PWLLHELI	55a High Street LL53 5RT	01758 613331
SHREWSBURY	2 The Square SY1 1LA	01743 353430
SWANSEA (Kingsway)	64-65 The Kingsway SA1 5HW	01792 655791
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SWANSEA (Mumbles)	53 Newton Road, Mumbles SA3 4BD	01792 360223
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WREXHAM	20-22 Regent Street LL11 1SA	01978 261788

Agency Office Addresses

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PORTHMADOG	103 High Street, Gwynedd LL49 9EY	01766 512011
ROSS-ON-WYE	8 Broad Street HR9 7EA	01989 763553
TALBOT GREEN	38 Talbot Road CF72 8AF	01443 224000
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Principality Building Society is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, reference number 155998. Principality Building Society, Principality Buildings, Queen Street, Cardiff, CF10 1UA. www.principality.co.uk

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