ANNUAL REPORT
AND ACCOUNTS

2016

Building your future

Principality
Building Society
Cymdeithas Adeiladu

Where home matters
principality.co.uk

72.7%

Customer service net promoter score of 72.7% (2015: 65.9%)

Our net retail mortgage lending grew by over

£600 million

3500 first time buyers

We helped over 3500 first-time buyers onto the housing ladder

£50.3 million

Our pre-tax profits grew to £50.3m (2015: £49.0m)

We continued to grow savings balances – they increased to over £6.1bn

(2015: 5.6bn)

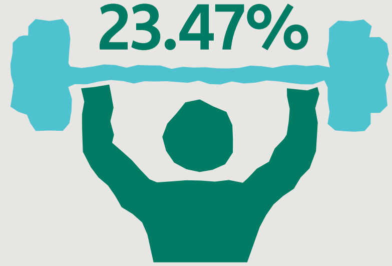
1.57%

Net interest margin 1.57% (2015: 1.81%)

We entered into a 10 year partnership with the WRU to invest in rugby at all levels

We raised a record **£150,000** for our charity partnerships

23.47%



Strong capital ratios with a Common Equity Tier 1 ratio of 23.47% (2015: 20.97%)

Find out more about our charity and community work

Meet your Board of Directors

Understand our consolidated income statement

Performance and Strategy

Governance

Financial Statements

Section 1

Performance and Strategy

Building your future

Chairman's Statement

for the year ended 31 December 2016

Strong Performance

Laurence Adams
Chairman

It has been another positive year for Principality, with record assets and our highest volume of lending, the major headlines of which are detailed in the Chief Executive's Review.

Our mutual model and the strategy the Board adopted in 2012 continues to fulfil our key ambition to help our Members prosper in their homes at every stage of their lives.

The Group's financial position has strengthened further through strong profitability which places the Society in a good position to invest in our business for the future. It is important we continue to develop the organisation so it meets the demands of a rapidly changing technological landscape and the diverse lifestyles of our Members.

Such a strong performance helps us to futureproof the business as we enter greater uncertainty created by global events. We have a very strong Statement of Financial Position and I am in no doubt that our strategy has been crucial in helping the business meet with these challenges.

Regulation

The scale of regulatory change is undiminished, as domestic and international authorities maintain their wide-ranging programmes of reform. This will clearly continue to represent a principal area of focus for the financial services industry, as firms respond to the increasingly demanding regulatory agenda.

The Society has maintained a prudent approach towards risk management and we will continue to work closely with our regulators in order to ensure that our aspirations remain consistent with their expectations. The Group's business model and strong Member focus leaves us well-placed to meet current and emerging regulatory requirements. Our team strives to keep our Members and their money safe and we remain supportive of our regulators as they seek to raise standards across the industry.

Supporting our Members, Colleagues and Communities

Principality prides itself on representing the values of our Members and this bond is what makes us stand out as a trustworthy brand on the high street. We are aware of the great challenges faced by the communities we serve and remain committed to helping them through an uncertain period in the coming years. It is our purpose to help our Members and communities prosper at every stage of their lives and there are many ways our colleagues help to do this.

Pictured: Two Members meeting with Sam Warburton and Ken Owens

Our ongoing commitment to the high street has maintained our strong connection with our Members. We will continue to invest in developing our service offering so we can adapt to modern ways of interacting with our customers.

In January 2016 we began a ten-year sponsorship with the Welsh Rugby Union (WRU) which included renaming the stadium the Principality Stadium. We have seen an increase in positive reaction to our brand as a result of this partnership. One of the major factors in signing the deal with the WRU was ensuring that we gave more benefits to our Members. They now have the opportunity to apply for tickets through priority access, and enter exclusive competitions and ticket giveaways for rugby, concerts and events.

Principality colleagues voted to do something different when it came to our impressive charity work. They voted to help three charities during the next three years. That is a big challenge but one they have risen to in the first year. You can read in more detail about the innovative and fantastic ways our colleagues raised an enormous amount of cash in our Members, Colleagues and Communities section.

In the summer the Principality signed up to HM Treasury's Women in Finance Charter to improve gender diversity. We are proud that women currently account for almost two-thirds of our workforce, and we have set ourselves a senior leadership team target of one third of women in post by 2021.

Member, colleague and community highlights

Principality began a 10 year sponsorship with the Welsh Rugby Union

Principality colleagues voted to help three charities over three years - Cancer Research Wales, Llanmau, School of Hard Knocks

Principality signed up to HM Treasury's Women in Finance Charter to improve gender diversity

Appointments

Along with a strong management team and skilled workforce, the strength of any business's Board is vital to its success and at Principality that is no different. We ensure that we have Directors of the highest calibre to represent the Society from a variety of different backgrounds.

After a rigorous selection process, I am delighted to announce Stephen Hughes as our new Chief Executive Officer. His commitment to our mutual values, invigorating leadership, financial and commercial acumen will help ensure he builds on the Society's success.

During his time at Principality Building Society, he has played an important role in keeping the Society safe during some difficult economic conditions.

He is the right person to ensure we continue to deliver long term value and excellent service to both existing and future Members.

This year we were pleased to appoint Julie-Ann Haines to our Board. Julie-Ann joined Principality in 2007 and brings with her more than 20 years of experience in leading customer-centric businesses.

Her appointment was driven by a clear focus on Principality's growth strategy. Julie-Ann will bring invaluable experience and insight to the Board as part of the Society's focus on its products, marketing and customer experience. Her range of skills and experience, together with her knowledge of the industry and her deep understanding of our Members, customers and communities will strengthen the current collective knowledge within the Board.

Pictured: Partner schools Ysgol Strade and Bro Myrddin with School of Hard Knocks enjoy training at Parc y Scarlets

Pictured: Meeting Members at our AGM last year

Pictured: New CEO Steve Hughes gives Sam Milligan an achievement award after he raised £2,000 for a breast cancer ward

Pictured: The Senior Leadership Team on a sponsored sleepout for Llamau

Thank you

I would like to extend my thanks to all of the hard-working colleagues in our branches, agencies and head office who connect so positively with our Members. It is the unique culture of hard work and the caring nature of our teams that makes Principality stand out from its competitors. We have strong values at the core of our business which are the foundations of its success.

I would like to take this opportunity to thank our outgoing Group Chief Executive, Graeme Yorston. I am very sorry that Graeme has decided to step down but understand his reasons for doing so. Graeme has led this business through a hugely successful period and he exemplifies the mutual sector values. I am extremely grateful for all that he has done for this business over the past ten years and more recently as Chief Executive.

Under his leadership the Society has delivered consistently strong financial results and excellent customer service for the benefit of all our Members. His considerable efforts have left us in a healthy position to withstand any uncertainty in the next few years and a model that will allow us to grow the business for our Members. On behalf of the Board and all our colleagues at the Principality I want to take this opportunity to wish him and his family the very best of luck and health for the future. Diolch yn fawr Graeme!

Laurence Philip Adams
Chairman
14 February 2017

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Group Chief Executive's Review of the year

for the year ended 31 December 2016

Strong financial performance and resilient business

Graeme Yorston
Group Chief Executive

I am delighted to say that the strength of the brand of Principality alongside our outstanding service and the dedication of our leaders and teams across the business have together delivered a very strong business performance in 2016.

Our trusted model continues to stand the test of time through difficult and sometimes uncertain periods. Despite a challenging interest rate environment for savers we have continued to grow savings balances which has been fundamental to supporting our growth in mortgage lending.

Delivering a strong performance is essential, both for our ability to withstand any downturn in the economy as well as providing investment in the business for the future. If Principality is to remain relevant for future generations then how we deliver products and services has to evolve. This will mean building on our current model and ensuring that we have digital capability across our business as well as a broader product set that will ensure the business is able to thrive for generations to come.

In order to achieve this, we have been growing our business, and 2016 proved to be one of our strongest years ever where we achieved some significant milestones; see overleaf.

Each of our businesses continue to perform very well and I am particularly pleased with the performance of Nemo given that we took the difficult decision to cease accepting new business at the beginning of 2016.

Our Commercial Lending division continues to improve and has delivered one of the best performances for many years. This part of our business plays an important role in supporting, amongst other things, local house builders, and this is very much in line with the core purpose of the Building Society.

The strategy of growing the core business of the Building Society continues to deliver and the growth achieved this year is a record for this part of the business. This means that we have delivered on our promise to help more people own a home - both in Wales and beyond - than ever before.

It is important I signal that, in future years, it is likely that profits will reduce and this is entirely planned and expected. This will happen primarily for two reasons, firstly from 2017 the investment programme to improve and develop our capabilities, digital and more generally, will start and so the cost of running

2016 Significant Milestones

Gross mortgage applications of £2bn for the first time in Principality's history

Our focus on providing outstanding customer service has once again delivered and our customer service net promoter score stood at 72.7% for the year (2015: 65.9%)*

Our net lending to people buying homes grew by over £600m

Profit before tax for the year of £50.3m (2015: £49.0m)

Our savings balances also grew strongly and now stand at over £6.1bn (2015: £5.6bn)

Our Commercial Lending division had one of its strongest years and delivered a significant contribution to the Group with a profit before tax of £12.5m (2015: £6.2m)

We continued our prudent business approach and strengthened the statement of financial position further in the year as well as taking the overall size of the to £8.3bn (2015: £7.6bn)

Nemo continues to make a significant contribution to the Group and in 2016 delivered a profit before tax of £11.6m (2015: £14.0m)

*Source: Based on internal survey data for 12 months ended December 2016

the business will increase as we invest more in our infrastructure, therefore impacting profitability. Secondly, the run off of the Nemo balance sheet will continue and the loss of this higher profitability business will also have an impact. As I have said this is a planned reduction before the investment begins to deliver a return in future years.

We continue to live in uncertain times and 2016 has proved to be no exception to this, with what some would say were unexpected political changes which served to destabilise markets and led to the Bank of England reducing interest rates to another historical low.

Despite these uncertainties Principality performed well and the profits delivered in 2016 will further add to the strong capital position that we both need to and should have to provide a strength that will be able to weather any downturn in the market that may occur.

Serving our communities

As our Members and communities face increasing challenges, which show no sign of diminishing, we understand the responsibility that this places on us and the increasingly important role we have to play in helping in these difficult times. We are very clear about why Principality exists, and that is to help people prosper in their homes at every stage of life. This has become a real rallying call for our colleagues and we will do all that we can to deliver on this. Prosperity can mean many things to different people but we try and live up to this by focusing on the areas we can support, from children's accounts to providing financial education in schools, from first time buyers through to the work we now do with a number of institutions to look at ways that we can help people stay in their own homes for longer later in life. This is what we mean by prospering and we will continue to find ways to help people through our products and services both now and into the future.

We remain committed to the high streets of Wales as being a place where our Members enjoy the great service delivered by our excellent teams. However, like the banks, we have seen the use of our branches decline, although this has been much more gradual than perhaps some of the banks have seen. This more gradual decline does give us time to think about what the branch needs to be and what a sustainable network looks like. We need to reinvent the model and make sure that our branch network remains viable and relevant, and continues to be valued by our Members in the years ahead.

Pictured: The three charities we will support over the next three years: Llamau, Cancer Research Wales, School of Hard Knocks

Supporting our three charities over a three-year period, as well as our local community work, continues to be a focus. The charities, chosen by our colleagues, play an important role in supporting research into finding a cure for cancer, helping those who are, for many reasons, not in a position to provide a roof over their head and those who have fallen on hard times and who need support in coping with day-to-day life. We continue to be determined to support our colleagues in giving up their time, and work time, to fundraise for these very important initiatives. I never fail to be impressed with the efforts put in by people right across our business to do this. You will find much more information in our Member, Colleague and Community section.

Looking to the future

Technology has a very important role in helping people to run their lives, including being able to make payments easily and in running their accounts with us. Making sure technology is married to what we offer through our branch network is going to be critical for the long-term prosperity of our business. This is what we are required to do to ensure that this business is here to serve future generations. Our growth strategy has been about providing the platform to allow this investment to happen, therefore ensuring that Principality exists for many years to come in supporting people throughout Wales and beyond.

This business is very well placed to be able to respond to all of the demands that will inevitably come its way, whether that be changes in economic conditions or in meeting the changing demands of consumers in the financial services marketplace. The business has a strong executive and leadership team who understand these demands and who also understand the value of the mutual model. I am delighted that our current Finance Director, Stephen Hughes will take over as CEO in March 2017. I am confident that this appointment, together with the significant financial strength of the business, puts Principality in a position of being, rightly, optimistic about the future.

Personal reflections

In August of 2016 I indicated my intention to step down as Chief Executive of Principality, a decision that I am very fortunate to be able to take but one that was incredibly difficult. I am privileged to have spent the final years of my executive career serving the Members of Principality over an 11 year period and the last five as Chief Executive.

Pictured: Three youngsters from Ysgol Bro Myrddin take a tour of Principality Stadium

Pictured: Principality's Louise Harrington presenting Principality Premiership's 'Referee of the Season' Award to Ben Whitehouse

I really do consider this to have been the pinnacle of my career. My role was simply to ensure that the business was stronger than when I took over and I can honestly say that this is the case; but I also recognise that I could not have achieved this without the support of my Executive and Board colleagues as well as colleagues up and down the breadth of Wales who have day in, day out looked after our Members. Finally I am very grateful for the support and loyalty of the Principality Members themselves, a great number of whom have been loyal to this organisation for many, many years – it has been my pleasure to serve you all and to meet many of you over my time here in Wales – thank you, diolch!

Graeme H. Yorston
Group Chief Executive
14 February 2017

Strategic Report

for the year ended 31 December 2016

Pictured: Jim and John from Principality's Commercial Lending division

Group strategy

Principality exists to help people prosper in their homes, at every stage of life. Providing a secure home for savings and helping people to buy homes are the two principles on which Principality has grown to a Member base of over 500,000 who trust the Society with their savings and mortgages, and to employing over 1,000 colleagues.

Principality is Wales' largest building society and the 6th largest in the UK. The Group has over £8 billion in assets and accounts for 5.0% of the Welsh residential mortgage market and 13.1% of the total Welsh retail savings balances. The Group also operates successful commercial lending and secured personal lending businesses that support the core Building Society.

The Group's principal strategy is to focus on growing the Society, through increasing its retail mortgage lending and enhancing its overall proposition. In order to achieve this, the Group strives to provide Members with exceptional service, and is committed to becoming 'The most recommended financial services provider in Wales'.

A key aspect of this strategy is the financial stability of the Society, and the growth strategy is underpinned by a clearly defined risk appetite. Financial stability is achieved through sustainable financial performance, which in turn relies on the following:

- Strong capital generation achieved through ongoing profitability
- Effective liquidity management to ensure the Society maintains a sufficient buffer of available funds
- A diverse and cost effective funding base
- Operational efficiency achieved through a culture of continuous improvement within the Society
- Fit for the future technology and processes
- The right culture and values amongst colleagues

Being a mutual building society

Principality has been a mutual building society for over 150 years, and remains committed to its mutual heritage because it believes that this is in the best long-term interests of current and future Members. Being a truly mutual Society means that Principality is owned by and run for the benefit of its Members. Because Principality does not have any shareholder interests to satisfy, all its profits are reinvested to benefit Members. Principality's key priority is to keep Members' money safe, and generating capital through making adequate profit is a vitally important part of this. Further, it is important that the Group continue to invest in the business to ensure its future can be as successful as its past.

Group business model

The Group has three primary business units: retail financial services and commercial lending, both conducted through the Society, and secured personal lending, managed through the subsidiary company Nemo Personal Finance Limited (Nemo). Following a comprehensive strategic review of the future options for Nemo during 2015, the Group ceased new lending through Nemo in March 2016. Nemo continues as a reshaped business to provide excellent service to its customers through its loan servicing operations.

A summary of the products offered through the retail financial services and commercial lending business units is set out below:

		LOANS	SAVINGS	OTHER	CHANNEL			
					BROKER	ONLINE	PHONE	FACE-TO-FACE
PRINCIPALITY GROUP	Principality Building Society Cymdeithas Adeiladu	RESIDENTIAL MORTGAGES			✓		✓	✓
		BUY-TO-LET MORTGAGES			✓		✓	✓
			FIXED RATE SAVINGS			✓	✓	✓
			VARIABLE RATE SAVINGS			✓	✓	✓
				LIFE INSURANCE			✓	✓
				HOME INSURANCE		✓	✓	✓
	Principality Commercial	COMMERCIAL LOANS						✓

Investment programme

In response to the fast changing financial services landscape, with well publicised innovation through mobile applications, devices and other internet linked technologies, during 2015 the Group set out on an ambitious programme of investment to ensure it has the right foundations to achieve its growth aspirations and remain relevant and successful in an ever-changing marketplace.

It is the Group's robust financial performance which has delivered a strong platform from which to invest for the future, and the Group is well placed in terms of resources and skills to deliver effectively against its ambitious programme of change. This will see significant further investment in people, processes, brand and technology capability.

Technology will be critical to meeting this challenge, in particular to be able to provide a seamless experience across branch, internet, broker and contact centre so that the Society is easy to do business with, which means simple processes with minimal effort and maximum convenience for Members.

The Group's investment programme has continued to deliver real benefits in 2016. Those benefits include additional product propositions, such as overpayment facilities for mortgages, and enhancements to Member experience through investment in savings servicing capabilities. It has delivered improvements to the working environment for colleagues, through the development of Principality House, and has continued the investment in colleagues, including the development of the Group's Reward Strategy. The investment in the Principality brand has enhanced the brand awareness in Wales and beyond during 2016, with high profile events such as the autumn internationals held at Principality Stadium. The Group has also continued to deliver against a challenging regulatory change agenda, ensuring that Members continue to experience excellent products and service, delivered in a compliant way following best practice.

Key performance indicators

The Group monitors a number of key performance indicators (KPIs) to measure progress towards its strategic objectives. This table details these KPIs:

	2016	2015
Member Experience		
Customer Service Net Promoter Score[1]	72.7%	65.9%
Financial Performance		
Group Profit Before Tax	£50.3m	£49.0m
Retail Mortgage Balances	£5,858.3m	£5,244.9m
Group Net Interest Margin	1.57%	1.81%
Management Expense Ratio (underlying cost basis)[2]	1.00%	1.07%
Financial Stability		
Common Equity Tier 1 Ratio	23.47%	20.97%
Liquidity Ratio	14.6%	13.9%

1. Source: Based on internal survey data for 12 months ended December 2016.

2. Further details contained under the heading 'Operating expenses' page 17 and 18.

Member experience

The Society measures Member experience in two primary ways. The first is an external Net Promoter Score (NPS), which benchmarks, against others in the industry, the likelihood of a Member to promote the Society based on their experience. On this measure the Society was ranked 2nd in the year in relation to savings providers in Wales.*

The second is a customer service NPS, which also measures the likelihood of a Member to act as a promoter of the Society, but which is a measure based on internally designed instant feedback surveys. This provides additional detail in relation to Member experience. On this measure, Group performance in the year improved from 65.9% to 72.7%.

Both measures demonstrate the continued focus on providing industry leading service levels to Members.

* Source: GfK FRS, 12 months ending December 2016. Includes all Wales savings providers with >100 respondents.

Financial performance

Income statement overview

Continuing operations:	2012* £m	2013* £m	2014 £m	2015 £m	2016 £m
Net interest income	99.1	116.4	133.8	134.1	124.9
Other income	24.3	13.2	8.1	6.8	9.7
Fair value gains/(losses)	0.2	(1.2)	(1.5)	0.9	1.6
Operating expenses	(71.2)	(65.3)	(64.7)	(83.7)	(82.1)
Impairment provisions	(16.3)	(22.4)	(13.5)	(4.8)	2.7
Other provisions	(11.9)	(12.5)	(8.7)	(4.3)	(6.5)
Other gains	1.5	–	–	–	–
Profit before tax from continuing operations	25.7	28.2	53.5	49.0	50.3

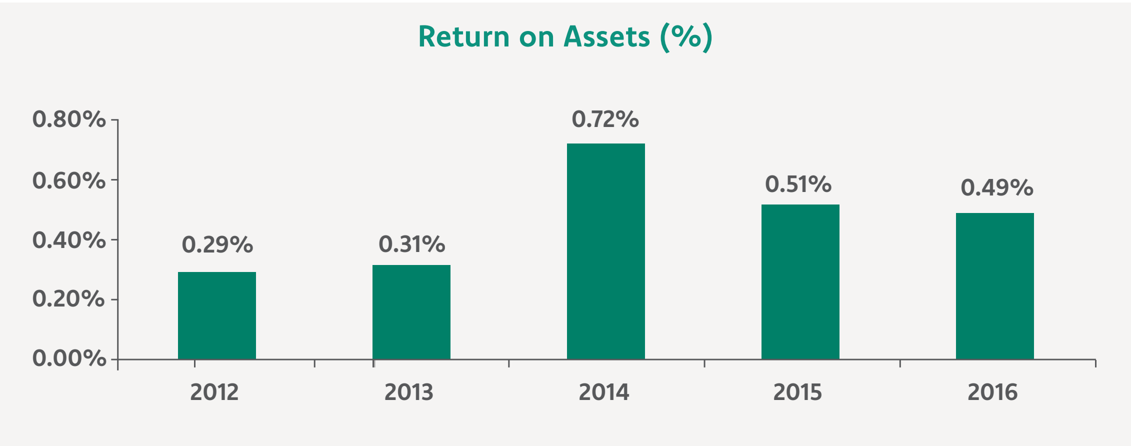
* Not adjusted for the impact of the sale of the Peter Alan estate agency business in 2014.

Group financial performance was strong in the year, with pre-tax statutory profit of £50.3m (2015: £49.0m). Underlying profit, which adjusts for one off factors not reflective of current trading performance, increased to £59.2m (2015: £57.8m). Both measures reflect the ongoing strong performance of the Group, which support the ability of the Group to invest for the longer term.

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

	2016 £m	2015 £m
Statutory profit before tax from continuing operations	50.3	49.0
Nemo strategic review and restructuring costs	2.4	4.5
Provisions for other liabilities and charges	6.5	4.3
Underlying profit	59.2	57.8

The Group's return on assets, calculated as statutory profit after tax divided by average total assets, was as follows:



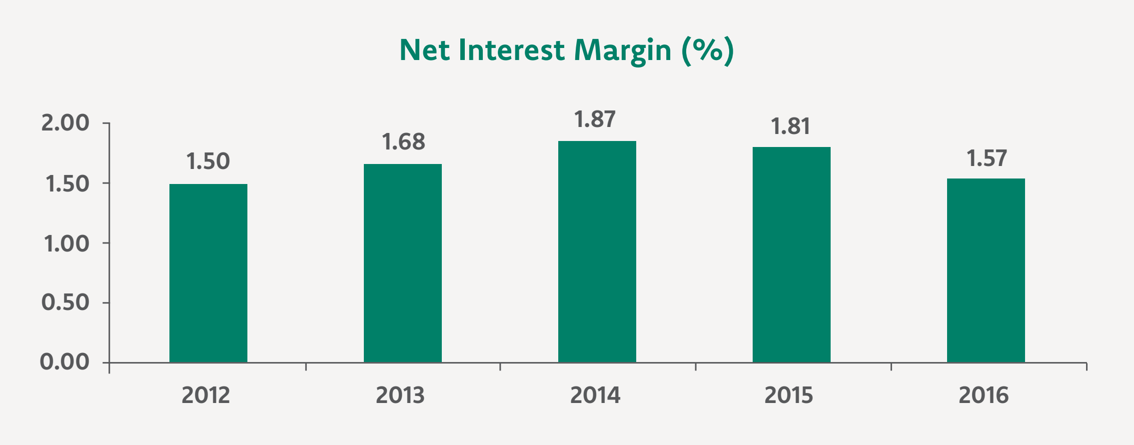
Net interest margin

The Group's margin continues to be robust at 1.57%, albeit lower than in the prior year (2015: 1.81%). In line with other financial services organisations, the Group has experienced a reduction in margin in the year. This reduction is a result of the continued downward pressure on rates in the residential mortgage market, particularly following the reduction in base rate in September 2016, which is not fully offset by the reduction in cost of funds.

Commercial lending margins have remained strong, and the Group continues to benefit from the higher margins receivable on the Nemo secured lending portfolio.

Retail savings rates continued to fall throughout 2016, in particular following the base rate reduction in September 2016, with many lenders reducing savings rates by a greater amount than the base rate reduction. Whilst the Society continued to offer better than average rates, this led to a reduction in the Group's retail funding costs. The Society aims to support savers in the current ultra-low interest rate environment, but it must do so in a secure and sustainable way, and balance the needs of savers against the long term financial security of the Group.

The Group's lending continues to be primarily funded by Members' retail savings, with 87.2% (2015: 85.9%) of loans and advances to customers funded in this way. In order to ensure the Group can continue to offer competitive rates in competitive markets, the Group also utilises low cost wholesale funding. In February 2016 the Group completed a further issuance of residential mortgage backed securities, raising £375m of funding. This diverse funding mix allows the Society to compete effectively in lending markets, and ensures the funding position is robust in uncertain market conditions.



Other income

Other income at £9.7m (2015: £6.8m) has increased from the prior year, driven by the receipt of profit share income of £2.4m (2015: £nil) in respect of the Group's general insurance partnerships. The remainder of the difference is due to an increase in mortgage related fees and charges, together with an increase in property-related income.

Fair value movements

Fair value movements represent the change in value of certain assets and liabilities to reflect underlying market rates. These movements are primarily timing differences, which will reverse as the asset or liability approaches maturity. During the year the Group recognised a gain of £1.6m in the income statement (2015: £0.9m gain) in relation to these movements in fair value.

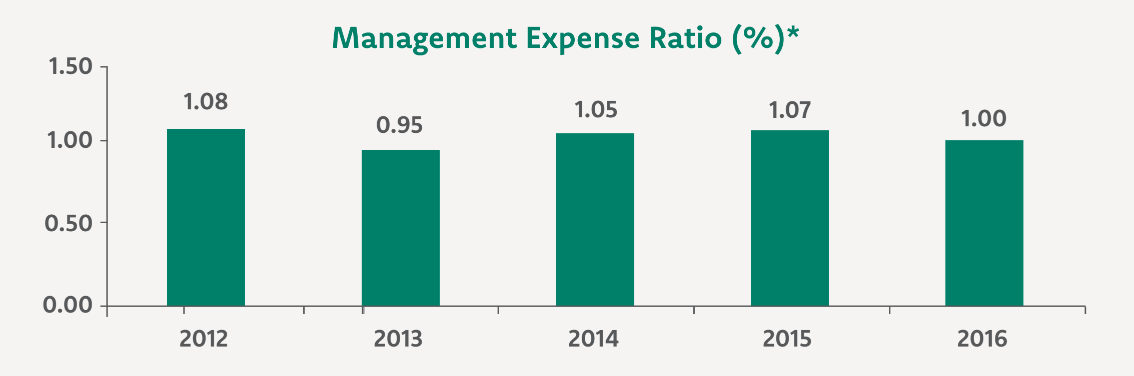
Operating expenses

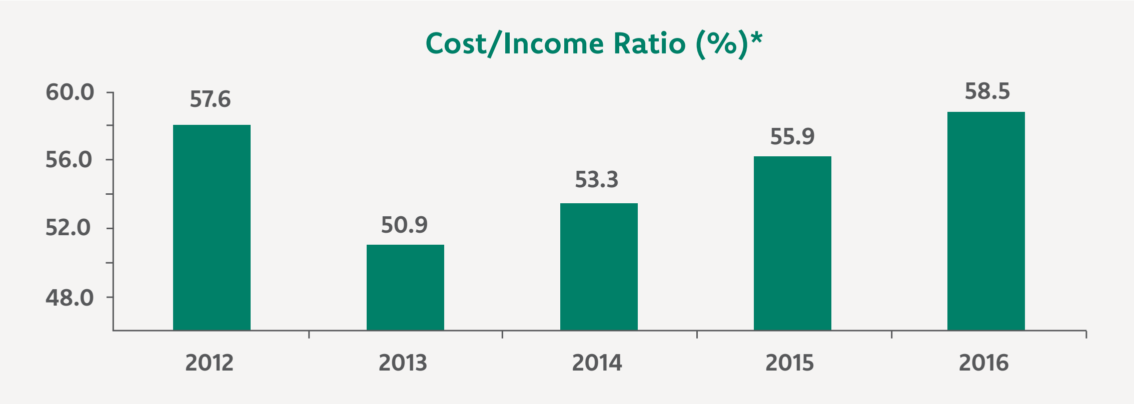
Operating expenses remain a key focus for the Group. On a statutory basis, Group operating expenses reduced in the year to £82.1m (2015: £83.7m), driven by the reduction in the restructuring costs associated with the decision to cease origination of new business in Nemo to £2.4m (2015: £4.5m). The increase in operating expenses for Retail financial services was driven by expenditure on strategic programmes, including the Group's investment programme, together with an increase in property impairment charges.

Excluding these items, the underlying operating expenses comparison is set out in the table below:

		2016 £m	2015 £m
Retail financial services		67.7	62.2
Commercial lending		3.7	4.0
Secured personal lending		8.3	13.0
Underlying operating expenses		**79.7**	**79.2**
Nemo strategic review and restructuring costs		2.4	4.5
Total operating expenses		**82.1**	**83.7**
Management expense ratio	Underlying cost basis	1.00%	1.07%
	Statutory cost basis	1.04%	1.13%
Cost/Income ratio	Underlying cost basis	58.5%	55.9%
	Statutory cost basis	60.3%	59.0%

On the basis of underlying operating expenses, the Group's cost to income ratio for the year was 58.5% (2015: 55.9%), and the management expense ratio (cost as a proportion of mean assets) was 1.00% (2015: 1.07%).





*Stated on an underlying cost basis

Impairment provisions for losses on loans and advances

The Group experienced a net release of impairment provisions of £2.7m (2015: £4.8m charge).

	2016 £m	2015 £m
Retail mortgage lending	0.2	1.2
Commercial lending	(0.7)	5.0
Secured personal lending	(2.2)	1.4
Total	**(2.7)**	**4.8**

Continued low levels of arrears and moderate house price growth have acted to reduce impairment charges against both retail mortgage lending and secured personal lending in the year. The low overall levels reflect the Group's prudent approach to lending and robust affordability, credit quality and underwriting standards, and these standards mean the Group is well positioned to deal with potential volatility associated with the uncertain political and economic environment.

Impairment charges against commercial loans have also decreased in the year, reflecting the work undertaken in recent years to bring to resolution the remaining historic impaired or low credit quality loans.

For the reasons set out, the total statement of financial position impairment provision has also decreased from the previous year. The total impairment provisions held on the statement of financial position were as follows:

	2016 £m	2015 £m
Retail mortgage lending	5.6	6.3
Commercial lending	24.5	24.7
Secured personal lending	15.3	18.2
Total	**45.4**	**49.2**

Provisions for other liabilities and charges

The Group made an additional provision of £3.1m (2015: £1.0m) during the year in relation to previous sales of Payment Protection Insurance (PPI). Other provisions of £2.0m (2015: £0.1m) have been made in respect of various other customer related items. At 31 December 2016, the Group holds a provision of £2.7m (2015: £1.0m), 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.

The Group notes that the FCA is expected to finalise rules and guidance in relation to the handling of PPI complaints in relation to the 2014 Supreme Court decision in Plevin vs Paragon Personal Finance Limited (Plevin). The Group will continue to monitor the developments on these proposed rules and guidance.

The Group has recognised a Financial Services Compensation Scheme (FSCS) interest charge of £1.4m in respect of scheme year April 2016 to March 2017 (2015: interest charge of £1.7m, and capital charge of £1.6m).
Further information on the level of provisions and the uncertainties therein can be found in Notes 2 and 30.

Taxation

The statutory rate of corporation tax was reduced to 20.0% from 1 April 2015, and remained at 20.0% throughout the year. In addition, the Society was subject to the Bank Corporation Tax surcharge for the first time in 2016, resulting in an additional tax charge of 8% for Society profits over £25.0m.

The actual effective tax rate from continuing operations for the Group was 22.3% (2015: 23.0%) compared with the statutory rate of tax of 20.0% (2015: 20.3%). The rate differential is primarily due to income statement expenditure which is disallowable for corporation tax purposes, together with the impact of the Bank Corporation Tax surcharge.

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

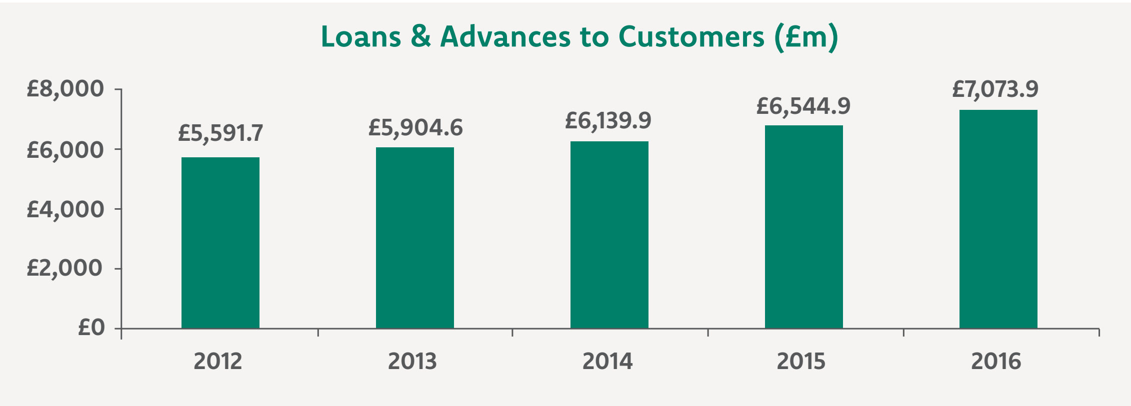
Statement of financial position

Total statement of financial poisition assets increased by £696.8m to £8,281.2m.

	2012 £m	2013 £m	2014 £m	2015 £m	2016 £m
Liquid assets	1,074.3	1,042.1	1,037.4	962.0	1,116.8
Loans and advances to customers	5,591.7	5,904.6	6,139.9	6,544.9	7,073.9
Other assets	118.3	111.4	87.7	77.5	90.5
Total assets	**6,784.3**	**7,058.1**	**7,265.0**	**7,584.4**	**8,281.2**
Retail savings	5,467.0	5,562.6	5,613.0	5,621.8	6,165.2
Wholesale funding	710.5	902.8	1,001.7	1,287.5	1,468.8
Other liabilities	266.5	238.0	239.0	226.1	168.8
Total liabilities	**6,444.0**	**6,703.4**	**6,853.7**	**7,135.4**	**7,802.8**
Reserves	340.3	354.7	411.3	449.0	478.4
Total liabilities and equity	6,784.3	7,058.1	7,265.0	7,584.4	8,281.2

Loans and advances to customers

The Group continues to target growth in its retail mortgage portfolio, where that growth can be delivered profitably and in line with the Group's risk appetite. Net retail mortgage lending in the year was £613.4m (2015: £460.1m), delivering against the Group's strategic objective, and driving an increase in loans and advances to customers of £529.0m (2015: £404.1m) to £7,073.9m (2015: £6,544.9m).



The Group's largest portfolio, at £5,858.3m (2015: £5,244.9m), is its retail mortgage portfolio. This is prime lending against first charge residential property, and includes a high quality buy-to-let portfolio of £1,494.3m (2015: £1,300.2m). The Group continues to support the buy-to-let market, recognising the need for diversity in the housing market to provide different options to individuals and families. All buy-to-let lending is assessed against stringent interest cover and loan-to-value criteria. The Group also holds a secured personal lending portfolio, Nemo of £404.1m (2015: £517.2m), secured against residential property by a second charge, typically for home improvements or debt consolidation. The Group ceased writing new business in this portfolio in March 2016, following the strategic review considering the options for Nemo which took place in 2015.

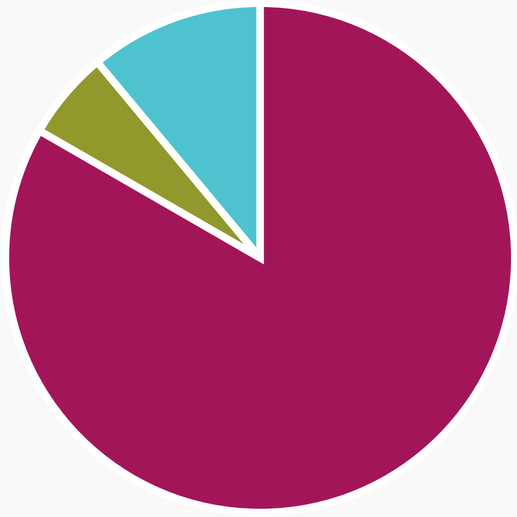
Loans & Advances to Customers by Portfolio (£m)**

Commercial £772.1

Secured Personal Lending, £404.1

Retail Mortgages £5,858.3

**Figures in the graph opposite exclude fair value adjustments.



The Group's retail mortgage and secured personal lending portfolios reflect the prudent nature of the Group's lending policies, with 72% (2015: 70%) of exposures having a loan to indexed valuation of less than 70% and 86% (2015: 85%) less than 80%.

The Group's exposures are well spread by geographical area within the UK, albeit with a larger share of lending in Wales, which by value makes up 28.8% of lending (2015: 27.5%) in the retail mortgage and secured personal lending portfolios.

The strong credit quality of loans issued is reflected in the low value and volume of the Group's arrears against first and second charge residential lending.
The percentage of retail mortgage lending cases fully secured by a first charge currently with arrears of more than three months is 0.63% (2015: 0.62%) which compares favourably with the industry average of 1.01%*. The number of properties taken into possession during the year was 48 (2015: 86).

The percentage of secured personal loans currently in arrears of two months or more by number is 5.88% (2015: 6.87%), which by value is 6.69% (2015: 7.14%).

The Group's commercial lending portfolio is made up of commercial property exposures representing 39.7% of balances, and lending against residential property and to registered social landlords of 60.3%. The Group provides loans secured on commercial property across England and Wales, with 50.2% of lending situated in Wales.

*CML arrears and possession data at 30 September 2016.

The commercial lending portfolio had one exposure greater than three months in arrears at the year end (2015: none). 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.

Defined benefit pension scheme

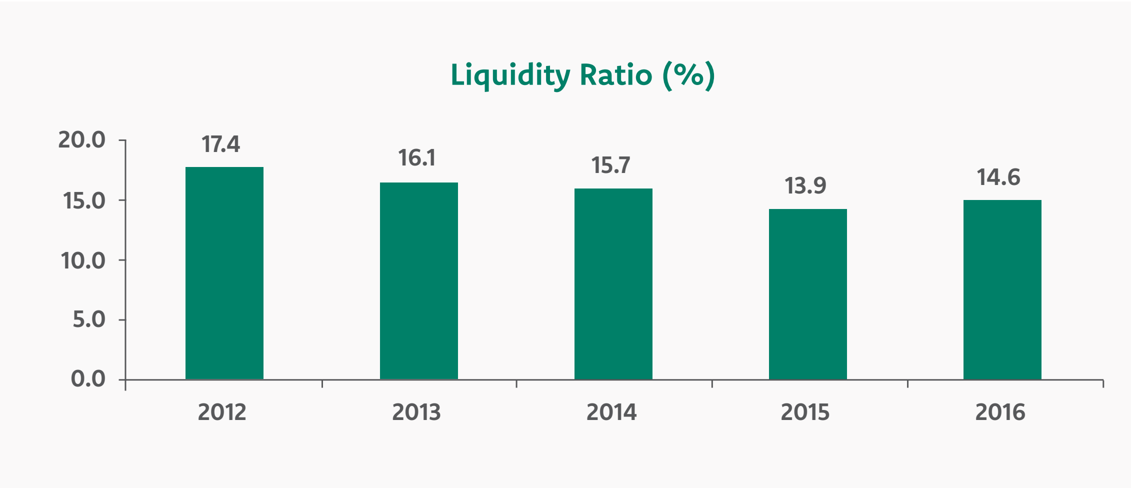
The Group operates a defined benefit pension scheme, which is closed to new entrants and to further accrual. During the year, the pension scheme deficit (the difference between the scheme assets and scheme liabilities) increased to £15.3m (2015: £4.1m).
This was driven by an increase in the valuation of scheme liabilities, caused in turn by a decrease in bond yields in the second half of the year.

The scheme is subject to a triennial valuation by the scheme's independent actuary, with the most recent valuation underway with a reference date of 30 September. This process will be complete prior to the 31 December 2017 year end, and the Group continues to work closely with the Trustees of the scheme to ensure an appropriate funding plan is in place, and that the pension risk to the Group is appropriately managed.

The Group made contributions to the scheme in the year of £1.5m (2015: £1.8m).

Liquidity

The Group holds liquid assets to ensure it has sufficient access to funds to meet its financial obligations in both normal and stressed scenarios. The Group continues to maintain a robust liquidity position, with liquid assets at year end of 14.6% (2015: 13.9%) as a proportion of shares, deposits and loans (SDL).



The Liquid Asset Buffer as defined by the Prudential Regulatory Authority (PRA) includes highly liquid assets, typically central bank and sovereign exposures. At the year end, the proportion of the Group's available liquidity which was buffer eligible was 84.1% (2015: 67.2%). Of the total liquid assets, 1.2% (2015: 1.7%) are less than A rated under Fitch credit ratings.

Two new regulatory measures of liquidity have been introduced as part of the CRD IV regulatory changes, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The Group's Liquidity Coverage Ratio, a measure of the Group's ability to withstand a short-term liquidity stress, was 161.2% at the year end (2015: 129.8%), well above the regulatory requirement. The NSFR is a longer-term stable funding metric, which measures the sustainability of the Group's long-term funding. It is expected to be implemented from January 2018. Based on current interpretations of the regulatory guidance, the Group's NSFR is in excess of 100%, and the Group holds sufficient stable funding to meet the new requirement.

The Group is a participant in the Bank of England's Term Funding Scheme, and also has access to contingent liquidity through the Bank of England's Sterling Monetary Framework.

The Group's liquid assets are set out in the table below:

	2016 £m	2015 £m
Cash and balances with the Bank of England	585.7	357.6
Securities issued by the UK Government and Multilateral Development Banks		
On balance sheet	348.6	400.9
Off balance sheet	30.7	77.0
Total buffer eligible assets	**965.0**	**835.5**
Loans and advances to credit institutions and other debt securities	182.5	203.5
Total	1,147.5	1,039.0

Funding

The Group raises funds from a variety of sources in order to meet the strategic objective of maintaining a diversified funding mix. The largest component is retail savings, which at £6,165.2m (2015: £5,621.8m) represent 87.2% (2015: 85.9%) of all mortgage and loan balances. Retail savings balances have increased by £543.4m in the year (2015: £8.8m), reflecting the continued focus on offering attractive products to Members despite the challenging interest rate environment.

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

In February 2016 the Group completed its third issuance of residential mortgage backed securities (RMBS), raising £375m of funding from wholesale markets. In addition to supporting the Group's interest margin, the utilisation of wholesale funding furthers the Group's strategic objective of maintaining a diverse and balanced funding base. The total value of RMBS notes outstanding at the end of the year was £615.5m (2015: £451.9m).

The Group's current credit ratings are set out in the table below:

	Short-term	Long-term	Outlook
Moody's	P-3	Baa3	Stable
Fitch	F2	BBB+	Stable

Asset encumbrance

The Group uses its assets as collateral to support the raising of secured funding, primarily as part of the RMBS issuances or pledged under the terms of Bank of England funding schemes. At the end of the year, 19.3% (2015: 21.1%) of the Group's assets were encumbered, representing £1,470.1m (2015: £1,457.7m) of residential mortgage assets and £129.9m (2015: £143.4m) of other assets.

Capital

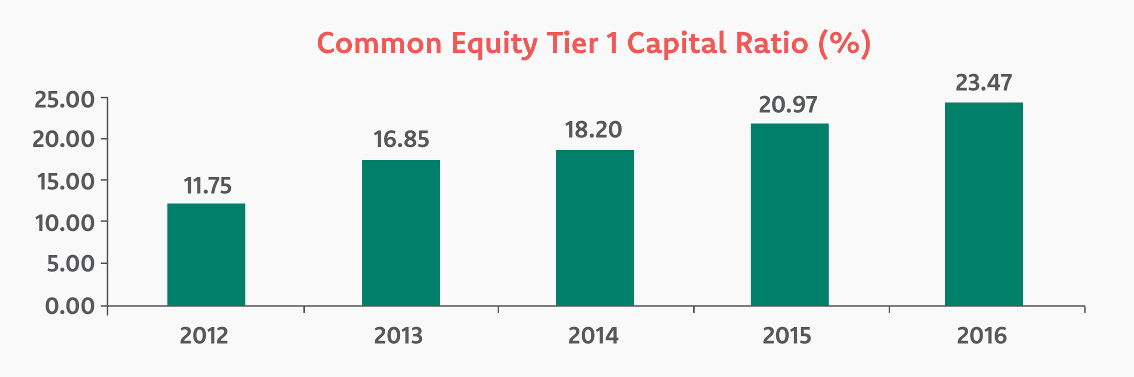
The Group holds capital to protect Members' deposits by providing a buffer against unexpected losses. The amount of capital required is assessed in relation to the Group's overall risk appetite, the material risks to which the Group is exposed and the management strategies employed to manage those risks. Capital comprises the Group's general reserve and subscribed capital (Permanent Interest-Bearing Shares, or PIBS), adjusted in line with regulatory rules.

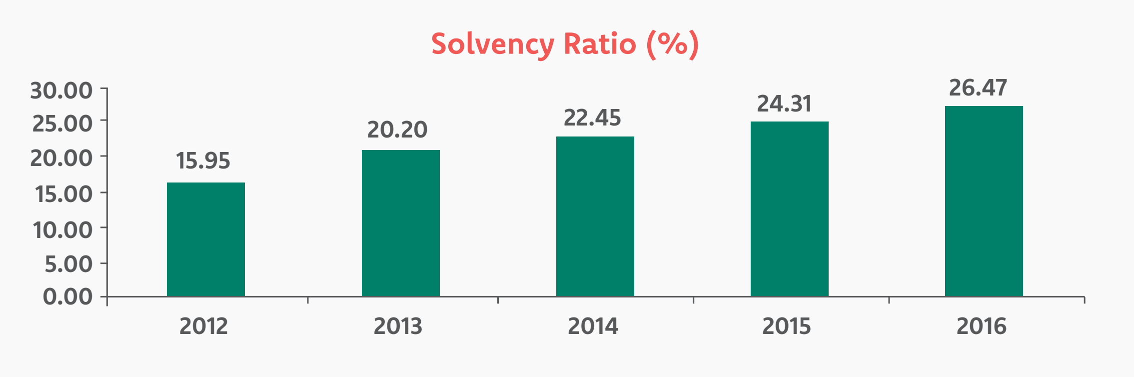
The Group holds capital in each of three regulatory tiers: the Group's general reserve qualifies as Common Equity Tier 1 capital, the very highest quality of capital. Under Basel III transitional rules, the PIBS qualify as Additional Tier 1 capital, but amortise on a straight line basis over eight years from 2014. The amortised portion of the balance is classified as Tier 2 capital.

The Group's primary measure in assessing capital adequacy is the Common Equity Tier 1 (CET1) ratio, which expresses the highest quality capital as a proportion of the sum of the risk weighted assets of the Group. The risk weighting for each asset is calculated either through the use of internal models or through standardised calculations dependent on regulatory permissions for each portfolio of assets.

The Group's CET1 ratio at 23.47% (2015: 20.97%) has increased, with the impact of the increased capital generated by the profitability in the year more than offsetting the increased risk weighted assets associated with the growth in the statement of financial position. This means the Group is generating sufficient capital through its financial performance to facilitate the increase in lending to households and businesses. The Group's Solvency ratio, the ratio of total capital to risk weighted assets, has increased to 26.47% (2015: 24.31%).

A further measure of capital strength is the leverage ratio, a measure of Tier 1 capital held against total (non-risk weighted) assets, including certain off-balance sheet commitments. At the end of the year the Group's leverage ratio was 5.47% (2015: 5.47%), which is significantly above the regulatory minimum.





Member, Colleague and Community

Member, Colleague and Community are the subject of a separate report on pages 25 to 31.

Principal Risks and Uncertainties

The Principal Risks and uncertainties faced by the Group, together with the approach to managing these risks, are set out in the separate Risk Management Report on pages 33 to 46.

Stephen Hughes
Group Finance Director
14 February 2017

Member, Colleague and Community

for the year ended 31 December 2016

Pictured: Newport Branch Manager Laura meeting Members at the Evening of Chat in Celtic Manor Resort

Member

We know that listening to our Members is the best way to make sure we understand how to meet their needs and expectations, and achieve our goal of being recommended every day. Members often tell us that they value the friendliness and helpfulness of our staff. We encourage and reward colleagues for providing great service to our Members, and encourage the sharing of experience and expertise with others.

As a Member, this entitles you to certain rights and benefits. You will be able to have your voice heard by the people that run the business.

Our Members tell us that spending time with their families and friends is what matters to them the most. So this year we created Member Rewards as a way of saying thank you to all our loyal Members by giving them the chance to win some fantastic prizes and create some unforgettable memories.

One of the major factors in signing a sponsorship deal with the Welsh Rugby Union was ensuring that our Members were able to 'get more'. Principality Members who sign up to Your Account, will be able to access a Member Rewards page where you could start enjoying exclusive benefits, including:

- Priority ticket access to selected events at Principality Stadium;
- 15% discount at the WRU online shop;
- Exclusive competitions;
- Automatic entry into all of our unmissable prize draws.

Since its launch we have seen over 5,000 Members register and over 900 Members have benefited from tickets and prizes to a number of the events held at the Stadium including RBS 6 Nations, Beyoncé, Speedway, Monster Jam and the Under Armour Series.

Talkback events

We don't just rely on surveys to understand our Members' needs and desires; our senior leadership teams hold regular Talkback events all over Wales which are open to all our Members. The Talkback sessions offer Members the opportunity to ask our senior leadership teams questions about the way we run our business. These sessions also give Members the chance to hear about our performance as a business and the different ways in which we support our local communities. The Talkback sessions are also a great opportunity for us to find out what our Members like about us and what they would like us to change. This year we visited St Asaph in the North, Carmarthenshire in the West, Aberavon in the South, and Newport in the East. These events are always interactive and give Members the chance to meet the people who run their Society.

People recommend us

To ensure we continually deliver an excellent service to our customers we use multiple surveys to track our Net Promoter Score (NPS). After a customer has interacted with Principality Building Society in branch, by phone or online, we contact them by email to request they complete a short survey. The Net Promoter question in the survey asks the customer 'How likely or unlikely would you be to recommend Principality to anyone?' following the service they recently experienced. The combined NPS from all tracking surveys across 2016 is one of the highest in the industry.

Member Forum

Our Member Forum is made up of six Members, who act as a collective voice for all our Members. They attend meetings on a quarterly basis to share their thoughts and tell us what they think of our products and Society initiatives and help us make the right decisions for all Members. Each meeting is hosted by a Non-Executive Director and attended by other Directors and senior managers from across the business. Forum members are asked to commit to a minimum of three years' membership and our current members come from various locations across Wales and the borders. During 2016, we invested time in revamping the Forum to ensure that it continues to evolve and offer the best possible value for all attendees. We have since tested a number of new product and marketing opportunities with the Forum, to gain their valuable insight and challenge our executive team on their thinking. We always welcome contact from any Society Members interested in becoming part of the Forum and taking advantage of the opportunity to voice their opinions in a small group setting.

Research panel

To gather alternative forms of feedback we regularly utilise our Customer Research Panel which consists of a large number of our Members and customers.

Through the use of online surveys, our Panel helps us to understand the customer view on different elements of our business and Panel feedback is particularly helpful to us in determining Member views when we do something new. For example, when we produce new product information leaflets we ask Panel members to read them and answer product related questions to identify if we have presented the information in a clear way. We then use their feedback to determine if there is anything else we can do to incorporate their views and make the literature easier to understand. This is an exciting time for Principality, as we invest in changes that will make a real difference for both our current and future Members, and testing these ideas with members ensures that we continue to listen.

All of these different ways of gaining insight into our customers help us to ensure that whenever we are making decisions about our business we are putting the Member, and the best outcome for them, at the heart of everything we do. A great example of this is that our Members continue to tell us that our presence on the high street remains important to them. So we remain committed to having a presence in our heartland of Wales and on the borders, while still looking at how we can modernise the business.

Technology is becoming increasingly important in the marketplace and is now a common way for consumers to interact with businesses. Throughout 2017 we will continue to invest and make improvements to our multi-channel service to ensure that our Members are able to interact with us in the way that they choose.

Annual General Meeting (AGM)

Our AGM gives you the opportunity to vote and put questions to our Board. Voting ballot papers are sent out ahead of the AGM and encourage all Members to get involved and have their say on who runs their organisation.

By continually putting our Members and customers at the heart of our decisions and involving them in every step of the process, we continue to strive on our commitment to be the most recommended financial services provider in Wales.

Sponsorship and partnership

As well as providing outstanding value, excellent service and a safe place for our Members' money, Principality plays a vital role in helping the communities where we and our Members live and work across Wales and the borders. From sport to culture, our sponsorship portfolio, presence at major events, community initiatives and charity projects are central to our mutual ethos and culture.

Pictured: Virginia, Carmarthen Branch Manager with the Bro Myrddin Hockey Team who were delighted with their new kit

We have a long association with rugby in Wales and are passionate about developing young talent. In September 2015, it was announced that Principality would enter into a landmark partnership deal with the Welsh Rugby Union (WRU) securing the naming rights of the Stadium, now called Principality Stadium. It formed part of a deal to help grassroots rugby in Wales for the next ten years.

The naming rights has associated us with an iconic Welsh sport and a building that has strong emotional connections for many people in Wales and also offers the opportunity for brand exposure both nationally and internationally. A year on since the official launch we have seen an increase in positive reaction to our brand, making us stand out from other building societies. The sponsorship has raised the recognition and profile of the Society significantly.

As title sponsors of the Principality Rugby Premiership since 2005, our shared aim with the Welsh Rugby Union has been to increase the profile of grass roots rugby. Changes to the Premiership structure have raised the standard of rugby and created a more competitive environment for the regions and their feeder clubs. There are now 16 Premiership clubs, including for the first-time a North Wales based team.

As proud supporters of the Principality Premiership, we have seen many players progress from the village playing field to the professional game and the Welsh squad. The Premiership is the breeding ground and lifeline for the regions and we are proud that many of today's international stars first made a name for themselves in our league. We want our Members to share in the excitement of our national game and the Principality Premiership. That's why, at the start of every season, we run competitions offering the winners season tickets to watch their favourite team in action.

Supporting our heritage and culture

We are committed to sponsorships that support social and community life, enable young people to develop life skills and support creativity, and celebrate our heritage and culture in a vibrant, contemporary environment.

Only Boys Aloud's (OBA) mission is to engage each new generation of young people across Wales with the power of choral singing and through this activity to promote self-belief and self-confidence, to encourage aspiration, to build skills and to develop a sense of community. Founded by Artistic Director Tim Rhys-Evans MBE, OBA believes in encouraging young people to find their own way and to make their own mark, using choral singing as a catalyst to effect positive change in their lives. This award-winning partnership goes from strength to strength with new choirs based in North Wales plus the original nine in South and West Wales. OBA now operates in nine out of the ten most socially deprived areas in Wales.

In 2016, Principality celebrated 37 consecutive years of sponsorship of the National Eisteddfod of Wales, a record of which we are very proud. The Eisteddfod is one of the world's greatest cultural festivals, and brings together people from all ages and backgrounds to enjoy an eclectic mix of music, literature, dance, theatre, visual arts and much more. We have also had a presence at the Royal Welsh Show for over 25 years where we are delighted to welcome Members to our stand. Our partnership with the Royal Welsh Show helps us to foster relationships with rural communities, successfully bridging the gap between Welsh towns and cities and farming and rural life. To further strengthen this relationship, we are proud to support the National Farmers' Union by sponsoring the Welsh Woman Farmer Award and Community Champion Farmer Award.

Supported by Principality since its inception in 2012, Access All Eirias has played hosts to numerous famous music acts such as Sir Tom Jones, Sir Elton John, Lionel Ritchie and many more. This event has given our North Wales branches the opportunity to engage with Members in an innovative and exciting way and has also helped to inject an estimated £400,000 into the local economy.

Colleague

We have a clear people strategy in place to deliver our aspiration of being the employer of choice for Wales, which will support our growth strategy. To achieve this, we are focusing on: attracting, retaining, developing and inspiring colleagues; being recognised for our equality, diversity and inclusion; embedding our values and culture and ensuring high colleague engagement. Our ambition is for our colleagues to give their best, putting Member outcomes and service first to deliver our growth strategy and plans. By doing this consistently, we anticipate that our Members will recommend us to their friends and family. The key elements of our people strategy are:

Creating the right culture

Our people strategy seeks to promote a high performing organisation through colleagues living our values throughout their everyday interactions with one another and with our Members. At Principality, we are committed to providing an environment in which diversity is both promoted and supported, and where our colleagues feel valued and respected, so that everyone can contribute to building a successful Society.

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 develop, and this drives colleague satisfaction which, in turn, drives customer satisfaction. This year, we carried out a culture assessment with the Banking Standards Board to enable us to compare ourselves with the major banks and building societies in our sector. This showed that we have a strong focus on our customers, especially in our branch network.

Our five values continue to promote and support our culture:

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

Managers work with all colleagues to help them achieve their best, and values and behaviours are an important part of our performance reviews. We believe that by focusing on our values, we will become even more effective and successful as an organisation.

Pictured: Principality staff taking to the dancefloor with members of the Penarth community in Paget Tea Rooms

Promoting diversity

Our people strategy is committed to being recognised for our colleague diversity through our employment practices, policies and culture. We have signed up to the Women in Financial Services Charter and set ourselves the target of having 33% of our senior managers as women.

A breakdown of colleagues in the Society by gender is presented below:

	Female (%)	Male (%)
Directors (including Non-Executive Directors)	31.0	69.0
Senior managers	19.0	81.0
Colleagues	65.0	35.0

Staff turnover, which measures how many of our colleagues are leaving of their own choice, is 10%. 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 colleagues have grown with us and the average length of service is approximately five years.

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 people strategy continues to seek to ensure that all employees feel connected to the business and understand the strategic direction and purpose in their everyday roles. Our colleague surveys are 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. Research shows there is a strong correlation between high levels of performance and engagement, and we made a decision in 2016 to move away from one annual survey to quarterly surveys in order to get a more responsive insight into colleague views and to take action more promptly if needed.

The first of these was run in December 2016 with a view to being shorter and more focussed on topics and themes that are meaningful at that moment in time, as well as having some core questions that we will ask each quarter. We were delighted with a high response rate of 78.9% across the whole Group, and the new survey tool allows us to gain a clear insight into how colleagues feel about working with us, especially through their individual comments. We will run a survey at the end of each quarter, and in the third quarter of each year we will run a longer and richer survey that will also allow us to benchmark ourselves externally.

Our recent survey showed that 75% of our colleagues are satisfied with the Group as their employer and 85% of colleagues are proud to work for us. In addition, the survey revealed that:

- 85% of colleagues believe that we put customers at the heart of the organisation;
- 88% of colleagues are motivated by the company's success; and
- 81% of our colleagues would recommend the Group as a great place to work.

This year we have reached engagement levels of 79% in the Society compared to the financial services industry average of 72%.

We appreciate 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 have refreshed our approach to internal communications, introducing a new intranet and feedback tool, and approaches to share news and gain feedback. In addition to the annual colleague conference, we have held "Meet the Executive" sessions: the Chief Executive completes a monthly blog; we also have monthly newsletters and business briefings and we are using videos and regular senior leadership meetings to cascade the communication further to all our colleagues.

Rewarding colleagues fairly

Our people strategy seeks to put in place reward, recognition and benefit frameworks that allow the business to attract and retain great people and fairly reward them for high performance and great teamwork in support of our business strategy. 2016 saw the launch of a new Rewarding Excellence Award which rewards all colleagues for contributing to the successful growth of the Society and improving service to customers, thus aligning the efforts of everyone with Members' interests.

Investing in talent to realise potential

Our people strategy seeks to build strong leadership and management capability whilst ensuring operational competence across the organisation to enable us to manage both day-to-day operations and business change. We have changed our approach to recruitment throughout 2016, undertaking more of the recruitment directly rather than via third party agencies, placing a much higher value on cultural fit as well as skills and experience. Once colleagues successfully join us, the induction programme that they follow has been extended to a full calendar year to ensure that all new starters feel fully supported in their new role.

Pictured: Principality's touch rugby team - Principality Puffins

Learning and development helps our leaders and colleagues to develop their ability to provide the best customer service for our Members. Both the Society and colleagues benefit from maximising 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.

We have launched a series of new leadership programmes designed to equip our leaders with the necessary skills, capabilities and techniques to achieve our People Strategy. The suite of four programmes provide development in the key elements of leadership, at all levels, commencing with Introduction to Leadership and progressing through for the needs of junior, middle and senior management .

This Leadership Pathway is supported by a core offering of Management Development Workshops and bespoke individual and team learning interventions, which benchmark and continue to improve our leadership capabilities by employing a range of assessment, observation and feedback measures. All of our courses are designed to enable our leaders to transfer their theory into practice in their day-to-day responsibilities.

Community

Towards the end of 2015 we refreshed our approach to helping communities and being responsible with a new Corporate Social Responsibility policy. The policy introduced three themes which aimed to position our community activities closely with our vision of helping people prosper in their home at every stage of their lives. The themes included helping people get a home and stay in their homes for longer, health and wellbeing by helping them to spend more time with loved ones, and financial education which will help prepare younger generations to save for the things that matter to them, such as getting their first home. Throughout 2016 we have proudly been working to bring these themes to life with new partnerships and initiatives all across Wales and the borders.

Home

Based on colleague feedback we revamped the way we help charities and replaced our Charity of the Year approach with three new charities that we'll work closely with over a three year period. In 2016 colleagues have enthusiastically fundraised for our charities, taking part in mountain climbs, marathons, walks, cycles and lots more. We have raised over £150,000 for our three incredible charities.

One of our three partner charities is Llamau who support young people and women who face the terrible prospect of homelessness. Throughout our first year in partnership, we have attended Llamau events, supported campaigns and colleagues have been busy fundraising, including a Big Sleep Out event at Cardiff City Stadium in which more than 40 colleagues, including Directors, participated.

We also proudly supported Wales Action Week in November 2016, as part of Business in the Community. Wales Action Week brought together lots of different businesses to tackle homelessness. We held a workplace visit for Llamau service users, providing them with an opportunity to learn more about our business and employment opportunities in financial services. We also helped out the housing association Trivallis with their appeal to support residents moving into new accommodation. Colleagues kindly donated hundreds of toiletries which were put into hampers.

Furthermore, we explored new projects based on previous charity partnerships with Age Cymru and the Community Foundation in Wales. We contributed £10,000 to the Age Cymru Handy Van Service, which provides vital home improvement and safety services to elderly residents in parts of South Wales, directly helping people stay in their homes for longer. We also contributed £5,000 to the Wales Flood Recovery Fund in response to the winter floods.

Health and wellbeing

We have been long-term supporters of community sport and cultural activities across Wales and in 2016 we helped 124 different community groups and projects through our local sponsorship programme, with a total investment of over £56,000, a record performance for our business.

Cancer Research Wales is the second of our new charity partners and we are delighted to be supporting them during their 50th anniversary celebrations. Our fundraising will contribute to their research work and we were proud sponsors of their Family Footsteps walk in Cardiff Bay.

In 2015 we signed up to support the Time to Change campaign, which is all about breaking down the stigma of mental health in the workplace. We have continued to support the network of Time to Change organisations this year, and proudly welcomed over 50 representatives to Principality Stadium for their biggest network meeting yet. Following on from being named Responsible Large Business of the Year 2015 by Business in the Community, this year we were finalists for the Wellbeing at Work Award.

Financial education

We are committed to helping build the financial skills of young people and have worked closely with five secondary schools as part of the Business Class programme alongside the Welsh Government and Careers Wales. Business Class provides targeted support to each school over a three year period and we have helped with budgeting workshops, kits for sports teams, hardship bursaries, mock interviews, branch visits, achievement awards and lots more. The schools we support include Llanishen High School in Cardiff, Tonypandy Community College, Ysgol Y Grango in Wrexham, Strade in Llanelli and Bro Myrddin in Carmarthen. As part of our support to Llanishen High School we sponsored 100 pupils to complete the London Institute of Banking & Finance Award in Personal Finance, which provided pupils with knowledge on the principles of money and the skills to manage their money. We have also been working closely with the BSA Financial Education Working Group, sharing practice with other building societies and discussing development opportunities.

Additionally, this year we started an exciting Further Education partnership with Cardiff & Vale College using the same principles as Business Class. We have collaborated with the charity MyBnk – with a team of Principality colleagues and college staff getting trained to deliver a Money Twist class that provides information on wages, deductions, savings and pensions. More than 100 pupils have taken part so far, reporting a boost in skills around finance, communication and teamwork. In the Cardiff & Vale College Awards 2016 we were proud recipients of a Business & Partner Award for the work we do to support the students.

Our third charity partner is one founded on sports inclusion, School of Hard Knocks - who thanks to our support have officially launched across Wales. The charity, which has been featured on Sky Sports, uses the power of sport and psychology to help vulnerable young people. They now have three full time staff members in Wales and their work continues to grow in terms of scope and impact. We arranged for them to run taster sessions in some of our Business Class schools and they have started delivering their intensive educational support programme in Cardiff.

Pictured: Welsh international rugby player Dan Biggar presenting our prize draw winning Member with her grand prize

Slavery and Human Trafficking

for the year ended 31 December 2016

This statement has been produced in compliance with Section 54, Part 6 of the Modern Slavery Act 2015 (the Act) and sets out the steps that the Principality Building Society and its subsidiary business Nemo Personal Finance Limited ("the Principality Group") have and which continue to be taken to ensure that slavery and human trafficking are not taking place in its supply chains or any parts of its business.

Principality Group

The Principality Building Society is the UK's sixth largest Building Society and collectively with Nemo Personal Finance Limited employs over 1,000 people. The Building Society operates through 71 branch and agency offices which are located across Wales and the border area with England. The Building Society's central administrative office is located in Cardiff. Nemo Personal Finance operates from a single location in Cardiff.

Slavery and human trafficking policy

The Principality Group operates a number of policies which reflect its commitment to acting ethically and with integrity in business relationships, designing and implementing controls which are designed to ensure slavery and human trafficking are not taking place anywhere in its supply chains.

The Principality Group regularly re-evaluates its business practices to ensure high standards of business behaviour and social responsibility. The Society's Board is committed to promoting fairness and dignity for all colleagues and others involved in the Principality Group. This commitment extends to the products, goods and services provided by suppliers. It is important to Principality Group that all suppliers represent the Society in a manner that reflects its focus on doing the right thing for customers, colleagues and wider stakeholder groups.

The Principality Group aims to establish a supplier code of practice. This code of practice will include key areas such as human rights standards relating to forced or involuntary labour, human trafficking, child labour, working hours, wages and benefits, freedom of association, harassment and bullying. Principality Building Society will expect all suppliers to adhere to the supplier code of practice.

Supply chain risk

As the Principality Group is not in an industry with a high risk of modern day slavery, a risk based approach has been adopted to review supply chains that fall within sectors that carry a higher risk of modern day slavery. On a case by case basis and where considered necessary, either by the Board or the Group Management Committee further assurance is obtained that suppliers are acting ethically and with integrity.

In addition, where suppliers are required to make their own statements in accordance with the Act, the Principality Group will monitor the content of the statements published.

Due diligence processes for slavery and human trafficking

As part of the Principality Group's approach to identifying and mitigating risk, appropriate due diligence work is carried out when engaging and working with both new and existing suppliers, whilst also ensuring that the work undertaken is proportionate to the services or goods to be provided and the risk involved.

Training

The Principality Group provides relevant training and career development for all employees. Managers receive further support that includes training and line manager guidance to ensure consistency on the application of recruitment processes, management of suppliers and policies on fair treatment at work and equality and diversity.

The Group's Procurement team provides additional training on the requirements of the Act to all relevant managers who are responsible for managing third party supplier relationships.

National living wage/low pay

The Principality Group is committed to being a fair and reasonable employer and ensures that salaries remain competitive within the market through a variety of methods, including role evaluations and external benchmarking. The Society ensures that all colleagues are paid at the level of at least the national living wage rate, regardless of age.

C. P. Adams

Laurence Philip Adams
Chairman
14 February 2017

Risk Management Report

for the year ended 31 December 2016

Risk overview

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

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

The three lines of defence

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

First line of defence

Day-to-day risk management

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

Second line of defence

Risk oversight and compliance

Independent functions within Group Risk and Compliance are responsible for providing independent oversight and challenge of activities conducted in the first line.

Third line of defence

Internal Audit

Group Internal Audit provides independent assurance over both the first and second lines of defence.

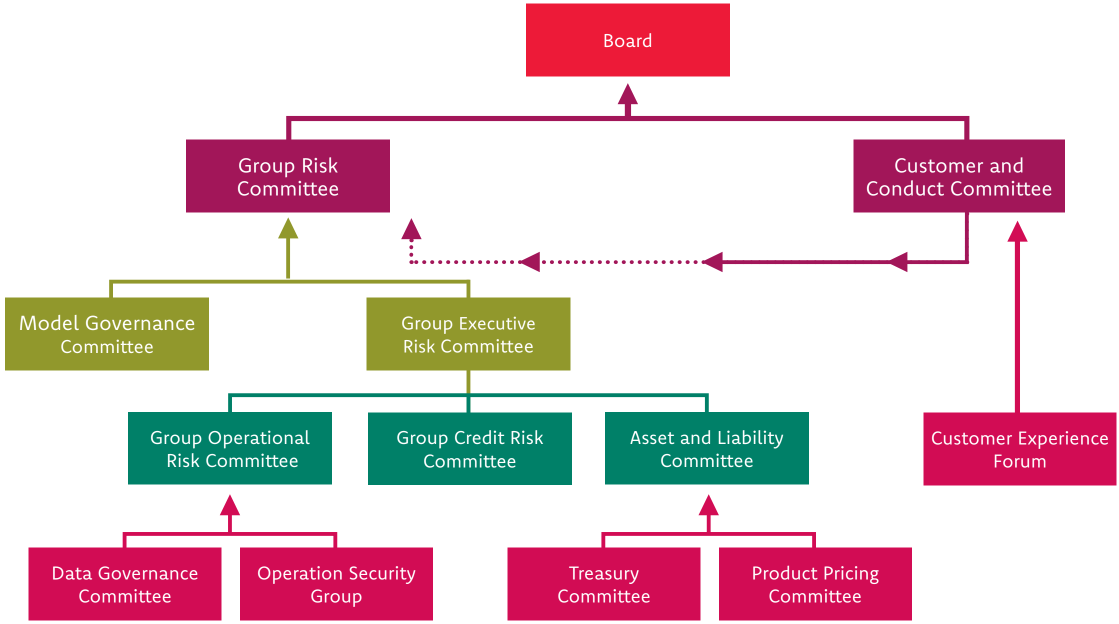
Risk management and governance

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 six 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 Executive Risk Committee (GERC)** is chaired by the Group Chief Executive and is responsible for oversight of all prudential and conduct risks across the Group and monitoring and reviewing risk exposures.
- **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 risk.
- **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. Weekly monitoring is conducted by the Society's Treasury Committee, which is a subsidiary of ALCO.
- **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. The Operational Security Group and the Data Governance Committee report into the GORC and are responsible for providing specific oversight of these two key risks.

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 business area. Oversight and governance are provided through specialist support functions including Group Risk, Group Treasury, Group Finance and Group Compliance and 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.

Group Internal Audit provides independent assurance regarding the activities of the strategic 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 regularly considers the impact of major strategic risks, taking account of changes in the macroeconomic environment, new regulation, competitor strategy, customer preferences and emerging technology.

Risk appetite

The Board sets a risk appetite to enable the Group to:

- Identify and define the types and levels of risks it is willing to accept both qualitatively and quantitatively in pursuit of strategic goals;
- Establish a framework for business decision making and;
- Consider exposure to risk by reference to three underlying principles: Safety, Member Value and Reliability.

The Board risk appetite statements are linked to the Group's strategy and are supported by a broad suite of Board risk metrics, limits and triggers, designed to cover the Group's exposure to key prudential and conduct related risks. Reporting, limits and controls are set in a hierarchy that links the Board's tolerance for risk to its strategic goals, medium-term plans and 'business as usual' activities.

Risk culture

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

Stress testing and planning

The Group engages in thorough stress testing, scenario analysis and contingency planning programmes, allowing it to understand the impact of remote but potentially severe risks and to ensure that it remains resilient. This includes a range of Group-wide, multi-risk category stress tests, reverse stress tests and operational risk scenario analyses. Stress testing is an integral part of the annual planning process, the adequacy assessment processes for liquidity and capital, and the annual review of the Group's risk appetite. Outputs from stress testing are used to inform capital and liquidity planning, articulate potential management actions within contingency plans, and further improve the management of the Group's risk profile. The Internal Capital Adequacy Assessment Process (ICAAP) is the Group's evaluation of its capital position and requirements, assessed under the Capital Requirements Regulation and Capital Requirements Directive (CRD IV) framework. The ICAAP provides details of the current approaches used to manage risk across the Group. As part of that process, the ICAAP assesses capital requirements both against the Group's current position and during severe but plausible stresses. In addition, other more severe stresses are considered in support of the overall capital assessment.

The Internal Liquidity Adequacy Assessment Process (ILAAP) is the Group's evaluation of its liquidity position and requirements, assessed against regulatory requirements and risk tolerance. An integral component of the approach to liquidity risk management is stress testing, some of which is prescriptive, using very detailed rules and guidance issued within prudential regulations. In addition to the regulatory prescribed stress testing, the Group undertakes its own stress tests and sets limits on these which tend to extend beyond minimum regulatory requirements.

Reverse Stress Testing (RST) is a key component of the Group's existing stress testing framework considering extreme events that could result in failure of the Group. As such it complements the existing ICAAP and ILAAP processes, helping to improve risk identification and risk management more generally. A qualitative approach is used to explore potential scenarios which, if crystallised, could have the capacity to result in failure of the Group. This is supplemented with a quantitative assessment of the risks which explores the level of capital or liquidity utilised in these scenarios. A key outcome from the process is to consider whether any of the scenarios considered is sufficiently plausible to necessitate a change to the Group's strategy or underlying controls.

Recovery and resolution plans

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

Assessment of current threats

The Group's exposure to current and emerging risks is closely tracked through the formal risk governance structure. The Group continues to keep these risks under close observation through risk reporting and measuring performance against key risk indicators. The Group conducts regular horizon scanning activity to identify any new or emerging risks which could impact delivery of the Board's strategy, or threaten the long-term viability of the business. The Group considers its exposure to emerging risks by reference to these themes: macroeconomic and market uncertainty, innovation and business resilience and conduct challenges.

Macroeconomic and market uncertainty

The Group's financial position continues to improve through strong profitability and continued deleveraging of the highest risk lending assets. However, economic and political uncertainty in both the UK and the European Union as a result of the UK's decision to leave the European Union (the 'Brexit' vote) poses a number of threats that could affect the Group's exposure to financial and operational risks:

- The triggering of Article 50 of the Lisbon Treaty and the negotiation of the UK's exit from the European Union could adversely affect the stability of the UK economy and the operating environment of the Group. A loss of investor confidence could potentially lead to dislocation in wholesale markets and an increase in funding costs.
- A deterioration in the UK economy accompanied by falling house prices could increase credit losses. Government policies and the low interest rate environment continue to stimulate the housing market but there is a risk that these conditions may reverse, increasing credit losses in the Group's mortgage portfolios. A loss of public confidence in the UK economy could reduce the demand for new mortgage lending resulting in the Group's growth strategy becoming unachievable.
- The impact of a sterling currency devaluation is likely to result in an increase in the cost of imported goods and services which could affect customers' ability to make mortgage payments if wage inflation does not keep track with the Consumer Prices Index (CPI).
- The lower funding costs as a result of the Bank of England's Term Funding Scheme (TFS) introduced post the Brexit vote could further increase competition and thereby reduce the margin earned on the Group's core products.

Innovation and business resilience

The pace of technological development continues to create significant opportunities and risks for the financial services sector. The Group is exploring the possibility of adopting new technology to deliver a service that Members and customers expect and value. In line with the wider financial services market, the following key areas pose risks to achieving its goals:

- In an increasingly digitalised world, customer expectations are rising with a significantly lower tolerance and acceptance of service disruption. The Group must ensure it manages its service provision to maintain high levels of customer satisfaction. Furthermore, in the event that the Group decides to invest in technology to support the delivery of new products or services, then appropriate steps will need to be taken to ensure that the transition from existing to new systems is carefully managed. In a fast-paced environment there is the potential for new technologies to become outdated before the end of their expected lives.

- The scale and pace of required change may outstrip the Group's capacity to achieve its transformation programme. This could create delivery challenges and may lead to disruption of the Group's operating environment and distribution strategy or require process enhancements on legacy systems. The Group continues to deploy experienced change management and IT resource to ensure that these risks are managed and mitigated.
- The ever-increasing sophistication of cyber-criminal activity raises the likelihood and severity of cyber-attacks and money laundering. Security controls need to keep pace to prevent, detect and respond to any threats or attacks. In recognition of the cyber risk facing both the Group and the financial sector in general, the Group continues to focus its efforts on investing in appropriate technology, processes and controls.

Regulatory conduct risks

The Group's business model and strong member focus leaves it well placed to meet current and emerging regulatory conduct requirements. However, the following matters pose potential risks to the achievement of the Group's goals:

- Unknown legacy conduct issues may emerge. Regulation relating to the fair treatment of Members and customers continues to be a focus for the industry. It is possible that in consideration of how past business was conducted, the Group may be judged as not having complied fully with regulations or be regarded as not having delivered fair or reasonable outcomes in the treatment of Members and customers. In addition, unforeseen conduct issues may arise in existing products.
- The regulatory landscape continues to evolve and may lead to increased risks. As a consumer focused business operating in highly regulated markets, the Group is subject to complaints and threatened or actual legal proceedings in the ordinary course of business. In addition, at a sector level, the incidence of regulatory reviews, challenges and investigations is increasing. Regulatory expectations in respect of conduct standards increase the risk of future sanctions, fines or customer redress.
- Recognising the potential for rate rises in the longer term, the FCA continues to emphasise the need for firms to treat customers with vulnerabilities and those in financial difficulty fairly. Mindful of this, the Group has delivered training to all customer-facing staff in order to help identify and deal with vulnerable customers. The Group worked with the mental health charity MIND in the design and roll out of the training.

Principal Risks

The key risks to which the Group is exposed are outlined below:

Credit risk
Credit risk is the risk that borrowers or counterparties do not meet their financial obligations to the Group as they fall due.
Market risk
Market risk is the risk that the value of income derived from the Group's assets and liabilities may change adversely as a result of changes in interest rates.
Liquidity and funding risk
Liquidity risk is the risk that the Group has insufficient funds to meet its obligations as and when they fall due. Funding risk is the inability to access funding markets or to do so only at excessive cost.
Conduct risk
Conduct risk is the risk that the Group does not treat its customers fairly resulting in inappropriate or unfair outcomes.
Operational risk
Operational risk is the risk of loss arising from inadequate or failed internal processes, systems, human error or from external events.
Business risk
Business risk is the risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geographical, regulatory or other factors.
Pension risk
Pension risk is the risk that the value of the Scheme's assets will be insufficient to meet the liabilities of the Fund.

In addition to the Principal Risks, the Group is also exposed to model risk which is defined as the risk that an adverse outcome (incorrect or unintended decision or financial loss) occurs as a result of weaknesses or failures in the design or use of a model. Given that internal models are frequently used by the Group, model risk could potentially arise in assessing and managing exposure to a number of the Principal Risks outlined above. The Group uses a variety of techniques to mitigate model risk, including sensitivity analysis to key assumptions and applying shock stresses. The MGC is dedicated to the oversight of the Internal Ratings Based (IRB) model supporting the management of credit risk.

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 and uncertainties

Recent economic indicators have provided some encouragement, with the UK and Welsh economies showing modest growth. However, the sustainability of the recovery remains uncertain, given the volatile global outlook, and the impacts of the Brexit vote. A deteriorating exchange rate, together with future Bank of England base rate rises, could impact mortgage affordability and pose a threat to longer-term recovery in the UK and overseas. 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 inflation and interest rates, decreases in house prices, impacts on commercial property market values, the ability to re-finance at maturity, a sustained deterioration in the macroeconomic environment and consequential increases in unemployment.

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 Group's strategy. Each of the business areas, residential first and second charge lending, commercial lending and treasury, has its own individual Credit Risk Policy Statement setting out the Board's risk appetite including policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring.

Day-to-day management of credit risk is undertaken by specialist teams using credit risk management techniques adopted as part of the 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 new lending ensuring that the mix of overall portfolio exposures is within the prudent limits and risk appetite set by the Board. Applicant quality is monitored closely, defined in terms of creditworthiness, loan to value (LTV) and loan to income (LTI) ratios, and affordability profile. The GCRC receives regular reports on the performance of retail credit risk portfolios with further oversight provided by the GRC. These reports incorporate forward looking information and we continue to further develop our forecasting capabilities to ensure adherence to key limits. The Group assesses affordability using a stressed, higher interest rate to protect the borrower from entering into a mortgage commitment which could prove unsustainable in a higher interest rate environment.

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

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

The 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 and forbearance measures. Experience in these areas allows for feedback into the underwriting process. Customers in financial difficulties need support at what may be a difficult time so careful consideration is given to the most appropriate strategy likely to result in a fair outcome for the Group and the customer. Repossession of a property is only sought where all reasonable efforts to regularise matters have failed or the mortgage is unsustainable in the longer term.

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

Commercial credit risk

Commercial risk appetite is regularly reviewed in the light of changing economic and market conditions and is also subject to annual review. Commercial lending continues to operate within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

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

Responsibility for the overall quality of the lending book and the adequacy of credit procedures and controls rests with the commercial lending division with oversight provided by 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 prescribed by the Board.

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

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

Market background and uncertainties

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

In August 2016 the Bank of England launched the Term Funding Scheme (TFS). This is designed to help facilitate the transmission of Bank Rate cuts to those interest rates actually faced by borrowing households and businesses by providing medium term funding to banks and building societies at rates close to Bank Rate. The TFS provides participants with a cost effective source of funding in the form of central bank reserves to support additional lending to the real economy. The Group became a participant of the TFS in October 2016.
In 2015, the PRA published a Policy Statement PS11/15 'CRD IV: Liquidity' which included, implementation of the Liquidity Coverage Ratio (LCR), a short-term liquidity stress metric designed to promote short-term resilience of a firm's liquidity risk profile by ensuring it has sufficient high quality liquid assets to survive a significant stress scenario lasting for one month. This was set at 80% of the full requirement from October 2015 and will increase to 90% in January 2017 and 100% from January 2018. The Policy Statement also outlined the intention to introduce a Net Stable Funding Ratio (NSFR) which is designed to promote a sustainable funding maturity structure over at least a 12 month period, and is expected to be implemented from January 2018.

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. The Treasury Committee and ALCO exercise control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving weekly reports on current and projected liquidity positions.

The Board determines the level of liquid resources required to support the Group's strategy through undertaking an annual ILAAP as part of the development of the Group's Corporate Plan. Stress tests consider a range of severe but plausible scenarios and their impact on the Group, particularly with respect to retail saving outflows. The most recent ILAAP was approved by the Board in June 2016.

As at 31 December 2016 the Group held an LCR ratio well in excess of 100%. Based on current interpretations of the NSFR regulatory guidance, the Group held an NSFR ratio well in excess of the full 100% ratio requirement due for implementation in January 2018.

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, and GRC which approves the market risk policy and receives regular reports on all aspects of market risk, including interest rate 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.

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

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

Market background and uncertainties

The Bank of England reduced interest rates to an all-time low of 0.25% in August 2016. The Bank of England's expectation, and a view shared by many economists, is that rates will remain low for a prolonged period of time.

Notwithstanding this, the impact of the sterling devaluation, however, and any resulting increase in CPI materially above the Bank of England's own target may necessitate a rate rise in order to restore CPI to an acceptable level.

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

The Board is confident that it has the necessary tools to manage a protracted low rate environment and the Group's statement of financial position is positioned to take account of this current view.

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, and appropriate analysis of the mortgage pipeline and early redemption behaviour. Derivative instruments are used to manage various aspects of interest rate risk including the net basis positions where appropriate.

On a monthly basis, ALCO considers the impact of a number of interest rate risk and basis risk stress tests on the Group's statement of financial position considering both earnings and value measures. In addition ALCO and GRC review the Group's options and strategies 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 stressed accordingly.

Use of derivatives

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

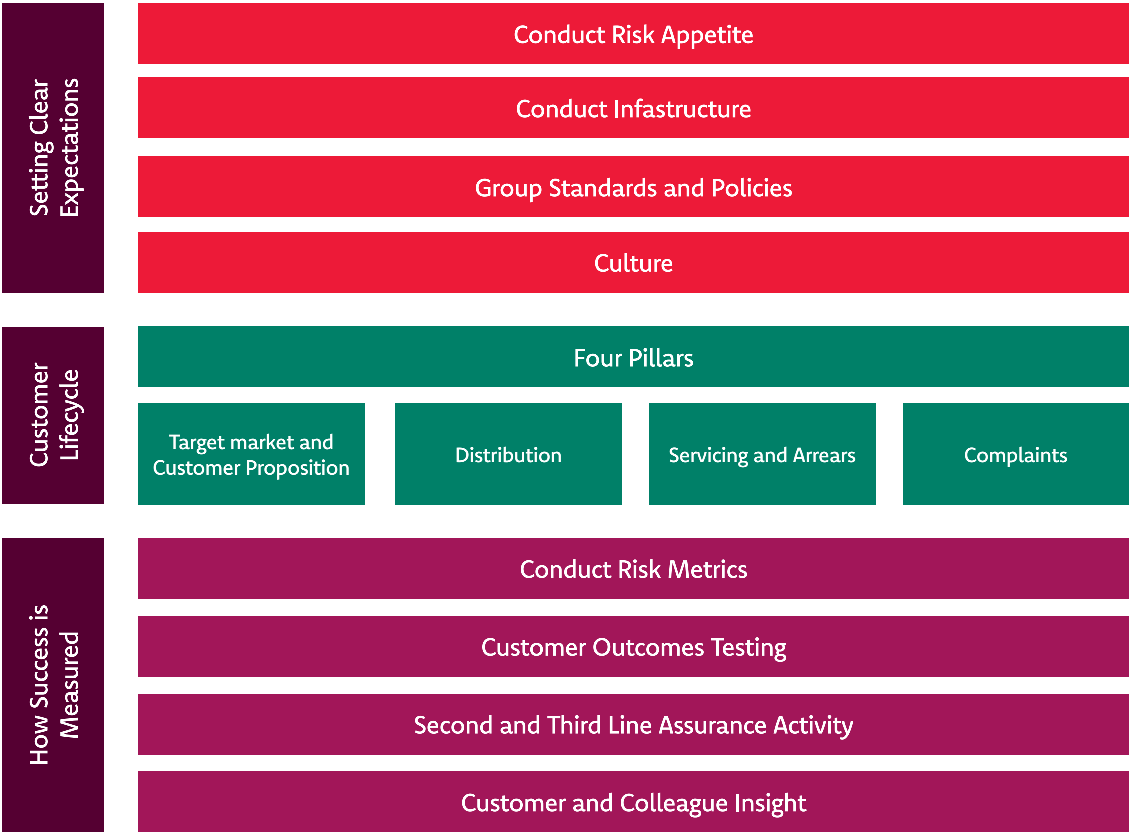
Conduct risk is the risk of the Group treating its customers unfairly resulting in the delivery of inappropriate outcomes.

Market background and uncertainties

The sustainability of the Group's business model and achievement of its longer-term strategy are dependent upon the consistent and fair treatment of Members and customers. The Group has always been committed to ensuring that Members and customers are treated fairly. Furthermore, the current regulatory regime has resulted in increased scrutiny around the conduct of firms and their focus on delivering fair customer outcomes, with significant consequences for those firms that do not manage conduct risk effectively. In 2014, the Group reappraised its framework and approach to managing conduct risks and has continued to make appropriate investment and adjustments to ensure the ongoing ability to meet its conduct obligations.

Risk mitigation

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



The Group's conduct strategy was updated and approved by the Board in December 2016. This sets out the Group's strategy for managing conduct risk and also articulates the Board's risk appetite in relation to conduct risk.

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

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

The Group's conduct risk appetite is defined against each of the four pillars of the conduct strategy:

Pillar	Desired outcome
Target market and customer proposition	Business plans and incentive schemes are developed, and reviewed, by senior managers in accordance with the Group Conduct Strategy.
	The Group only offers products and services which clearly meet the needs and circumstances of the target market.
	The Group offers straight-forward products with clear, fair and not misleading literature.
	The Group regularly reviews the performance of our products to ensure that they function and deliver fair outcomes for our customers.
Distribution	The Group lends responsibly ensuring the loans are affordable at the point of purchase.
	For non-advised sales, the Group provides customers with clear information, enabling them to make an informed decision about the products they purchase.
	Where customers receive advice, the advice will be suitable.
Servicing and Arrears	Customers will be provided with information that is clear, fair and not misleading and kept appropriately informed throughout the lifetime of their product or service.
	The Group takes all reasonable steps to ensure that financial crime, information security and business continuity risks, associated with products or services provided to customers, are appropriately managed.
	The Group will work with borrowers in financial difficulty towards an appropriate resolution and all appropriate forbearance options will be considered. In addition, customers will be treated sympathetically. The Group will only repossess customers' homes when this is the fair outcome.
Complaints management	Customers will not face unreasonable barriers to make a complaint.
	All complaints will be resolved in a timely manner and fairly based on review of the customer's individual circumstances.
	The Group will undertake root cause analysis and where appropriate act on any lessons learnt to enable us to improve the outcomes for customers.

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

Operational risk

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

The Group assesses its exposure to and management of operational risks by reference to 12 principal categories:

Risk category	Brief definition
Business continuity management	The risk of loss arising from an inability to service customers and key stakeholders due to a failure of the operational infrastructure including people, premises and IT systems.
Customer experience	The risk of loss to the business from a failure to provide best practice customer service, including the level of service required to meet retention and new lending growth targets, and from failing to ensure that the level of service offered is key to differentiating the business in the future.
Change management	The risk of non-delivery of the strategic change programme objectives or disruption to business as usual activity resulting from the implementation of change.
Financial crime	The risk of loss to the business arising from activities which circumvent controls, the unauthorised use of assets or services or illegal activities.
Financial management	The risk of losses arising from the failure to set and monitor budgets, reconcile accounts, price appropriately and monitor compliance with exposure limits. Failure to design and produce adequate, timely and accurate MI for decision-making purposes.
Information security	The risk of loss arising from a failure to protect information from unauthorised access, use, disclosure, modification or destruction.
IT	The risk of loss to the business arising from an inability to service customers, counterparties and other stakeholders due to the failure of the integrity or performance of the IT infrastructure and critical systems and/or an inappropriate IT strategy and/or inadequate use of the Group's information technology.
Legal and regulatory	The risk of loss, penalties and consequential disciplinary action, restitution costs, restrictions on business or missed opportunities arising from a failure to identify, understand, interpret and comply with UK and European regulatory rules/laws/codes of conduct.
People	The risk of failure to maintain and develop the appropriate level of skilled resource, maintain employee relations, provide a safe environment in line with legislative requirements and comply with ethical, diversity and discrimination laws.
Process	The risk of loss arising from the failure in the design, documentation or performance of an operational process.
Premises and facilities	The risk of loss arising from the ownership, management and security of and threats to, the property and facilities used in the Group.
Third party	The risk of loss arising from the failure of a key supplier or outsourcing arrangements or in failing to meet agreed target levels from the use of outsourcing or third party service providers.

Market background and uncertainties

The external environment continues to evolve with new challenges arising from technological innovation, increased customer expectations and emerging regulatory standards. The sector as a whole has become exposed to increased levels of operational risk, with greater reliance placed upon the resilience of technology platforms and staff capability. Growing levels of financial and cyber-crime require the adoption of increasingly sophisticated anti-fraud controls. The Group recognises that the cyber threat remains a key industry concern and will continue to adopt additional controls in line with industry best practice. Notwithstanding recent and substantial investments by financial institutions in technological solutions aimed at combatting the more sophisti cated financial crime threats, there is an increasing trend of financial deception targeting consumers directly.

The Group continues to strengthen its control environment to protect those who are most vulnerable to financial abuse, and continues to work collaboratively with industry partners to further improve controls and enhance customer education. In addition, the Society is continuing a strategic review of its IT capabilities, including the identification of improvements to enhance Members' experience when interacting with the Society.

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 achieve its strategy while protecting its reputation and the interests of its members. The Group manages its exposure to operational risk by considering risk events analysed by the operational risk categories described above. In addition to any direct loss attributable to risks in these categories, the reputational impact of such an event may damage the Group leading to secondary impacts.

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 Data Governance Committee provides specialist oversight in relation to this specific area of operational risk and reports directly to the GORC. The Operational Security Group provides specialist oversight in relation to operational decisions that affect the security of the Group's information, information systems and information assets.

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, to ensure they continue to reflect emerging potential operational weaknesses or threats.

Business risk

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

The management of strategic risk is intrinsically linked to the corporate planning and stress testing processes, and is further supported by the regular provision of consolidated business performance and risk reporting data to the Board and senior risk committees. In addition, a risk to reputation is inherent in all risk categories where actions and incidents can affect the extent to which people trust, and wish to do business with, the Group. Reputation risk is assessed via incident reporting, media monitoring, business performance, complaints monitoring and both internal and external benchmarking.

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

Market background and uncertainties

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

In the longer term, the Group acknowledges that in order to meet the needs of a more technologically demanding customer demographic, it must invest in new technology to support the delivery of new products or services. A strategic review of IT capabilities, including the identification of improvements to enhance Members' experience when interacting with the Society, is currently underway.

Risk mitigation

The management of strategic risk is intrinsically linked to and is supported by the provision of consolidated business performance and risk reporting data to the Board and senior risk committees whose remit encompasses all risk categories. During the year the Group decided to cease originating new business through its second charge lending subsidiary Nemo Personal Finance Limited. That decision reflected the Board's desire to focus more closely on core lending activities whilst ensuring that the high standard of service provided to Nemo's existing customers is maintained.

The Group will continue to carefully manage its reputational risk and invest significant resources in enhancing the robustness of its systems and controls, governance, product set and ongoing monitoring.

Pension obiligation risk

Pension risk is the risk that the value of the Scheme's assets will be insufficient to meet the estimated liabilities of the Fund. Pension risk can adversely impact the Group's capital position and/or result in increased cash funding obligations to the Scheme.

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.

Market background and uncertainties

Investment returns from assets and the value of liabilities cause volatility. Key risk factors which include interest rates, credit spreads, inflation and asset performance are closely linked to economic performance. The other key risk factor is life expectancy as pension benefits are paid for life. Changes in these factors can have positive and negative impacts on the deficit. The Scheme is also exposed to possible changes in pension legislation.

The impact of the 'Brexit' vote and the volatility this has created in domestic and international markets has increased the deficit as outlined in note 11.

Risk mitigation

The Group actively engages with the Pension Scheme Trustees to ensure broad alignment on investment objectives and implementation. This is supported by the sharing of management information between the Group and the Trustees. The Group and the Trustees of the Scheme regularly review reports prepared by the Scheme's independent actuaries and take appropriate action which may, for example, include adjusting the investment strategy and/or contribution levels.

The Scheme was subject to a triennial valuation in September 2016. Over the next 12 months the Group and the Trustees will agree a revised schedule of contributions in order to reduce the deficit.

Solvency risk and capital management

The Group holds capital to protect its Members by ensuring that there are sufficient assets to repay liabilities even in the face of unexpected losses. When assessing the adequacy of its capital, the Group considers the material inherent risks to which it is exposed and also the need for capital to be available to support the development of the business. The Group manages its capital to ensure it continues to meet minimum regulatory requirements, as well as meeting the expectations of other key stakeholders.

The Group employs a number of tools to support the management of solvency risk. The Board is responsible for setting a risk appetite with respect to solvency risk, which is articulated through its risk appetite statement, defining minimum capital ratios and thresholds, including leverage, within which it is willing to operate. These are supported by specific limits and triggers, against which performance is monitored by GRC, ALCO and other relevant internal management committees. General reserves form the majority of the Group's capital resources.

The Group undertakes a regular ICAAP, which considers the minimum amount of capital to be held in order to cover credit risks, operational risks, interest rate risks and pension risks, and also considers an additional buffer to ensure that the impact of a severe but plausible stress can be absorbed. The most recent ICAAP was approved by the Board in July 2016.

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

Key regulatory developments

Solvency

Basel III was implemented through CRD IV which came into force on 1 January 2014. It is supervised in the UK, together with local implementation rules and guidance, by the PRA. The objective of CRD IV is to improve the banking sector's ability to absorb shocks arising from financial and/or economic stress, thus reducing the risk that a stress in the financial sector damages the wider economy.

CRD IV introduced a non-risk based leverage ratio that is supplementary to the risk-based capital requirement. The Financial Policy Committee (FPC) has proposed the minimum requirement for this measure to be 3%, applicable immediately to the largest global banks, and domestically significant banks and building societies. It is unlikely that the Group will be classified as domestically significant, therefore the minimum requirement will become binding no later than 2018.

One of the consequences of CRD IV is to reduce the Group's capital resources primarily through restricting the eligibility of Permanent Interest Bearing Shares and subordinated debt on a phased basis under transitional rules which extend to 31 December 2021.

CRD IV sets a minimum for Tier 1 capital of 6% of risk weighted assets (RWAs) of which Common Equity Tier 1 (CET 1) is required to be a minimum of 4.5% of RWAs. The total of Tier 1 and Tier 2 capital must be a minimum of 8% RWAs and this is referred to as the Pillar 1 requirement. The total Pillar 2A capital requirement (capital held against risks not fully captured by Pillar 1) should be met with a minimum of 56% of CET 1, up to 44% of Additional Tier 1 (AT 1) capital, and a maximum of 25% of Tier 2 (T2) capital. The Society meets the minimum criteria stipulated in the Directive.

Capital level	Comprising	Minimum requirement (% of RWA)	Proportion of total capital	
			Minimum	Maximum
CET1	CET1	4.5%	56%	
Tier 1	CET1, AT1	6.0%		44%
Total	CET1, AT1, T2	8.0%		25%

To promote the conservation of capital and the build-up of adequate buffers that can be drawn down in periods of stress, CRD IV implements the use of supplementary common equity capital buffers. These comprise a sector-wide standard capital conservation buffer of 2.5% of RWAs to be built up from 2016 to 2019; a systemic risk buffer applied to institutions judged to be systemically important and macro-prudential Countercyclical Buffer (CCyB). The FPC, in April 2016, outlined that the CCyB will be used to adjust the resilience of the banking system to the changing scale of risk it faces over time. The current CCyB is set at 0%.

In addition to these system-wide requirements, the PRA may also apply additional buffer requirements in the form of an additional CET1 buffer. This PRA buffer represents elements of risk not covered elsewhere, avoiding duplication with other regulatory CET1 buffers.

Capital utilised in meeting the Society's firm-specific Pillar 1 and Pillar 2A capital requirements may not be used in meeting the additional CRD IV supplementary buffers.

Payment Services Directive

The Payment Services Directive (PSD) was adopted in 2007. This legislation provides the legal foundation for an EU single market for payments, to establish safer and more innovative payment services across the EU. The objective is to make cross-border payments as easy, efficient and secure as 'national' payments within a Member State. In 2013, the European Commission proposed to revise the directive (PSD2). The PSD2 updates and complements the EU rules put in place by the Payment Services Directive. Its main objectives are to:

- Contribute to a more integrated and efficient European payments market;
- Improve the level playing field for payment service providers (including new players);
- Make payments safer and more secure;
- Protect consumers; and
- Encourage lower prices for payments.

The Group will need to implement the requirements of PSD2 by January 2018.

The General Data Protection Regulation (GDPR)

The GDPR is the biggest change in data protection legislation since the Data Protection Act of 1998. The overarching aim of the GDPR is to strengthen and unify data protection for individuals within the European Union (EU). It also addresses export of personal data outside the EU. The European Commission's primary objectives of the GDPR are to give individuals back the control of their personal data, enhance privacy rights and to simplify the regulatory environment for business by unifying the regulation within the EU. The UK regulator (ICO) has recommended that businesses should proceed with GDPR readiness in spite of Brexit.

Main changes include:

- Sanctions – fines of up to 4% of worldwide turnover/greater of €20 million (current max is £500,000);
- Mandatory data breach notifications within 72 hours;
- Accountability and privacy by design including privacy impact assessments;
- Consent and specific protections for children;
- The right to be forgotten, right of data portability and enhanced subject access rights; and
- Burden of proof on organisations to prove compliance.

The Group will need to be compliant with the requirements of GDPR by 24 May 2018.

Treasury and lending activities

In December 2016, the PRA published Policy Statement (PS34/16): 'Supervising Building Societies' Treasury and Lending Activities' which describes the key lending and treasury risks to which societies are exposed, and sets out a framework illustrating different potential models ('approaches') for managing and controlling these risks. It is designed to provide clarity on supervisory expectations for the risk management characteristics and organisation that should be in place in relation to the level and types of risk taken by each society. The PRA expects each society to adopt the approaches (lending and treasury) that are most appropriate to its own business model and risk management capabilities.

The Policy Statement presents opportunities and risks to the Group's risk appetite, risk capacity and may have potential impacts on the medium term strategy for the Group.

Future uncertainties

Whilst a number of consultation and policy statements have been published, a number of the technical standards being published by the European Banking Authority have not been finalised and the Basel Committee and PRA are still consulting on a number of topics across many risk disciplines.

Based on the Board's current understanding of the future regulatory landscape and framework, the Board is confident the Group is well positioned to maintain regulatory compliance as the framework continues to evolve.

To meet Basel III 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 2017.

R. Michael Jones
Group Risk Director
14 February 2017

Section 2

Governance

Building your future

Laurence Philip Adams
MA

Chairman,
Non-Executive
Director

Age: 60

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

I have more than 25 years' experience in the banking industry, to help advise and guide the Society through the increasingly demanding and complex regulatory environment in which it now operates. Most recently I have been involved as a Non-Executive Director helping to rescue the troubled Northern Rock PLC in 2007 where I headed the Risk Committee.

I am a qualified solicitor and previously served as Managing Director and Global Head of Legal and Compliance for the investment banking wholesale division of ABN Amro Bank and had a similar role for Citibank.

Born in 1956, I lived in Neath until I was five before moving to Barry where I went to school. I currently live in London with my wife and two children. I am a Non-Executive Director of Novae Group PLC and of Exane Limited.

Derek Anthony Howell
BSc [Hons], FCA

Senior Independent
Non-Executive
Director

Age: 62

I was appointed a Director of the Society in April 2014 and have subsequently been appointed to the role of Senior Independent Director.

I also serve as Chairman of the Audit Committee and as a member of the Board Group Risk and Governance and Nominations Committees. As Senior Independent Director I act as a sounding board for the Chairman, serve as an intermediary for other Directors, and I am responsible for leading the annual review of the Chairman's performance. I am also available to Members if they have concerns which they have not been able to resolve through the normal channels of the Chairman, Chief Executive or other Executive Directors or for which such contact is inappropriate.

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

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

Born in 1954, I am married with two grown up children and live close to the centre of Cardiff.

Graeme Howes Yorston
FCIB MBA

Group Chief Executive

Age: 59

I joined the Society as Chief Operating Officer in July 2006 and was appointed to the main Board in October 2007.

As Chief Operating Officer I was responsible for all of the Building Society's operations including distribution, marketing, IT and operations. I became Group Chief Executive in October 2012. I am Chairman of the Group Management and Group Executive Risk Committees. In addition I am a member of the Asset and Liability and Commercial Asset and Liability Committees and attend meetings of the Board Audit, Group Risk, Customer and Conduct and Remuneration Committees.

During my time in financial services I have worked for Abbey National where I carried out a number of senior roles including Regional Director for Branches, Director of Sales for the call centres and CIO for the Retail Bank. I have led a number of significant strategic change programmes including one of the largest Customer Relationship Management system implementations in Europe.

In addition to my role at the Principality, I am a member of the Board of Governors at Cardiff Metropolitan University, I am on the Wales Council for the CBI, and sit on the Executive Committee for the CML, one of the leading industry trade bodies. I am also a Fellow of the Chartered Institute of Bankers and hold an MBA from Warwick Business School.

I was born in 1957 and now live close to Cardiff in the Vale of Glamorgan with my wife. I have three grown up children and three grandchildren.

Natalie Elphicke
LLB

Non-Executive Director

Age: 46

I was appointed to the Society's Board as a Non-Executive Director in July 2012.

I am the Chief Executive of The Housing & Finance Institute, a national not-for-profit organisation which works to deliver more homes and better housing services by working across the public and private sectors. I am a qualified barrister and solicitor, and started my legal career in the government legal service becoming a city law firm partner. I am a national expert in my field of housing and property finance and a regular adviser to the UK Government. I have worked on over £4bn of complex finance transactions across a range of finance, investment and regeneration projects. I was appointed an OBE in the Queen's Birthday Honours 2015 for services to housing. More recently I have become a member of the Board of the Student Loan Company.

At Principality, I chair the Board's Group Risk Committee and also sit on the Governance and Nominations Committee. Prior to joining the Society, I led the structuring team for the Ely Mill project which Principality jointly founded with the Welsh Government and which is on track to deliver 800 new affordable homes in Cardiff.

I am 46, married with two children and my family home is in Kent.

Robert Michael Jones
BA [Hons] MBA, ACIB

Group Risk Director

Age: 58

I joined the Society's Board in February 2013. Having worked for the Society since 1997, I was appointed Head of Group Risk in 2005 and promoted to the role of Director of Group Risk in 2009.

I have attended full Board meetings since September 2009 and attend all meetings of the Board Audit, Group Risk, Customer and Conduct and Remuneration Committees. I also chair the Group Credit Risk Committee and Group Operational Risk Committee and I am a member of the Group Management Committee, Group Executive Risk Committee, Model Governance Committee and the Asset and Liability Committees.

I have spent over 35 years working in financial services, starting my career at Midland Bank and subsequently at HSBC, undertaking a number of managerial roles in both the retail and corporate banking divisions. I hold a degree in Economics, an MBA from Henley Management College, and I am an Associate Member of the Chartered Institute of Bankers. Together with the Group Finance Director I have particular responsibility for ensuring that the Society maintains a strong capital base which will enable it to continue to grow and compete successfully over the long term.

Born and educated in Denbigh, North Wales, I now live just outside Cardiff and am married with two children.

Stephen Hughes
ACMA

Group Finance Director

Age: 44

I was appointed Group Deputy Finance Director in December 2011 and was appointed to the Society's Board in March 2013 as Group Finance Director with responsibility for Finance, IT and Business Change.

I chair the Society's Asset and Liability Committee and Model Governance Committee and I am a member of the Group Management Committee and Group Executive Risk Committee. I also attend all meetings of the Board Audit and Risk Committees. I have particular responsibility for ensuring that the Society retains a strong capital base and has high quality and sufficient levels of liquidity.

I am a qualified Management Accountant and bring over 20 years' experience in finance to my role. Prior to joining the Society I held a number of finance roles across a range of industries including manufacturing, retail and insurance. Prior to joining the Society I performed the role of Finance Director of the Lloyds Banking Group General Insurance business.

I am Chairman of the Wales Advisory Board for Business in the Community (BITC) and I am passionate about our community work and the difference it can make to people's lives in our heartland.

I was born in Swansea in 1972 and continue to live close to that city with my wife and three sons who share my passion for sport with our weekends taken up by both watching and playing football and rugby.

Nigel Charles Annett CBE, MSC, MA [Hons], DSC Econ

Non-Executive Director

Age: 58

I joined the Board of Principality as a Non-Executive Director in October 2013.

I now serve as Chairman of the Customer and Conduct Committee of the Board and also serve as a member of the Remuneration, Governance and Nominations and the Audit Committees. As Chair of the Customer and Conduct Committee I am responsible for making sure that the fair treatment of Members and customers is central to the Society's culture and operations.

I used to work in investment banking, but after ten years I decided on a change of career and joined the Board of Welsh Water, initially as Planning Director. I was one of the founding Directors of Glas Cymru, the not-for-profit company that took over the ownership of Welsh Water in 2001, and I was Managing Director of Welsh Water until 2014. In addition to serving on the Board of Principality I am also a Board member of the Canaland River Trust and a Trustee of the Community Foundation in Wales. I believe strongly that mutual business models can do a great deal of good for the people and the communities that they serve.

I have lived in Wales for more than 25 years and I have two grown up boys both of whom recently graduated from university.

Sally Jones-Evans FCIB, MBA

Non-Executive Director

Age: 50

I was appointed to the Society's Board in February 2015.

Since joining the Board I have become Chair of the Remuneration Committee and also serve as a member of the Customer and Conduct and Governance and Nominations Committees and the Transformation sub-committee. As Chair of the Remuneration Committee I am responsible for ensuring that the Group's remuneration and reward strategy, policy and procedures follow best practice, support the strategy approved by the Board, and reflect the best interests of Members.

Formerly, I spent 30 years in retail banking and general insurance during which time I gained wide ranging experience in leading people through change, mainly in areas directly serving customers including the branch network, telephone centres, internet banking and operations centres; I hope this will help me to shape the Society's ongoing change agenda. I am always impressed by the dedication and skills of our teams in the Principality who are so passionate about looking after our Members.

I also sit on an advisory panel to the Welsh Government which seeks to stimulate the financial and professional services sector in Wales to create employment and economic growth. In addition I serve as an Non-Executive Director on the Boards of the Student Loans Company and the Department for International Development, the latter due to my deep interest in strategies to lift people out of poverty in the developing countries of the world, especially Africa where I have also spent time in voluntary service.

My husband Alun and I were both born and educated in Cardiff, and we lived in the Vale of Glamorgan until work commitments moved us to Wiltshire some years ago. We love Welsh rugby, and music of many kinds, and spend a lot of time in Pembrokeshire.

David James Rigney
ACMA, MBA, MA

Non-Executive Director

Age: 53

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

In addition I am Chairman of Nemo Personal Finance Limited, a wholly owned subsidiary of Principality Building Society.

I am a Chartered Management Accountant and during my career I have performed a broad range of roles across multiple sectors including a Board Director at Nationwide Building Society. I believe this experience leaves me well placed to contribute to the Society's ongoing change programme and to have the opportunity to contribute to the Society's continuing success. I passionately believe in the mutual business model and everything that I see at Principality demonstrates that the customer is truly at the heart of the business.

I am also Chairman of BACS Payment Schemes Limited, Non-Executive Director and Senior Independent Director of Elexon Limited and Deputy Chairman of Sports Resolutions Limited. Born in 1963, I now live in Bristol.

Julie-Ann Haines
MSC, BA [Hons]

Customer Director

Age: 44

I was appointed to the Board in May 2016 and have been the Society's Customer Director since 2012.

In my role as Customer Director I am responsible for marketing, distribution and operations as well as having responsibility for the core operational performance of the Society. My role is designed to ensure that regardless of how Members choose to interact with Principality, they receive a consistent and high standard of service as well as offering great products. I am also responsible for ensuring that our colleagues play an active part in the communities we live and work in demonstrating our mutual value through many community projects.

I originally joined the Society in 2007 to build and develop our award winning e-commerce business. Prior to Principality, I held a number of senior roles in sales, marketing and technology, working in leading customer-centric businesses including Sainsbury's, Reckitt Benckiser and HBOS.

I am the current Chair of The Council of Mortgage Lenders (CML) Cymru, which represents mortgage lenders and promotes sustainable housing finance in Wales. I also sit on the Welsh Government's Expert Panel on Housing for Older People, in a role that offers guidance to help Government ensure people can continue to prosper in their homes into old age.

I was born and educated in Scotland, but Cardiff has been my home since 1999. I'm married to a Welshman and we have two daughters. Outside of work I love watching rugby, I am a fan of all types of music and a keen theatre goer.

Corporate Governance Report

for the year ended 31 December 2016

The Chairman is responsible for ensuring that the Board operates effectively within a sound governance framework and that there is appropriate oversight of governance arrangements at Board level. During the year the remit of the Society's Nominations Committee was expanded to expressly include oversight of the Group's governance arrangements. Through the work of that Committee the Board is able to ensure that there is appropriate focus on the changing governance landscape within which the Society operates. The Society's approach to corporate governance is set out within a comprehensive Corporate Governance Manual.

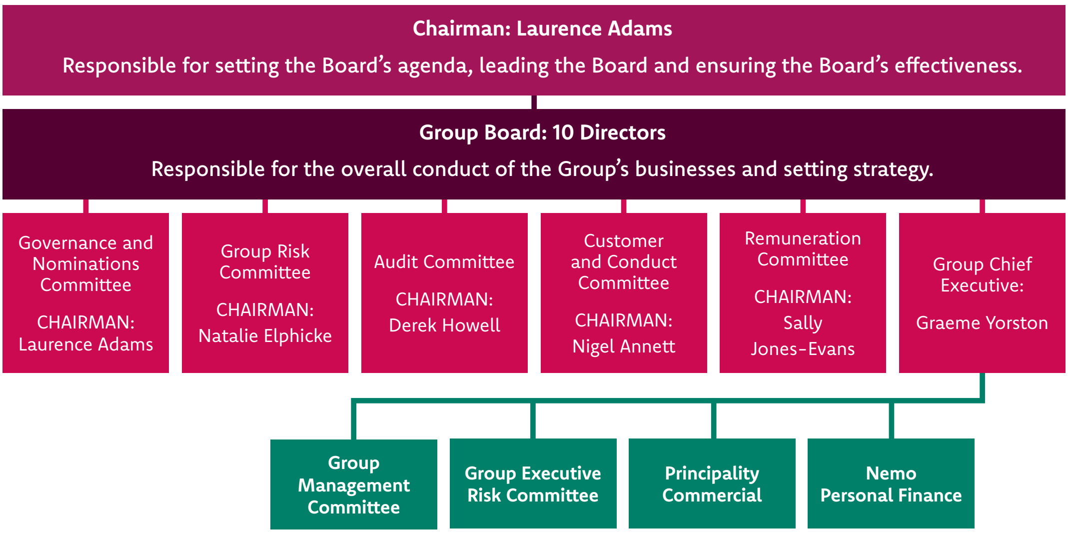
The Board is committed to and proud of the Society's mutual status and proactively works to balance Member interests with those of other stakeholder groups such as the communities which the Society serves, colleagues employed within the business, its suppliers and the regulatory authorities. The Board is accountable to the Society's Members and is responsible for:

- Ensuring that there is an appropriate culture (values, attitudes and behaviours) in place across the Society and its subsidiary businesses. The Group Chief Executive and the executive team are responsible for embedding the agreed culture. The Board takes regular steps to assess and ascertain that the Society's culture is fit for purpose.
- The overall conduct of the Society and its subsidiary businesses and the proper conduct of those businesses.
- Fostering transparency and honesty across the Group and ensuring that good standards of behaviour permeate throughout all levels of the organisation.
- Ensuring the sustainability of the Society's business model. The Board's focus has been to simplify the business model which has resulted in the previous disposal of the Peter Alan estate agency business and ceasing to originate new business through Nemo Personal Finance.
- Maintaining a sound system of control and setting the Group's appetite for risk. The Board delegates the responsibility for monitoring performance against appetite to the Group Risk Committee. The Board delegates responsibility for reviewing the adequacy and effectiveness of the Group's internal controls to the Audit Committee.

The Society voluntarily 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 to primarily apply to listed companies and sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and a number of other matters. The Code also provides guidance in relation to audit, risk, governance and nominations and remuneration committees and the Society also aims to comply with that guidance as far as possible. This report summarises the Society's approach to corporate governance.

Corporate governance framework

The Board recognises that ensuring effective corporate governance is integral to the successful delivery of the Society's goals. The work of the Board is supplemented by the work performed by a number of Board Committees.



How the Board operates

At 31 December 2016, the Board comprised six Non-Executive Directors and four Executive Directors. The offices of Chairman and Group Chief Executive are separate and held by different individuals. In accordance with the Code all Directors stood for election or re-election in 2016 and were duly elected or re-elected. All Directors will again stand for election or re-election at the 2017 Annual General Meeting.

The Chairman is responsible for the leadership, operation and governance of the Board, ensuring the effectiveness of the Board, setting the agenda, style and tone of Board discussions and ensuring that Directors receive accurate, timely and clear information. The Chairman 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 Senior Independent Director is responsible for acting as a sounding board for the Chairman, serving as an intermediary for other Directors, being available to Members if they have concerns which they have not been able to resolve through the normal channels of the Chairman, Group Chief Executive or other Executive Directors or for which such contact is inappropriate. The Group Chief Executive's responsibilities are set out in a role profile approved by the Board. He is responsible for managing the Group's businesses, implementing the Board approved strategy and policies, and chairing the Group Management and Group Executive Risk Committees. He maintains a close working relationship with the Society's Chairman.

The Board focuses its work on setting the strategic direction of the Society and its subsidiary businesses, challenging the performance of the senior management team in the day-to-day management and control of the business, monitoring adherence to the Board agreed risk appetite limits, oversight of the work undertaken by Board Committees and the maintenance of effective risk management and corporate governance systems. The Board has a formal schedule of matters reserved for its decision which is reviewed annually by the Board. Amongst others, the following matters are reserved to the Board:

- Responsibility for the overall strategic management of the Group;
- Approval of the Group's long-term 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;
- Approval of the Group's Conduct Strategy;
- Activation of the Group's Contingency Funding Plan and Recovery and Resolution Plan; and
- Approval of any changes affecting the Group's risk management and 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 ten Directors including the Chairman, a further five independent Non-Executive Directors (including Derek Howell – Senior Independent Director and Board appointed Whistleblowing Champion) 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 expected to have a broad range of business knowledge and experience and exercise independent judgement on strategy, performance, risk management and corporate governance. 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 management framework;
- Assess whether current and future resources are commensurate with future plans;
- 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 parts of the Group.

Julie-Ann Haines, the Society's Customer Director, was appointed to the Board during the year and consequently will stand for election for the first time in accordance with the Society's Rules at the 2017 Annual General Meeting. 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 and PRA 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. Members of the Society have the right to nominate candidates for election to the Board subject to the Society's Rules and compliance with PRA and FCA requirements. No such nominations were received prior to the Society's 2016 AGM.

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 2017 AGM	Considered to be independent by the Board
Natalie Elphicke	April 2013	4	Yes
Nigel Annett	April 2014	3	Yes
Derek Howell	April 2015	2	Yes
Sally Jones-Evans	April 2016	1	Yes
David Rigney	April 2016	1	Yes

Accountability

The implementation in March 2016 of the Financial Conduct Authority's Senior Managers Regime has provided an opportunity to review the allocation of responsibilities, and ensure that individual accountabilities continue to be allocated appropriately and are fully understood by those individuals within the business whose roles fall within the scope of the Senior Managers Regime. Along with the Chairs of the Audit, Risk and Remuneration Committees the Chairman is subject to all aspects of the Senior Managers Regime. All Directors must continue to satisfy fitness and proprietary requirements.

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 any actual or potential conflict situations.
- Actual or potential conflicts of interest are noted in the minutes of Board meetings as appropriate.
- 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.

At the time of his appointment as Chairman, the Board assessed Laurence Adams to be independent. The Chairman commits a substantial proportion of his time to his role and consequently he is not expected to remain independent following his appointment. All of the Society's Non-Executive Directors are considered by the Board to be independent in judgement and free of any relationships likely to affect his or her judgement. All Directors must meet the fitness and propriety tests prescribed by the PRA and FCA and are subject to regulatory approval for their allocated responsibilities under the FCA's Senior Managers Regime. Directors must also continue to follow the regulatory code of conduct.

The Board operates through its regular meetings and five committees – Audit, Remuneration, Governance and Nominations, Group Risk and Customer and Conduct - all of which have written terms of reference. Matters considered at all Board meetings include: the Group Chief Executive's report including strategic and business KPIs; the Group Finance Director's Report; the Group Risk Director's report including updates on strategic, regulatory and operational risks to which the Group is exposed; the Customer Director's operations report and, where applicable, reports from the Chairs of each of the Board's Committees. The Board also receives regular reports from Non-Executive Directors on Member and colleague engagement activities.

Membership of Board Committees is reserved to Non-Executive Directors; however, Executive Directors and members of the senior management team continue to attend meetings of those committees as appropriate. 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 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.
- Monitoring the performance of the Society and its subsidiary businesses.

Governance and Nominations Committee

The Governance and Nominations Committee is responsible for oversight of the Board and Executive Management Succession Plan and making recommendations for new appointments to the Board. During the year the Committee appointed Odgers Berndtson to lead the recruitment process leading to the appointment of the Society's new Group Chief Executive. The Committee is also responsible for maintaining the Board and Executive Management Succession Plan, which is reviewed on at least an annual basis, and the Board Skills Matrix, which is used to help evaluate candidates for Board appointments. The Committee consists of all Non-Executive Directors and is chaired by Laurence Adams, the Society's Chairman. The Committee meets on not less than three occasions each year. During 2016 the Committee met on four occasions and continues to monitor whether the existing complement of Non-Executive Directors is sufficient. Below Board level there is a structured approach to succession planning designed to ensure a pipeline of talented and capable people is in place who will ultimately progress to Group Management Committee and Board positions. The Executive Succession Plan encompasses potential succession to all senior roles including that of Group Chief Executive and is regularly reviewed by the Group Management Committee. The Governance and Nominations Committee continues to be satisfied that each Non-Executive Director is able to discharge their responsibilities effectively.

During the year the Committee agreed the introduction of a Board Diversity Policy and in future the Committee will be responsible for monitoring adherence to the gender diversity target set out in that policy and the wider target for gender diversity put in place by the Board on agreeing to support the Women in Financial Services Charter.

Group Executive Risk Committee

The Group Executive Risk Committee is the principal management committee with responsibility for monitoring and controlling the risk embedded in the Group's business model and reports directly to the Group Risk Committee.

Board and Committee Membership and Attendance

	Board	Audit	Customer and Conduct	Group Risk	Governance and Nominations	Remuneration
Laurence Adams	10/10	-	-	-	4/4	6/6
Natalie Elphicke	10/10	3/3	-	4/4	4/4	-
Nigel Annett	10/10	3/3	5/5	2/2	4/4	6/6
Derek Howell	10/10	6/6	-	4/4	4/4	-
Sally Jones-Evans	10/10	-	5/5	-	4/4	6/6
David Rigney	10/10	6/6	-	4/4	4/4	-
Graeme Yorston	10/10	-	-	-	-	-
Stephen Hughes	10/10	-	-	-	-	-
Mike Jones	10/10	-	-	-	-	-
Julie-Ann Haines	9/9	-	-	-	-	-

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

Culture

During the year Non-Executive Directors have devoted a significant amount of time to meeting colleagues from across the business and Members as a means of experiencing the culture in the business at first hand. By doing this Non-Executive Directors are able to hear from a broad range of colleagues at all levels of the business. The Board also gains insight into the culture within the business through reviewing the outcome of colleague surveys and the information presented to it from a wide range of sources including the Group HR, the Group Compliance and Conduct and the Internal Audit teams.

Diversity

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 Board member must have the skills, experience and character that will enable him or her 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 and across the Executive and senior management team 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. During the year the Board agreed a new Board Composition Policy (which can be located on the Society's website) and agreed to support the Women in Financial Services Charter. Following the appointment of Julie-Ann Haines to the Board, 30% of Board members are female.

A copy of the letter of appointment for a Non-Executive Director can be obtained on request from the Group Secretary.

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 Chairman is responsible for ensuring that each Director receives induction training on joining the Board, and the subsequent ongoing training he or she needs tailored to their own specific requirements. As part of that process new Non-Executive Directors meet individually with each of the members of the Group Management Committee and other senior managers to hear about the aspects of the Society's affairs for which they are responsible. The Society maintains a programme for meeting Directors' training requirements. Keeping up to date with key business developments is essential in order that Directors may maintain and enhance their effectiveness. This is achieved through:

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

Performance evaluation

The effectiveness of the Board is subject to an external evaluation every three years. The next external review is due to be completed in 2018. 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. The Senior Independent Director evaluates the performance of the Chairman annually.

In the final quarter of 2015 the Board undertook an independently facilitated evaluation of its own performance. The key findings and areas for action arising from that review concerned: focusing on the execution of the Society's transformation programme; ensuring that the Board spends sufficient time on strategy; and improving the information provided to the Board. As a consequence of those findings the Board has focused its attention on the importance of delivering the aims set out in the Society's Medium Term Plan (MTP), executing the strategy of focusing on the growth of the core Building Society business and monitoring the focus on the transformation programme. The Board's agenda has been reshaped to improve the focus on and oversight of the transformational change project. The transformation programme is designed to modernise a number of aspects of the Society's operations with the aim of preserving the Society's franchise well into the future. During the year the information presented to the Board has also been refreshed and updated to include a range of Key Performance Indicators (KPIs) and Key Risk Indicators (KRIs). This information enables the Board to monitor adherence to the Society's overall risk appetite statement and ongoing operational performance and service levels.

A further review of the Board's effectiveness was completed in the fourth quarter of 2016. Internally facilitated reviews of the performance of the Audit, Remuneration, Customer and Conduct and Group Risk Committees were also completed in the year. The output of each review is assessed and appropriate plans put in place to address any areas identified for improvement.

Communication with Members and the Annual General Meeting

The Society is committed to fostering and maintaining good communications with Members. During the year four meetings were held by the Members' Forum as well as four Member Talkback sessions with groups of Members. These meetings were attended by various Society Directors. These meetings provide valuable means for Members' opinions about the Society to be canvassed by Directors.

The Society seeks to encourage all eligible Members to participate in the Annual General Meeting, either by attending in person or by voting by proxy. The Annual General Meeting provides Members of the Society with the opportunity to hold the Board to account through voting either for or against Directors standing for election or through voting for or against the other resolutions on the agenda at that meeting. A resolution on the Report on Directors' Remuneration is included on the agenda. Voting is encouraged through a donation to charity for each voting paper received. All proxy votes are returned to independent scrutineers, who also attend the meeting in person to count votes cast by Members. 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.

Laurence Philip Adams
Chairman
14 February 2017

Pictured: Sally Jones-Evans meeting one of our Members at last year's Annual General Meeting

Report of the Audit Committee

for the year ended 31 December 2016

The Audit Committee continues to focus its work on ensuring that the Group's financial reports taken as a whole are fair, balanced and understandable and that internal audit processes are rigorous.

Committee membership and responsibilities

Membership of the Committee has continued to evolve during the year. In addition to the Chairman, David Rigney has also served as a member of the Committee throughout 2016. Natalie Elphicke served as a member of the Committee until April 2016 with Nigel Annett joining the Committee in succession to Natalie Elphicke. The Chairman is grateful to Natalie for the contribution she has made to the affairs of the Committee since becoming a member in 2013. All members of the Committee are independent Non-Executive Directors. The Chariman has recent and relevant experience as demanded by the Corporate Governance Code. David Rigney is a Chartered Accountant and Nigel Annett has previous audit committee experience. The Chairman of the Committee is satisfied that as a whole members of the Committee have the requisite levels of knowledge and understanding relevant to the markets in which Society operates. The Group Chief Executive, the Group Finance Director, the Group Risk Director, the Group Secretary, the Chief Internal Auditor, and representatives of Deloitte, the external auditor, attend each meeting. Other relevant colleagues from across the Group are also invited to attend meetings of the Committee in order to provide a deeper level of insight into key issues and developments. The Committee acts as an Audit Committee for both the Society and its subsidiary companies.

The Committee's responsibilities include:

- Monitoring the integrity of the Group's financial reporting;
- Reporting to the Board on the appropriateness of the Group's accounting policies;
- Advising the Board on whether the Committee believes the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the necessary information for the Society's Members to assess the Group's performance, business model and strategy;
- Oversight of the Group's system of internal control, including the work performed by the internal audit function;
- Monitoring the relationship between management and the external auditor; and
- Monitoring the external auditor's adherence to the professional ethical standards expected of audit firms.

During the year the Committee met on six occasions. It continues to monitor the integrity and clarity of the financial statements and disclosures, together with formal announcements relating to the Group's financial performance. It reviews annually the acceptability of accounting policies and any significant financial judgements. The Committee is also responsible for considering annually whether a significant control failing has occurred. During the year no significant control failings or weakness were identified by the Committee.

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

Areas of judgement

- **Going Concern and Viability Assessment.** During the year the Committee has received regular reports from the Group Finance Director outlining the basis on which it is reasonable for the Group to continue to prepare its financial statements on a going concern basis and has continued to be satisfied that it is appropriate to consider the Viability Assessment over a three year planning horizon. As part of this process the Committee monitors closely the scale of off-balance sheet contingency funding available to the Society and has satisfied itself as to the quality of the assets in which the Group's surplus funds are invested. As part of its assessment the Committee has considered carefully the risk that the decision to leave the EU could adversely affect the availability and cost of wholesale funding
- **Impairment provisions on loans and advances.** During the year the Committee has monitored the performance of the Group's loan books closely. The performance of Nemo's loan book has improved during the year notwithstanding the decision to cease new loan origination in that business in early 2016. The performance of the commercial loan book has also continued to improve during the year. Members of the Committee have continued to support the steps being taken by management to maintain the resilience of the Group's balance sheet having regard to the risk that the UK's decision to leave the EU might have a negative impact on commercial and retail property prices. The level of impairment provision is a key area of judgement and the Committee continues to give careful consideration to the methodologies used by management to assess the likelihood of losses against

each loan book and the appropriateness of the overall level of provisions held against the Group's loan book. The Committee concluded that the assumptions which support management's judgement as to the adequacy of impairment provision continue to be appropriate.

- **Provisions for regulatory and customer redress.** The Committee has considered carefully the assumptions made by management in connection with the scale of the provision recognised for this purpose having regard to the steps being taken by the FCA to introduce new Rules and Guidance on the management of PPI complaints and following the decision made by the Supreme Court in the case of Plevin v Paragon Personal Finance Limited.

- **Financial Services Compensation Scheme levy.** The Committee continues to give careful consideration to the methodologies used by management to assess the Group's exposure to the future level of levies under the Financial Services Compensation Scheme. The Committee concluded that the extent of the provision held for this purpose continues to be appropriate.

- **Revenue recognition under IAS 39 using the effective interest rate (EIR) method.** Due to the complexity of the models used to calculate a constant yield over the life of a loan asset, the Committee continues to review carefully the EIR methodology used by management to determine revenue levels. In particular the key assumptions as to the period of time over which fees are amortised based on historical settlement rates and the determination of which fees should be included in the spreading calculation have been considered. The Committee concurred with management's judgement that the methodology used for this purpose continues to be appropriate.

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

After reviewing reports presented by management and after consulting with the Group'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.

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

During the year the Committee has received regular reports on the progress of work being undertaken in advance of the implementation of IFRS 9. The standard introduces new guidance on the classification and measurement of financial assets, and impairment and is effective from 1 January 2018. Members of the Committee have attended a number of training events designed to ensure that they are familiar with the requirements of this standard and the Group's approach to implementation. The Committee will continue to monitor progress of the IFRS 9 project during 2017.

Assessment of internal controls

Management is responsible for establishing and maintaining adequate internal controls. The Committee is responsible for monitoring and ensuring the effectiveness of those controls. This work is primarily driven through the work performed by the Internal Audit function. Members of the Committee are actively involved in planning the work undertaken by the Chief Internal Auditor and his team which is designed to reflect a risk based approach having regard to the risks embedded in the Group's operations. The Committee receives regular reports on the effectiveness of the Group's systems and controls framework including financial controls and internal control and risk management systems.

The Committee is responsible for approving the annual Group Internal Audit plan and receives regular reports from the Chief Internal Auditor on the progress being made by the Internal Audit team, the adequacy of the resources available to that department, the results of any unsatisfactory audits and associated action plans, and on management's implementation of audit recommendations. In order to preserve the independence of the Chief Internal Auditor, the individual performing that role continues to have a dual reporting line to the Group Chief Executive and Chairman of the Audit Committee. In addition, the Chief Internal Auditor also has direct access to the Society's Chairman. The Committee has held three private meetings with both of the Chief Internal Auditor and Deloitte during the year.

Whistleblowing policy

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

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

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

Audit engagement

During 2016 the Committee conducted a tender of the external audit engagement. After careful consideration, the Committee agreed to recommend to the Board that Deloitte LLP should be re-appointed to undertake the audit engagement. The Board approved this recommendation at its December 2016 meeting.

Auditor independence

The Audit Committee assesses annually the qualification, expertise, resources, independence and objectivity of the external auditor. The Committee conducts a formal review of the effectiveness of the external audit. Members of the Committee and senior members of the Group Finance team consider a number of relevant questions. The Committee conducts this evaluation without the auditor being present. There is periodic rotation of the audit partner responsible for the audit engagement, and each year the external audit firm confirms to the 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.

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 Audit Committee is responsible for making recommendations to the Board in relation to the appointment, remuneration and removal from office of the external auditor.

After serving a term of five years Matt Perkins of Deloitte will stand down as the audit engagement partner after the conclusion of the 2016 audit. He will be succeeded as audit engagement partner by Kieren Cooper.

In order to safeguard auditor objectivity and independence, the Audit Committee maintains a formal policy which governs the engagement of the external auditor for non-audit services. The policy is designed to ensure that the provision of such services does not have an impact on the external auditor's independence and objectivity. The policy is reviewed annually by the Committee, and will be updated during 2017 to reflect the introduction of new EU regulations in respect of the provision of non-audit services. This policy 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 auditor may only provide such services if such advice does not conflict with their statutory responsibilities and ethical guidance.

The Committee receives a schedule of fees for non-audit work paid to the audit firm at each meeting, an annual report on the non-audit services being provided and the cumulative total of non-audit fees. The audit fee for the year in respect of the Group was £202k. Non-audit fees, mainly in relation to the provision of tax advisory and further assurance services, were £134k.

Other matters

Immediately following each Audit Committee meeting, the Chairman of the Audit Committee provides an oral update to the Society's Board of Directors on matters considered by the Committee. In addition, the Board continues to receive the minutes of meetings of the Committee.

The Committee conducts an annual review of its own effectiveness, the result of which is reported to the Board. 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. Members of the Committee are expected to undertake relevant training as part of their ongoing development as an individual Board member. Each year, as considered appropriate, the Committee as a whole receives training on current topics. In 2016 this included updates on future changes as a result of IFRS 9, regulatory themes and financial statement disclosures.

Derek Howell
Chair of the Audit Committee
14 February 2017

Report of the Remuneration Committee

for the year ended 31 December 2016

The important work of the Remuneration Committee is to ensure that all of our remuneration policies align with the Board-approved strategy to ensure that the business is run safely and successfully for our Members. This has been a year of embedding and consolidating our new reward schemes launched last year; there are no major changes to report.

Board changes

Our Chief Executive Graeme Yorston advised the Board of his intention to stand down from the Board, on 31 August 2016, serving 12 months' notice. The terms of his departure have not yet been agreed and will be shared in next year's report. Stephen Hughes has been appointed as the new Chief Executive, and further detail of his remuneration is set out on page 66. As Julie-Ann Haines was appointed as an Executive Director to the Board on 18 May 2016 her remuneration is reported here for the first time.

Performance in 2016

As you have read in other sections of this Annual Report, the Society's performance has been very positive despite a challenging external environment. Assets and new lending are at record levels, profitability is strong, customer and Member feedback is very positive, and important steps have been taken to invest to grow the core Building Society over the coming years. This performance is reflected in the Directors' remuneration as shown in the table on page 65.

Variable pay

2016 is the first year of operation of our two new variable pay schemes which were shared in last year's Report; the Rewarding Excellence Award (a single scheme for all staff) and the Long Term Incentive Plan (for Executive Directors and a small number of Senior Executives). These schemes are linked to financial and customer measures to align with Member interests. Det ails of these schemes are shown on pages 67 to 68. The awards made to Executive Directors under both schemes are shown in the tables on page 66.

As the long-term strength, safety and health of the Society is paramount to our strategy, initial risk 'gateways' were set for our capital and liquidity position for both schemes and have been met. Performance against the stretching targets set by the Board for financial and customer service measures on both schemes have also been achieved in this very successful year; I am pleased to confirm awards close to the maximum level have been made. For our hard working staff this means an award of 11.7% of their salary to thank them for their contribution to this success. I am delighted that this scheme will be expanded to include all colleagues in our Nemo business for 2017.

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

Sally Jones-Evans
Chair of the Remuneration Committee
14 February 2017

Our remuneration policy

As a mutual Building Society, our objective is to deliver good outcomes for our Members. This means that we must keep our Members' savings safe and we must offer good and competitive products and services to our savers and borrowers that meet their needs. All our team members are well trained, motivated, and understand our purpose and values. We continue to ensure that we generate sufficient profits to maintain a strong capital position and run the business efficiently, keeping our costs under control, and investing for the future.

This thinking underpins our Remuneration Policy which is, above all, designed to ensure that the business is run safely and successfully for our 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;
- Share the success of the Society in line with Members' interests by offering Directors and colleagues (except our leaders of Risk, Audit and Conduct) the chance to share in a variable pay award of up to 12% of salary based on the achievement of stretching targets based on customer service and financial performance, and for some Senior Executives, an additional long term incentive scheme of up to 28% based on performance over three years;
- Promote the right behaviours that align with the Society's position on risk as well as its culture as a Member owned mutual Building Society; and
- Encourage sound conduct and risk management practices, in particular by setting capital and liquidity hurdles that must be met before any variable pay award can be made, and by ensuring our LTIP scheme for Senior Executives rewards consistent performance over multiple years.

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

Pictured: James serving a customer in our Queen Street branch, Cardiff

How this policy is applied to Executive Directors

The table below provides a summary of the different elements of remuneration for Executive Directors for 2017:

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

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

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

The Chairman and Non-Executive Directors are paid a fee for Board participation and additional fees for serving on Board committees. These fees are reviewed annually and in 2016 the fees were increased by 2% in line with colleagues' basic pay increase. The fees for chairing committees were also reviewed and adjusted as this had been omitted in the prior two years.

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

Annual report on remuneration

Introduction

The Group complies where appropriate with the Corporate Governance Code and aims to make the remuneration policy as transparent as possible. We therefore set out in this section the following information:

1. What the Executive Directors earned for 2016's performance compared with 2015;
2. What the Executive Directors can earn for 2017; and
3. What the Chairman and the Non-Executive Directors were paid in 2016 compared with 2015.

What the Executive Directors earned for 2016's performance

The following table shows a single total figure of remuneration for the 2016 financial year for each of the Executive Directors and compares this figure to the prior year. Annual Variable Pay is the total of both the Rewarding Excellence Award and the Long Term Incentive Plan.

The normal performance period of the LTIP will be three years and the 2016 LTIP will operate for the performance period 1 January 2016 to 31 December 2018. As a transition to these longer assessments of performance we have put arrangements in place for two years whereby the 2016 LTIP award vesting on 31 December 2016 will be assessed over 2016's performance only and for the second LTIP award vesting on 31 December 2017, we will assess performance over the two years ending on that date.

In February 2016, the Remuneration Committee decided that the base salary of all Executive Directors should increase by 2%. This was equal to the average pay increase awarded to all other colleagues in the Group.

Individual	Year	Salary and fees[1] £000	Benefits[2] £000	Pensions[3] £000	Annual variable pay £000	Total £000
Group Chief Executive Graeme Yorston	2016	341	14	51	129	535
	2015	335	14	50	87	486
Group Finance Director Stephen Hughes	2016	250	12	37	94	393
	2015	245	12	37	64	358
Group Risk Director R Michael Jones	2016	239	12	36	n/a	287
	2015	234	12	35	n/a	281
Customer Director Julie-Ann Haines (from 18/05/16)	2016	131	7	20	49	207
	2015	n/a	n/a	n/a	n/a	n/a

1. The review date for salary is 1 February 2016.
2. Benefits comprise a car allowance, life assurance, critical illness insurance and private medical insurance.
3. A cash allowance of equal value (15% of salary) may be taken in lieu of pension.
4. The 2015 variable pay scheme paid 50% of the award in 2016 and 50% is due in 2017. All deferred awards are subject to review annually and confirmation by the Remuneration Committee which has the discretion to reduce or withdraw any deferred awards in the event that the basis upon which the original performance measures were established proves unsustainable. This may not only relate to performance in the current year but also performance in previous years where relevant information has only come to light subsequent to the period for which the variable pay award was calculated. The deferred award will be paid in full in 2017.
5. Awards under the variable pay schemes are non-pensionable.
6. The Group Risk Director, Chief Internal Auditor and Chief Compliance and Conduct Officer do not participate in any variable pay scheme.

How the annual variable pay for 2016 was calculated

The 2016 annual variable pay awards for Executive Directors for each of the two schemes were calculated by reference to performance against challenging targets set by the Board for financial and customer measures. Performance in the year was demonstrated in the outcomes set out in the table below:

Rewarding Excellence Award 2016

Variable pay scheme target	Proportion of variable pay	Actual 2016 performance	Threshold	Target	Stretch	Award %
Group Profit before tax*	50%	£50.7m	£35.3m	£41.5m	£47.7m	6.0%
Customer Service Net Promoter Score	50%	72.7%	Below 64%	70%	73% or above	5.7%

Long Term Incentive Plan 2016

Variable pay scheme target	Proportion of variable pay	Actual 2016 performance	Threshold	Target	Stretch	Award** %
Return on Assets	50%	0.50%	0.37%	0.39%	0.41%	14.0%
Net Promoter Score	50%	Top 11%ile	Below 60%ile	Top 25%ile	Top 15%ile	14.0%

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

**Note: The Remuneration Committee has exercised its discretion to reduce the award on the 2016 LTIP from 28% to 26% in the light of an isolated risk management event that occurred in the third quarter of the year. This event had no material financial consequences for the Society and no impact on Members.

What the Executive Directors can earn for 2017

Base salary

The Committee reviews the Executive Directors' base salaries on 1 February of each financial year, taking into account factors such as individual and corporate performance, an assessment of market conditions and, most importantly, the salary increases applicable to the Group's other colleagues. The Remuneration Committee determines any salary increase based on that average percentage increase awarded to all colleagues. For 2017, they have awarded a 2% increase, the same as to all other colleagues.

Following this review, the Executive Directors' 2017 salaries are:

- Graeme Yorston £348,534
- Stephen Hughes £254,996*
- R Michael Jones £244,078
- Julie-Ann Haines £214,200

* Stephen Hughes' salary will increase to £310,000 from the date on which he assumes the role of Chief Executive Officer, reflecting his increased responsibilities in that role.

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

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

Annual variable pay
The all-colleague annual incentive plan, the Rewarding Excellence Award, will contine to operate from 1 January 2017. A summary is set out below:

Performance period	1 January 2017 to 31 December 2017
Participants	All employees of the Principality, except Executives such as R Michael Jones who is responsible for reviewing risk, the Chief Internal Auditor and Chief Compliance and Conduct Officer.
Administrator	Remuneration Committee.
Initial gateway condition	Capital and liquidity conditions and the absence of any material regulatory breaches.
Performance measures	Group Profit before Tax – 50%. Customer Service Net Promoter Score – 50%.
Potential payments	Nil for threshold performance. 6% of salary for meeting challenging target performance. 12% of salary for attaining highly stretching targets.
Payment date	Subject to Audit and Remuneration Committee approval, in February 2018. There will be no partial deferral of payment.
Clawback (demanding repayment)	The Remuneration Committee can apply clawback to an award to an Executive Director and other Senior Executives if it is discovered that the award should not have been paid, in the event of a material misstatement of the Group's annual results or in the event of a serious regulatory breach.

Long Term Incentive Plan

The three year Long Term Incentive Plan is designed to ensure that the Society's most senior management, who have responsibility for decisions affecting the long term health and success of the Society, are aligned to the longer-term corporate goals, prevailing market conditions, corporate governance best practice standards and the regulators' expectations.

Performance period	1 January 2017 to 31 December 2019
Participants	Invited senior management, except Executives such as R Michael Jones who is responsible for reviewing risk, the Chief Internal Auditor and Chief Compliance and Conduct Officer.
Administrator	Remuneration Committee.
Initial gateway condition	Capital and liquidity conditions and the absence of any material regulatory breaches.
Performance measures	Return on Assets – 50%. Net Promoter Score (externally benchmarked) – 50%.
Potential payments	Nil for threshold performance. 14% of salary for meeting challenging target performance. 28% of salary for attaining highly stretching targets.
Duration	Three years – 2017 to 2019 inclusive.
Payment date	Subject to Audit and Remuneration Committee approval, in February 2020. There will be no partial deferral of payment.
Clawback (demanding repayment)	The Remuneration Committee can apply clawback to an award to an Executive Director and other Senior Executives if it is discovered that the award should not have been paid, in the event of a material misstatement of the Group's annual results or in the event of a serious regulatory breach.

We are maintaining our policy that the maximum variable pay that the executives can be awarded in any year is 40% of salary (excluding the Group Risk Director who does not participate in any scheme). This comprises a maximum 12% annual incentive award under the Rewarding Excellence Award (the all-colleague plan) and a maximum 28% of salary award under the LTIP. The normal performance period of the LTIP is three years. Transition arrangements are in place for 2016 and the 2016-2017 two year period.

The Committee will have absolute discretion to adjust the awards under both schemes if necessary including withholding vested awards under "malus" arrangements or recovering monies paid under clawback.

No variable pay awards at the Society are pensionable.

Directors' service contracts

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

The Chairman and Non-Executive Directors' fees for 2016

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

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

Non-Executive Directors	Fees	
	2016 £000	2015 £000
Laurence Philip Adams	112	110
Nigel Annett (Chair of Customer and Conduct Committee)	60	61
Natalie Elphicke OBE (Chair of Group Risk Committee)	53	57
Derek Howell (Chair of Audit Committee and Senior Independent Director)	69	63
Sally Jones-Evans (Chair of Remuneration Committee)	56	50
David Rigney (Chair of Nemo Board)	59	50
Joanne Kenrick (to 30 September 2015)	-	34
Gordon MacLean (to 25 April 2015)	-	22
Menna Richards (to 30 September 2015)	-	41
Total	409	488

Approval

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

Sally Jones-Evans
Chair of the Remuneration Committee

Directors' report

for the year ended 31 December 2016

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 2016. The Audit Committee is responsible for considering on behalf of the Board whether the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary to Members to assess the Group's performance, business model and strategy.

In justifying this statement the Audit Committee has considered the robust process which operates in creating the report and accounts which includes the following:

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

The Chairman of the Audit Committee reports the Committee's conclusions to the Board. Final sign off is provided by the Board of Directors.

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.

Directors

The names of the Directors at the date of this report, together with brief biographical details, are listed on pages 48 to 52.

During the year Ms Julie-Ann Haines was appointed to the Board as an Executive Director. Also during the year and as part of the usual rotation programme of Board members between Board Committees, Mr Annett retired as a member of the Group Risk Committee and has become a member of the Audit Committee and Mrs Elphicke retired as a member of the Audit Committee. To comply with the UK Corporate Governance Code, and as permitted by Rule 26(1), all of the Directors retire and stand for re-election at the Annual General Meeting. All are eligible and willing to continue serving on the Board and there have been no other nominations.

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

Auditor

At the Annual General Meeting on 29 April 2016 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 73-79, 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.

So far as each Director is aware, there is no relevant audit information of which the Society's auditors are unaware. Each of the Directors, whose names and functions are listed in the Governance section on pages 48 to 52 have taken all steps that he or she ought to have taken as a Director in order to make himself/herself aware of any relevant audit information and to establish that the Society's auditors are aware of that information.

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

Long-term viability statement and going concern

The Directors have assessed the viability of the Group over a three year period taking into account the business strategy and the Principal Risks as set out in the Strategic Report and the Risk Management Report. The Directors have a reasonable expectation that the business can continue in operation and meet its liabilities as they fall due over the three year period of their assessment.

In making this statement the Directors have considered the resilience of the Group, taking account of its current position, the Principal Risks facing the business in severe but plausible scenarios, and the effectiveness of any mitigating actions. The assessment has considered the potential impacts of these risks on the business model, future performance, capital adequacy and liquidity over the period. The strategy and associated Principal Risks underpin the Group's three year plan and scenario testing, which the Directors review at least annually. The three year plan makes certain assumptions about the macroeconomic environment, the performance of the Group's lending portfolios and the availability of funding. The plan is stress tested through the Group's Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP). These processes use both scenarios determined by the Bank of England and internal scenarios which reflect the specific nature of the Group's business. Included within these scenarios are substantial falls in residential and commercial property prices, increases in unemployment, changes to interest rates and reduced funding availability within wholesale and retail markets.

The Directors have determined that a three year period of assessment is an appropriate period over which to provide its viability statement. The three year period is considered to be most appropriate as it is the longest period over which the Board considers that it can form a reasonable view of the likely macroeconomic environment and associated key drivers of business performance.

Having considered the plans and forecasts for the Group, the Directors are satisfied that there are adequate resources and no material uncertainties that lead to significant doubt about the Group's ability to continue in business for the foreseeable future. Accordingly, the financial statements continue to be prepared on a going concern basis.

The Group's strategic report information required by Schedule 7 to the Accounting Regulations and the capital structure of the Group are set out in the Strategic Report on pages 13-24.

Outlook

Economic conditions improved steadily during the first half of 2016. However the outlook has become less certain following the outcome of the UK referendum on continued membership of the EU and of the result of the recent election in the United States. There are further significant elections in 2017 in France and Germany, which have the potential to further unsettle markets. However, the Group is well placed to meet these challenges, and will continue through uncertain times to support the housing market in Wales and beyond, and to offer a safe and secure home for Members' savings.

Country by country reporting

In compliance with the Regulations of Article 89 of the Capital Requirements Directive IV (CRD IV) country-by-country reporting (CBCR) we disclose the following information:

a) **Name, nature of activities and geographical location**
Principality Building Society is the parent company and a list of the subsidiaries can be found in note 20 of these accounts.

The principal activities of the Group can be found in the Strategic Report and in note 20.

All Group companies operate in the United Kingdom only.

b) **Average number of employees**
The average number of employees is disclosed in note 9.

c) **Annual turnover**
Net operating income is set out in the Consolidated Income Statement.

d) **Pre-tax profit or loss**
Pre-tax profit is set out in the Consolidated Income Statement.

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

f) **Public subsidies received**
No public subsidies were received in 2016.

No political donations were made by the Society in the year.

On behalf of the Board of Directors.

Laurence Philip Adams
Chairman

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

for the year ended 31 December 2016

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 2016 and of the Group's and the Society's income and expenditure for the year then ended;**
- **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 that we have audited comprise:

- the Group and Society Income Statements;
- the Group and Society Statements of Comprehensive Income;
- the Group and Society Statements of Financial Position;
- the Group and Society Statements of Movements in Members' Interests;
- the Group and Society Cash Flow Statements;
- the Statement of Accounting Policies; and
- the related notes 1 to 35.

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

Summary of our audit approach

Key risks	The key risks that we identified in the current year were: • Revenue Recognition • Loan Loss Provisioning These key risks are consistent with those identified in the prior year.
Materiality	The materiality that we used in the current year for the Group was £2,515,000 (2015: £2,580,000) which was determined on the basis of income before tax as per the consolidated income statement.
Scoping	All entities in the Group are within our audit scope and will be audited to a local materiality for the purpose of individual entity reporting. All balances in the Group that are above our materiality threshold will be audited for the purpose of the Group reporting timetable.
Significant changes in our approach	No significant changes have been made to our audit approach.

Going concern and the Directors' assessment of the Principal Risks that would threaten the solvency or liquidity of the Group

We have reviewed the Directors' statement regarding the appropriateness of the going concern basis of accounting contained within note 1 to the financial statements and the Directors' statement on the longer-term viability of the Group contained within the Directors' report on page 71.

We are required to state whether we have anything material to add or draw attention to in relation to:

- the Directors' confirmation on page 33-46 that they have carried out a robust assessment of the Principal Risks facing the Group including those that would threaten its business model, future performance, solvency or liquidity;
- the disclosures on pages 33-46 that describe those risks and explain how they are being managed or mitigated;
- the Directors' statement in note 1 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements; and
- the Directors' explanation on page 71 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

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

We agreed with the Directors' adoption of the going concern basis of accounting and we did not identify any such material uncertainties. 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.

Independence

We are required to comply with the Financial Reporting Council's Ethical Standards for Auditors and confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards.

We confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the prohibited non-audit services referred to in those standards.

Our 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.

Revenue recognition	
Risk description	The recognition of revenue on loans using an effective interest rate method requires judgement by management to determine key assumptions related to the expected life of each loan and the associated cash flows. Such assumptions are also sensitive to changes in the economic environment. The Group held £11.2 million of unamortised origination fees on the Statement of Financial Position balance sheet at year-end which will be amortised over the expected life of the associated loan portfolios (2015: £13.8 million). Given the materiality of the balance, and the potential impact on the financial statements should system or process issues arise, we have also identified the risk that the general ledger does not accurately reflect interest receivable from the core lending system. Management's associated accounting policies are detailed on pages 88-95 with detail about judgements in applying accounting policies and critical accounting estimates on pages 95-96.
How the scope of our audit responded to the risk	We first understood management's process and key controls around revenue recognition by undertaking a walk-through. Following identification of the key controls we evaluated the associated design, implementation and tested operating effectiveness of such controls. We engaged Information Technology (IT) specialists to perform a detailed assessment regarding the accuracy of the in-built automated interest controls, and we have reviewed the flow of these calculations through to the general ledger. We challenged the appropriateness of management's key assumptions used in the calculation as described in note 1 (pages 88-95) by comparison to historical customer behaviour and assessing the sensitivity of key assumptions used to determine the behavioural lives of products. We assessed the fees included in the models for compliance against the requirements of the accounting standards. We tested the mechanical accuracy of the models which are used to determine revenue, including assessing whether the data used to compile the models was complete and accurate, as well as engaging our IT specialists to test the underlying key computer controls including access controls to key spreadsheets. We have also considered the associated disclosures in the financial statements for consistency with the Group's accounting policies.
Key observations	We have obtained reasonable assurance that the behavioural life assumptions used in the effective interest rate model are appropriate, and that the journals posted in the general ledger accurately reflect interest receivable as calculated in the core lending system. We consider the revenue recognition policies and the inclusion of fees that are an integral part of the mortgage products offered across the Group to be appropriate. Overall, we have determined the accounting for revenue to be acceptable.

Loan loss provisioning	
Risk description	The Group held £45.4 million of impairment provisions at year-end (2015: £49.2 million) against total loans and advances to customers of £7,073.9 million (2015: £6,544.9 million). Determining impairment provisions against loans to customers is a judgemental area requiring an estimate to be made of the losses incurred within the residential mortgage, commercial and secured personal lending portfolios. This requires the formulation of assumptions relating to customer default rates, property values and movements, sales costs, forced sale discounts, likelihood of repossession and potential impairment indicators, all of which may be sensitive to changes in the economic environment. Commercial lending provisions are mainly based on a case by case basis for individual accounts considered to be in default; the remainder of the commercial loan book is covered by a collective provision based on individually assessed credit risk factors. The assumptions used in the residential provisioning models for each portfolio of provision are mainly based on recent historical arrears behaviour demonstrated. Secured personal finance provisions are mainly based on recent historical arrears behaviour demonstrated and credit risk indicators within the loan book. Additionally, management includes overlays within secured personal finance and residential loan loss provisions to take into consideration additional impairment indicators, highlighted by credit bureau data, caused by excessive levels of indebtedness and bankruptcy. Loan loss provision balances are detailed within notes 18 and 32. Management's associated accounting policies are detailed on pages 88-95 with detail about judgements in applying accounting policies and critical accounting estimates on pages 95-96.
How the scope of our audit responded to the risk	We first understood management's process and key controls around loan loss provisioning by undertaking a walk-through. Following identification of the key controls we evaluated the associated design, implementation and tested operating effectiveness of such controls. We challenged, through testing of experiential data and benchmarking, the appropriateness of management's key assumptions used in the impairment calculations for loans and receivables, including the impairment trigger point, the estimation of property values, sales costs, forced sale discounts and the likelihood of repossession. We tested the mechanical accuracy of the related models, engaging our IT specialists to test the underlying key controls, including access controls to spreadsheets, and to test data flows into the models to assess whether the data was complete and accurate. We reconciled the year end mortgage book to the general ledger and substantively tested a sample of loans to assess whether the data used for the provision calculation is complete and accurate. Where significant management judgements have been applied, we challenged these by way of calculating independent ranges based on plausible alternative assumptions. • For commercial lending we have based our independent range on our quantitative and qualitative assessment of credit quality in the commercial lending book, and associated coverage ratios. • For secured personal finance we have built our range based upon default rates of accounts demonstrating certain risk indicators including other lending in arrears, debt to income ratios and customer credit scores.

Our assessment of risks of material misstatement (continued)

Loan loss provisioning (continued)	
How the scope of our audit responded to the risk (continued)	We performed substantive testing, including tests of existence and valuation, on the mortgage book, focusing on loans that display characteristics of audit interest. For commercial loans, following analysis on the loan portfolio performed by Data Analytics specialists, we performed detailed file reviews of a sample of properties across the book, including identifying any impairment indicators against the covenants in place and assessing whether these had been properly reflected within provision calculations by management. We tested the valuation of the underlying property collateral using our property valuation specialists. For residential and secured personal finance lending, we substantively tested the underlying credit bureau data to ensure it was complete and accurate.
Key observations	Based on the evidence obtained, we found that the assumptions underpinning the impairment models were determined and applied appropriately, and the recognised provision was reasonably stated.

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

Our application of materiality

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

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

Group materiality	£2,515,000 (2015: £2,580,000).
Basis for determining materiality	5% (2015: 5%) of profit before tax.
Rationale for the benchmark applied	The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the Group to invest in activities for its members. We have therefore selected profit before tax as the benchmark for determining materiality.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £115,000 (2015: £52,000), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. The change in the reporting threshold has been made following our reassessment of what matters require communicating to the committee. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

All entities in the Group are within our audit scope and will be audited to a local materiality for the purpose of individual entity reporting. All balances in the Group that are above our materiality threshold will be audited for the purpose of the Group reporting timetable. We have performed testing over the consolidation of Group entities. These audits were performed directly by the Group audit team and executed at levels of materiality applicable to each individual entity which were lower than Group materiality and ranged from £880,000 to £2,001,000 (2015: £1,026,000 to £2,150,000).

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.

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

In our opinion the information given on page 72 for the financial year ended 31 December 2016 has been properly prepared, in all material respects, in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records Under the Building Societies Act 1986 we are required to report to you if, in our opinion: • proper accounting records have not been kept by the Society; or • the Society financial statements are not in agreement with the accounting records; or • we have not received all 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 the financial statements and for being satisfied that they 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). We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team and independent partner reviews.

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

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.

Matt Perkins ACA (Senior statutory auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor, Cardiff
14 February 2017

Section 3

Financial Statements

Building your future

Consolidated income statement for the year ended 31 December 2016

	Notes	2016 £m	2015 £m
Interest receivable and similar income	4	229.1	243.3
Interest payable and similar charges	5	(104.2)	(109.2)
Net interest income		124.9	134.1
Fees and commission receivable	6	9.0	6.5
Fees and commission payable		(0.9)	(1.1)
Net fee and commission income		8.1	5.4
Other operating income		1.6	1.4
Other fair value gains	7	1.6	0.9
Net operating income		136.2	141.8
Administrative expenses	8	(74.2)	(77.1)
Depreciation and amortisation	21 & 22	(7.9)	(6.6)
Operating expenses		(82.1)	(83.7)
Impairment provision for losses on loans and advances	18	2.7	(4.8)
Provision for other liabilities and charges	19	(6.5)	(4.3)
Operating profit and profit before taxation		50.3	49.0
Taxation expense	12	(11.2)	(11.3)
Profit for the year		39.1	37.7

Consolidated statement of other comprehensive income

	Notes	2016 £m	2015 £m
Profit for the year		39.1	37.7
Items that will not be reclassified subsequently to profit and loss:			
Actuarial (loss)/gain on retirement benefit obligations	11	(12.6)	1.1
Taxation	12	2.5	(0.1)
Items that may be reclassified subsequently to profit and loss:			
Gain/(Loss)on available-for-sale assets		0.6	(1.3)
Taxation	12	(0.1)	0.3
Total comprehensive income for the year		29.5	37.7

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

The accounting policies and notes on pages 88 to 134 form part of these accounts.

Income statement of the Society for the year ended 31 December 2016

	Notes	2016 £m	2015 £m
Interest receivable and similar income	4	205.7	216.3
Interest payable and similar charges	5	(104.0)	(107.8)
Net interest income		**101.7**	**108.5**
Fees and commission receivable	6	8.7	6.1
Fees and commission payable		(0.7)	(0.7)
Net fee and commission income		**8.0**	**5.4**
Other operating income		2.5	2.7
Other fair value gains/(losses)	7	3.0	(0.4)
Net operating income		**115.2**	**116.2**
Administrative expenses	8	(64.9)	(65.7)
Depreciation and amortisation	21 & 22	(7.4)	(6.1)
Operating expenses		**(72.3)**	**(71.8)**
Impairment provision for losses on loans and advances	18	0.6	(6.2)
Provision for other liabilities and charges	19	(3.4)	(3.3)
Operating profit and profit before taxation		**40.1**	**34.9**
Taxation expense	12	(8.8)	(8.0)
Profit for the year		**31.3**	**26.9**

Statement of other comprehensive income of the Society

	Notes	2016 £m	2015 £m
Profit for the year		31.3	26.9
Items that will not be reclassified subsequently to profit and loss:			
Actuarial (loss)/gain on retirement benefit obligations	11	(12.6)	1.1
Taxation	12	2.5	(0.1)
Items that may be reclassified subsequently to profit and loss:			
Gain/(loss) on available-for-sale assets		0.6	(1.3)
Taxation	12	(0.1)	0.3
Total comprehensive income for the year		**21.7**	**26.9**

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

The accounting policies and notes on pages 88 to 134 form part of these accounts.

Consolidated statement of financial position as at 31 December 2016

	Notes	2016 £m	2015 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		585.7	357.6
Loans and advances to credit institutions	13	141.5	166.6
Debt securities	14	389.6	437.8
		1,116.8	962.0
Derivative financial instruments	15	30.4	21.3
Loans and advances to customers:			
Loans fully secured on residential property		6,766.7	6,210.1
Other loans		307.2	334.8
	16	7,073.9	6,544.9
Intangible fixed assets	21	1.3	1.4
Property, plant and equipment	22	44.5	46.5
Deferred tax assets	27	4.4	1.1
Other assets		1.7	3.0
Prepayments and accrued income		8.2	4.2
Total assets		8,281.2	7,584.4
Liabilities			
Shares	23	6,165.2	5,621.8
Deposits and debt securities:			
Amounts owed to credit institutions	24	611.2	543.1
Amounts owed to other customers		226.5	280.9
Debt securities in issue	25	631.1	463.5
		1,468.8	1,287.5
Derivative financial instruments	15	45.7	31.4
Current tax liabilities		5.3	5.2
Other liabilities	26	6.8	7.8
Provisions for liabilities	19	7.1	3.8
Accruals and deferred income		18.8	11.7
Deferred tax liabilities	27	0.5	–
Retirement benefit obligations	11	15.3	4.1
Subordinated liabilities	28	–	92.3
Subscribed capital	29	69.3	69.8
Total liabilities		7,802.8	7,135.4
General reserve		476.0	447.4
Other reserves		2.4	1.6
Total equity and liabilities		8,281.2	7,584.4

The accounting policies and notes on pages 88 to 134 form part of these accounts. These accounts were approved by the Board on 14 February 2017.

Signed on behalf of the Board:

Laurence Philip Adams
Chairman

Graeme H. Yorston
Group Chief Executive

Stephen Hughes
Group Finance Director

Statement of financial position of the Society as at 31 December 2016

	Notes	2016 £m	2015 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		585.7	357.6
Loans and advances to credit institutions	13	62.1	58.6
Debt securities	14	389.6	437.8
		1,037.4	854.0
Derivative financial instruments	15	30.4	21.3
Loans and advances to customers:			
Loans fully secured on residential property		6,362.6	5,720.8
Other loans		307.2	306.9
	16	6,669.8	6,027.7
Investments in subsidiary undertakings	20	328.3	451.8
Intangible fixed assets	21	1.3	1.4
Property, plant and equipment	22	43.7	45.2
Deferred tax assets	27	4.1	1.1
Other assets		1.4	2.2
Prepayments and accrued income		8.0	3.8
Total assets		**8,124.4**	**7,408.5**
Liabilities			
Shares	23	6,165.2	5,621.8
Deposits and debt securities:			
Amounts owed to credit institutions	24	1,148.8	886.7
Amounts owed to other customers		226.5	280.9
Debt securities in issue	25	15.6	11.6
		1,390.9	1,179.2
Derivative financial instruments	15	43.6	30.7
Current tax liabilities		4.3	3.9
Other liabilities	26	5.2	6.8
Provisions for liabilities	19	4.3	2.7
Accruals and deferred income		17.1	9.8
Deferred tax liabilities	27	0.5	0.3
Retirement benefit obligations	11	15.3	4.1
Subordinated liabilities	28	–	92.3
Subscribed capital	29	69.3	69.8
Total liabilities		7,715.7	7,021.4
General reserve		406.3	385.5
Other reserves		2.4	1.6
Total equity and liabilities		**8,124.4**	**7,408.5**

The accounting policies and notes on pages 88 to 134 form part of these accounts. These accounts were approved by the Board on 14 February 2017.

Signed on behalf of the Board:

Laurence Philip Adams
Chairman

Graeme H. Yorston
Group Chief Executive

Stephen Hughes
Group Finance Director

C. P. Adams

Statement of changes in Members' interests for the year ended 31 December 2016

	2016			2015		
	General Reserve £m	Available for Sale Reserve £m	Total Equity attributable to Members £m	General Reserve £m	Available for Sale Reserve £m	Total Equity attributable to Members £m
Group						
At 1 January	447.4	1.6	449.0	408.7	2.6	411.3
Comprehensive income for the year	28.6	0.8	29.4	38.7	(1.0)	37.7
At 31 December	476.0	2.4	478.4	447.4	1.6	449.0
Society						
At 1 January	385.5	1.6	387.1	357.6	2.6	360.2
Comprehensive income for the year	20.9	0.8	21.7	27.9	(1.0)	26.9
At 31 December	406.4	2.4	408.8	385.5	1.6	387.1

Consolidated statement of cash flows for the year ended 31 December 2016

	2016 £m	2015 £m
Net cash inflow/(outflow) from operating activities (see below)	252.3	(65.4)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(5.7)	(9.1)
Disposal proceeds of property, plant and equipment	–	0.3
Purchase of investment securities	(124.7)	(91.8)
Proceeds from sale and maturity of investment securities	173.4	106.8
Cash flows from financing activities		
Repayment of subordinated liabilities	(92.3)	–
Increase/(decrease) in cash and cash equivalents	203.0	(59.2)
Cash and cash equivalents at beginning of year	524.2	583.4
Cash and cash equivalents at end of year	727.2	524.2
Represented by		
Cash and balances with the Bank of England	585.7	357.6
Loans and advances to credit institutions repayable on demand	141.5	166.6
	727.2	524.2
Net cash outflow from operating activities		
Profit after taxation	39.1	37.7
Adjusted for		
Depreciation and amortisation	7.9	6.6
Impairment losses on loans and advances to customers	(2.7)	4.8
Change in fair values	(6.9)	2.9
Taxation charge	11.2	11.3
Other non-cash movements	(12.5)	1.1
Changes in net operating assets		
(Increase) in loans and advances to customers	(513.8)	(419.9)
Decrease in other assets	1.1	–
(Increase)/decrease in prepayments and accrued income	(4.0)	1.9
Change in derivative financial instruments	5.3	(1.8)
Increase in shares	538.8	14.5
Increase in deposits and debt securities	179.7	285.0
(Decrease)/increase in other liabilities	(1.0)	3.4
Increase/(decrease) in provisions for liabilities	3.2	(0.1)
Increase in accruals and deferred income	7.1	2.2
Increase/(decrease) in pension fund obligations	11.2	(2.8)
Taxation	(11.4)	(12.2)
	252.3	(65.4)

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2016 amounted to £11.9m (2015: £10.9m).

Statement of cash flows of the Society for the year ended 31 December 2016

	2016 £m	2015 £m
Net cash inflow/(outflow) from operating activities (see below)	281.0	(72.7)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(5.8)	(8.7)
Disposal proceeds of property, plant and equipment	-	0.3
Purchase of investment securities	(124.7)	(91.8)
Proceeds from sale and maturity of investment securities	173.4	106.8
Cash flows from financing activities		
Repayment of subordinated liabilities	(92.3)	-
Increase/(decrease) in cash and cash equivalents	231.6	(66.1)
Cash and cash equivalents at beginning of year	416.2	482.3
Cash and cash equivalents at end of year	647.8	416.2
Represented by		
Cash and balances with the Bank of England	585.7	357.6
Loans and advances to credit institutions repayable on demand	62.1	58.6
	647.8	416.2
Net cash outflow from operating activities		
Profit after taxation	31.3	26.9
Adjusted for		
Depreciation and amortisation	7.4	6.1
Impairment losses on loans and advances to customers	(0.6)	6.2
Change in fair values	(3.3)	2.9
Taxation charge	8.8	8.0
Other non-cash movements	(12.3)	1.3
Changes in net operating assets		
(Increase) in loans and advances to customers	(629.1)	(432.5)
Decrease in loans to subsidiary companies	123.4	23.7
Decrease/(increase) in other assets	0.8	(0.5)
(Increase)/decrease in prepayments and accrued income	(4.3)	2.0
Change in derivative financial instruments	3.8	(0.5)
Increase in shares	538.8	14.6
Increase in deposits and debt securities	206.7	276.9
(Decrease)/increase in other liabilities	(1.6)	2.5
Increase/(decrease) in provisions for liabilities	1.6	(0.6)
Increase in accruals and deferred income	7.2	1.8
Increase/(decrease) in pension fund obligations	11.2	(2.8)
Taxation	(8.8)	(8.7)
	281.0	(72.7)

Notes to the accounts for the year ended 31 December 2016

1. Accounting policies

Basis of preparation

The Group and Society's financial statements for the year ended 31 December 2016 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 financial statements have been prepared on a going concern basis. This is discussed in the Directors' Report on page 71, under the heading 'Long Term Viability Statement and 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 9 Financial Instruments	In July 2014, the International Accounting Standards Board (IASB) published the final version of IFRS 9 Financial Instruments. This standard adopts a phased approach to replace IAS 39 Financial Instruments: Recognition and Measurement. The new standard affects a number of areas of the accounts with the final version of the standard requiring the use of the expected loss impairment model.	Accounting periods beginning on or after 1 January 2018
	Classification and Measurement The revised classification and measurement approach will lead to the Group's financial assets being reclassified as amortised cost, fair value through other comprehensive income, or fair value through the income statement. Classification will be based on an analysis of the objectives of the Group's business model, and the contractual cash flow characteristics of its financial assets. Financial liabilities will in most cases be accounted for in the same way as under existing standards, the only change being that valuation amendments that relate to the changes in the entity's own credit risk will be presented in other comprehensive income rather than in the income statement.	
	Recognition of Impairment The impairment of financial assets under IFRS 9 will be calculated based on an expected credit loss model rather than the current incurred loss model under IAS 39. At initial recognition, a provision is required for expected credit losses within the next 12 months. In the event of a significant increase in credit risk, a lifetime expected credit loss is required to be recognised.	
	Hedge Accounting The revised hedge accounting requirements are designed to create a stronger alignment with the economic management of risk. IFRS 9 allows for the option to continue to apply the existing hedge accounting requirements of IAS 39 until the separate IASB project to consider dynamic risk management is completed. Therefore no changes are currently being implemented to hedge accounting policies and processes.	

Notes to the accounts for the year ended 31 December 2016

Pronouncement	Nature of Change	Effective Date
IFRS 15 Revenue from Contracts with Customers	IFRS 15 specifies how and when an IFRS reporter will recognise revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures.	Accounting periods beginning on or after 1 January 2018
IFRS 16 Leases	IFRS 16 specifies how an IFRS reporter will recognise, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases. IFRS 16's approach to lessor accounting is substantially unchanged from its predecessor, IAS 17.	Accounting periods beginning on or after 1 January 2019

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 is expected to have a material effect on the impairment provisions against loans and advances for the Group.

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

Accounting convention

The Group prepares its accounts under the historical cost convention, except for the revaluation of available-for-sale assets, 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 where 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 special purpose entities (SPEs) controlled by the Group. The securitisation enables a subsequent issuance of debt by the SPEs to investors who gain the security of the underlying assets as collateral. The SPEs are fully consolidated into the Group's accounts under IFRS 10 - Consolidated Financial Statements.

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

Notes to the accounts for the year ended 31 December 2016

1. Accounting policies (continued)

Basis of preparation (continued)

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 for 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 a loan.

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

The Group receives trail commission based on the performance of previous sales of insurance products. 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 assets with fixed or determinable payments that are not quoted in an active market. The Group's residential and commercial mortgage loans are classified as loans and receivables and are measured at amortised cost using the effective interest method, net of impairment provisions, with all movements being recognised in the income statement.

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

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

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

Notes to the accounts for the year ended 31 December 2016

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 is included in the 'other gains and losses' line item in the income statement. Fair value is determined in the manner described in note 31.

Impairment losses on loans and advances to customers and credit institutions

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

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

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

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

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

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

Notes to the accounts for the year ended 31 December 2016

1. Accounting policies (continued)

Impairment losses on loans and advances to customers and credit institutions (continued)

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

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

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

Loans and advances to credit institutions

The International Swaps and Derivatives Association (ISDA) Master Agreement is Principality's preferred agreement for documenting derivative activity. For certain counterparties a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions.

Derivative financial instruments and hedge accounting

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

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

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

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

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

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.

Notes to the accounts for the year ended 31 December 2016

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.

Intangible assets

Computer software

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

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

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

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

Taxation

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

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

Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences. Deferred tax assets are defined as the amounts of income taxes recoverable in future periods.

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

As of 1 January 2016, gains or losses on certain items within the available-for-sale (AFS) reserve will only be taxed or deducted when there is a termination event and the relevant amount is recycled through the income statement, where as previously amounts had been taxed or deducted in the period of any revaluation in other comprehensive income.

A deferred tax asset has therefore been recognised in respect of the amount which has already been taxed in the AFS reserve in other comprehensive income at 31 December 2015 but not recycled through the income statement. As from 1 January 2016, the amount which has already been taxed in the AFS reserve is allowable as a deduction for current tax purposes as a transitional adjustment spread over five years.

A separate, deferred tax liability has been recognised on the gain in the AFS reserve at the Statement of Financial Position date.

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.

Investment properties

Investment properties comprise of assets within the property portfolio held to earn rentals or for capital appreciation (or both), and not for the use in the production or supply of services or for administrative purposes. Investment assets within the portfolio include residential flats and commercial lettings. Valuations are completed annually by independent surveyors. Investment properties are stated at cost less accumulated depreciation and impairment losses.

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.

Notes to the accounts for the year ended 31 December 2016

1. Accounting policies (continued)

Property, plant and equipment (continued)

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

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

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

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

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

Pension costs

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

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

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

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

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

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

Leases

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

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

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

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

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

Notes to the accounts for the year ended 31 December 2016

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.

Advertising and promotional costs

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

Sale and repurchase agreements

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

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

2. Judgements in applying accounting policies and critical accounting estimates

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 that the HPI movements were to differ from current observations by 1%, the impact on provisions would be £0.1m. The impact of a 1% change in the forced sale discounts, a key source of estimation uncertainty, currently being experienced would impact provisions by £0.1m.

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.

Notes to the accounts for the year ended 31 December 2016

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

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 using 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. 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 and inflation 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 0.5% increase in the inflation assumptions would be to increase the carrying value of the pension obligations by approximately £4.8m. The impact of a 0.5% increase in the discount rate would be to reduce the value of pension obligations by approximately £4.9m.

Further details on the assumptions used in valuing retirement benefit obligations and other sensitivity analysis can be found in note 11.

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 £0.3m/(£0.9m) 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 £0.5m/(£0.5m) respectively.

Customer and regulatory complaints

The Group holds provisions for customer and regulatory complaints. Provisions have been made in respect of claims in relation to Payment Protection Insurance (PPI) which in the Group's case relate primarily to secured personal lending PPI products. 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.

Notes to the accounts for the year ended 31 December 2016

3. Business segments

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

	2016			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	87.9	13.8	23.2	124.9
Other income and charges	9.4	1.8	0.1	11.3
Net operating income	97.3	15.6	23.3	136.2
Operating expenses	(67.7)	(3.7)	(10.7)	(82.1)
Impairment provision for losses on loans and advances	(0.2)	0.7	2.2	2.7
Provision for other liabilities and charges	(3.2)	(0.1)	(3.2)	(6.5)
Operating profit and profit before taxation	26.2	12.5	11.6	50.3
Taxation expense				(11.2)
Profit after taxation				39.1

	2015			
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Total £m
Net interest income	93.6	13.7	26.8	134.1
Other income and charges	5.8	1.9	–	7.7
Net operating income	99.4	15.6	26.8	141.8
Operating expenses	(66.7)	(4.0)	(13.0)	(83.7)
Impairment provision for losses on loans and advances	(1.2)	(5.0)	1.4	(4.8)
Provision for other liabilities and charges	(2.7)	(0.4)	(1.2)	(4.3)
Operating profit and profit before taxation	28.8	6.2	14.0	49.0
Taxation expense				(11.3)
Profit after Taxation				37.7

Notes to the accounts for the year ended 31 December 2016

3. Business segments (continued)

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

	Group	
	2016 £m	2015 £m
Total assets by business segment		
Retail financial services	7,086.6	6,288.5
Secured personal lending	405.2	522.3
Commercial lending	789.4	773.6
Total assets	8,281.2	7,584.4
Total liabilities and equity by business segment		
Retail financial services and Commercial lending	7,876.0	7,062.1
Secured personal lending	405.2	522.3
Total liabilities and equity	8,281.2	7,584.4

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

4. Interest receivable and similar income

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
On loans fully secured on residential property	231.7	240.9	195.0	198.5
On other loans	12.3	15.1	12.3	15.1
On loans to subsidiaries	-	-	13.5	15.6
On debt securities	3.9	4.6	3.9	4.6
On other liquid assets	2.7	2.0	2.5	1.8
On derivative financial instruments	(21.5)	(19.3)	(21.5)	(19.3)
	229.1	243.3	205.7	216.3

5. Interest payable and similar charges

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
On shares held by individuals	91.1	97.9	91.1	97.9
On deposits and debt securities	17.2	15.9	19.5	16.7
On subscribed capital	4.2	4.3	4.2	4.3
On subordinated liabilities	0.8	1.5	0.8	1.5
On derivative financial instruments	(9.1)	(10.4)	(11.6)	(12.6)
	104.2	109.2	104.0	107.8

Notes to the accounts for the year ended 31 December 2016

6. Fees and commission receivable

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Insurance and related financial service products	4.4	2.0	4.4	2.0
Mortgage related fees	4.2	4.0	4.2	4.0
Other fees and commission	0.4	0.5	0.1	0.1
	9.0	6.5	8.7	6.1

7. Other fair value gains and losses

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
(Losses)/gains on derivatives	(5.3)	1.8	(3.9)	0.5
Gains/(losses) on hedged items attributable to the hedged risk	6.9	(0.9)	6.9	(0.9)
	1.6	0.9	3.0	(0.4)

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

8. Administrative expenses

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Wages and salaries	38.7	37.1	35.2	31.6
Social security costs	3.8	3.9	3.5	3.5
Other pension costs	1.7	1.9	1.6	1.7
	44.2	42.9	40.3	36.8
Other administrative expenses	27.6	29.7	24.6	24.4
Nemo strategic review and restructuring costs	2.4	4.5	–	4.5
	74.2	77.1	64.9	65.7

The Group has incurred exceptional costs of £2.4m in the year (2015: £4.5m) in respect of restructuring costs associated with the decision to cease origination of new business within Nemo Personal Finance Limited.

	Group		Society	
	2016 £000	2015 £000	2016 £000	2015 £000
Other administrative expenses include:				
Auditor's remuneration				
For audit of the Society's Annual Accounts	178	175	178	175
For audit of the Society's subsidiaries	24	16	–	–
Total	202	191	178	175
For other services				
Tax advisory	59	76	59	73
Further assurance services	75	66	75	24
Total other services	134	142	134	97

Operating lease charges – motor vehicles	224	225	224	225
– land and buildings	1,251	1,536	951	1,024

Notes to the accounts for the year ended 31 December 2016

9. Employees

The average number employed including Executive Directors was:

	Full-time		Part-time	
	2016 Number	2015 Number	2016 Number	2015 Number
Society's Customer Support Centre and administration office	608	578	102	90
Society branch offices	186	200	122	123
Employed by the Society	794	778	224	213
Subsidiaries	66	109	8	19
Employed by the Group	860	887	232	232

10. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on pages 65 and 69 in accordance with Schedule 5, paragraphs 4 and 5 to the Building Societies (Accounts and Related Provisions) Regulations 1998. Total Directors' emoluments for the year were £1.9m (2015: £1.6m).

11. Retirement benefit obligations

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

Defined contribution scheme

The Group operates a defined contribution scheme, the Group Flexible Retirement Plan (GFRP). A defined contribution scheme is one into which the Group and the employee pay contributions, without any obligation to pay further contributions. Staff employed after 1 January 2001 and those staff who were formerly members of the defined benefit scheme are eligible to join this scheme. The cost to the Group and Society of employer's contributions (before salary sacrifice arrangements) to the scheme in 2016 was £1.5m (2015: £1.7m). There were no contributions outstanding or prepaid at the end of the year.

Defined benefit scheme

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

The defined benefit scheme was subject to a triennial valuation by the Scheme's independent actuary on 30 September 2013. The Scheme is currently undergoing a triennial valuation with a reference date of 30 September 2016.

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 previous section.

During 2012, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the Scheme with Legal & General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the Scheme under which Legal & General assumed full responsibility for the benefits payable to the Scheme's current pensioners as at 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 was recognised in the statement of other comprehensive income.

A further £1.5m was paid into the pension scheme from the Society during 2016.

Scheme management consists of a Board of Trustees, comprising six individuals, three of whom were elected by scheme members as Member Nominated Trustees. The power of appointment and removal of the remaining 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.

Notes to the accounts for the year ended 31 December 2016

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

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRS is £32.8m (2015: £20.2m).

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

	At 31 December				
	2016 %	2015 %	2014 %	2013 %	2012 %
Rate of increase in pensionable salaries	2.25	2.20	2.05	3.50	3.00
Rate of increase of pensions in payment and deferred pensions	2.25	2.20	2.05	3.50	3.00
Discount rate	2.55	3.75	3.55	4.50	4.60
Inflation assumption (RPI)	3.25	3.15	3.05	3.50	3.00
Inflation assumption (CPI)	2.25	2.15	2.05	2.70	2.60

The assumptions on mortality are determined by the following tables:

	2016 %	2015 %
Retired and non-retired members	SAPS CMI2015 LTR1.25%	SAPS CMI2015 LTR1.25%
The assumptions are illustrated by the following year of life expectancy at age 65:		
Retired members		
Males currently aged 65	22.4	22.1
Females currently aged 65	24.5	24.5
Non-retired members		
Males currently aged 45	24.1	23.8
Females currently aged 45	26.4	26.5

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

	At 31 December				
	2016 £m	2015 £m	2014 £m	2013 £m	2012 £m
Target return funds	27.4	27.1	26.5	25.0	24.2
Annuities	26.4	23.5	25.2	23.4	22.7
Bonds and cash	4.3	3.5	2.9	1.3	0.5
Total fair value of plan assets	58.1	54.1	54.6	49.7	47.4
Present value of funded obligations	(72.9)	(57.7)	(61.0)	(66.3)	(60.1)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net deficit recognised in the statement of financial position	(15.3)	(4.1)	(6.9)	(17.1)	(13.2)

The deficit has increased primarily as a result of economic uncertainty in the wake of the Brexit vote and the associated fall in gilt yields, which had the impact of decreasing the discount rate and therefore increasing the valuation of pensioner liabilities.

The actual return on plan assets was £4.6m (2015: £1.8m).

Notes to the accounts for the year ended 31 December 2016

11. Retirement benefit obligations (continued)
Defined benefit scheme (continued)

The amounts recognised in the income statement are as follows:

	Group and Society	
	2016 £m	2015 £m
Analysis of the amounts recognised in the income statement		
Interest on pension scheme assets	(2.0)	(1.7)
Interest on pension scheme liabilities	2.1	1.9
Net interest expense	0.1	0.2
Total amount recognised in the income statement	**0.1**	**0.2**
Analysis of amount recognised in statement of other comprehensive income		
Gain/(loss) on scheme assets in excess of interest	2.6	(1.8)
Experience losses on liabilities	0.4	1.2
(Losses)/gains from changes to demographic assumptions	(0.1)	0.6
(Losses)/gains from changes to financial assumptions	(15.5)	1.1
Total remeasurement	**(12.6)**	**1.1**
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(4.1)	(6.9)
Movement in year:		
Net interest expense	(0.1)	(0.2)
Remeasurements	(12.6)	1.1
Contributions paid and accrued	1.5	1.9
Deficit in scheme at end of year	**(15.3)**	**(4.1)**
Analysis of the movement in the fair value of pension scheme assets		
Fair value of assets at the beginning of the year	54.1	54.6
Interest on assets	2.0	1.9
Society contributions	1.5	1.9
Benefits paid	(2.1)	(2.6)
Return on plan assets less interest	(0.3)	(0.1)
Change in fair value of the annuity policy	2.8	(1.6)
Fair value of assets at the end of the year	**58.0**	**54.1**

Significant actuarial assumptions in the determination of the defined benefit obligation are the discount rate, inflation rate and life expectancy. The sensitivity analysis below represents the net impact on the Scheme liabilities taking into account the change in the value of both the Scheme's liabilities and the bulk annuity contract.
No allowance has been made for any changes to the non-insured asset values.

Notes to the accounts for the year ended 31 December 2016

Defined benefit scheme (continued)

	Group and Society	
	Increase 0.5% £m	Decrease 0.5% £m
Discount rate	(4.9)	5.4
Inflation	4.8	(4.4)
Life expectancy (+1 year/-1 year)	2.2	(2.2)

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.

12. Taxation

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Current tax				
UK corporation tax charge for the year	11.6	11.3	9.2	8.5
Adjustments in respect of prior years	0.5	0.1	0.5	(0.4)
	12.1	11.4	9.7	8.1
Deferred tax				
Deferred tax credit for year	(0.1)	(0.5)	-	(0.5)
Adjustments in respect of prior years	(0.8)	0.4	(0.9)	0.4
	(0.9)	(0.1)	(0.9)	(0.1)
Taxation on profit on ordinary activities	**11.2**	**11.3**	**8.8**	**8.0**

The statutory rate of corporation tax was reduced to 20.0% from 1 April 2015. The Group was subject to corporation tax at the statutory rate for the period 1 January to 31 December 2016. In the prior period, the Group was subject to corporation tax of 21.0% for the period 1 January to 31 March 2015 and 20.0% for the period 1 April to 31 December 2015.

From 1 January 2016 the Group has been subject to a banking surcharge of 8% in addition to the statutory rate on profits within the Society of over £25m.

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	
	2016 £m	2015 £m	2016 £m	2015 £m
Profit before taxation	50.3	49.0	40.1	34.9
Profit multiplied by the standard rate of corporation tax at 20.0% (2015: 20.3%)	10.0	9.9	8.0	7.0
Effects of				
Expenses not deductible for tax purposes	0.4	0.9	0.1	0.9
Adjustments to prior years	(0.3)	0.5	(0.4)	0.1
Impact of banking surcharge	1.1	-	1.1	-
Taxation on profit from ordinary activities	**11.2**	**11.3**	**8.8**	**8.0**

Notes to the accounts for the year ended 31 December 2016

12. Taxation (continued)

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	
	2016 £m	2015 £m	2016 £m	2015 £m
Current tax				
Relating to retirement benefit obligations	(0.4)	(0.6)	(0.4)	(0.6)
Revaluations of available-for-sale financial assets	(0.1)	(0.3)	(0.1)	(0.3)
	(0.5)	(0.9)	(0.5)	(0.9)
Deferred tax				
Relating to retirement benefit obligations	(2.2)	0.7	(2.2)	0.7
Revaluations of available-for-sale financial assets	0.3	-	0.3	-
	(1.9)	0.7	(1.9)	0.7
Total charged to other comprehensive income	**(2.4)**	**(0.2)**	**(2.4)**	**(0.2)**

13. Loans and advances to credit institutions

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Loans and advances to credit institutions	141.5	166.6	62.1	58.6

Included in the above amount for the Group is £50.5m of collateral given under a Credit Support Annex (CSA) agreements (2015: £56.4m).

14. Debt securities

	Group and Society	
	2016 £m	2015 £m
Issued by UK Government	338.5	349.9
Issued by Supranational entities	10.1	51.0
Issued by other borrowers and unlisted	41.0	36.9
	389.6	437.8

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

	Group and Society	
	2016 £m	2015 £m
At 1 January	437.8	454.1
Additions	124.7	91.8
Disposals and maturities	(172.8)	(106.7)
Gains/(losses) from changes in fair value	0.6	(1.3)
Decrease) in accrued interest	(0.7)	(0.1)
At 31 December	389.6	437.8

Notes to the accounts for the year ended 31 December 2016

15. Derivative financial instruments

The Group undertakes transactions in derivative financial instruments, which include currency swaps, interest rate swaps, forward rate agreements, and similar instruments. These are commitments to exchange one set of cash flows for another. No exchange of principal takes place.

	Group			
	Contract/notional amount		Fair value	
	2016 £m	2015 £m	2016 £m	2015 £m
Derivative assets:				
Interest rate swaps	2,278.3	1,731.4	25.4	17.7
Equity and RPI index linked interest rate swaps	32.3	32.8	5.0	3.6
Total recognised derivative assets	**2,310.6**	**1,764.2**	**30.4**	**21.3**
Derivative liabilities:				
Interest rate swaps	3,325.9	3,047.3	(45.7)	(31.4)
Total recognised derivative liabilities	**3,325.9**	**3,047.3**	**(45.7)**	**(31.4)**

	Society			
	Contract/notional amount		Fair value	
	2016 £m	2015 £m	2016 £m	2015 £m
Derivative assets:				
Interest rate swaps	2,278.3	1,731.4	25.4	17.7
Equity and RPI index linked interest rate swaps	32.3	32.8	5.0	3.6
Total recognised derivative assets	**2,310.6**	**1,764.2**	**30.4**	**21.3**
Derivative liabilities:				
Interest rate swaps	2,810.3	2,782.7	(43.6)	(30.7)
Total recognised derivative liabilities	**2,810.3**	**2,782.7**	**(43.6)**	**(30.7)**

16. Loans and advances to customers

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Fully secured on residential property	6,744.8	6,198.1	6,325.9	5,693.6
Fully secured on land	323.9	330.6	323.9	330.6
Other loans	–	24.6	–	–
	7,068.7	**6,553.3**	**6,649.8**	**6,024.2**
Provision for impairment losses	(45.4)	(49.2)	(30.1)	(31.0)
Effective Interest Rate adjustments	11.2	13.8	10.7	7.5
Fair value adjustment for hedged risk	39.4	27.0	39.4	27.0
	7,073.9	**6,544.9**	**6,669.8**	**6,027.7**

Notes to the accounts for the year ended 31 December 2016

17. Asset encumbrance

The wholesale funding initiatives of the Group require that from time to time certain assets become encumbered as collateral against such funding. Assets that have been utilised in this way cannot be used for other purposes. The Group's principal forms of encumbrance relate to secured funding transactions and third party sale and repurchase agreements, with encumbrance also arising from excess collateral balances and cash collateral posted. As at 31 December 2016 the encumbrance ratio was 19.3% (31 December 2015: 21.1%). All other assets are defined as unencumbered.

An analysis of the Group's encumbered and unencumbered on-balance sheet assets as at 31 December 2016 is set out below. The table does not include off-balance sheet assets received by the Group as part of its participation in the Funding for Lending Scheme (FLS), which the Group is permitted to re-use.

	2016		2015	
	Encumbered	Unencumbered	Encumbered	Unencumbered
	£m	£m	£m	£m
Cash in hand and balances at the Bank of England	-	585.7	-	357.6
Loans and advances to credit institutions	129.9	11.6	143.5	23.1
Debt securities	-	389.6	-	437.8
Derivative financial instruments	-	30.4	-	21.3
Loans and advances to customers	1,470.1	5,603.8	1,457.6	5,087.3
Other assets	-	60.1	-	56.2
Total	1,600.0	6,681.2	1,601.1	5,983.3

Notes to the accounts for the year ended 31 December 2016

18. Provision for impairment losses

	Specific £m	Collective £m	Total £m
2016			
Group			
At 1 January 2016	19.3	29.9	49.2
Amounts written off during the year	(1.1)	–	(1.1)
(Release)/charge for loan impairment	(3.4)	0.7	(2.7)
At 31 December 2016	**14.8**	**30.6**	**45.4**
Society			
At 1 January 2016	12.9	18.1	31.0
Amounts written off during the year	(0.3)	–	(0.3)
(Release)/charge for loan impairment	(1.3)	0.7	(0.6)
At 31 December 2016	**11.3**	**18.8**	**30.1**
2015			
Group			
At 1 January 2015	36.6	26.1	62.7
Amounts written off during the year	(18.3)	–	(18.3)
Charge for loan impairment	1.0	3.8	4.8
At 31 December 2015	**19.3**	**29.9**	**49.2**
Society			
At 1 January 2015	22.3	14.9	37.2
Amounts written off during the year	(12.4)	–	(12.4)
Charge for loan impairment	3.0	3.2	6.2
At 31 December 2015	**12.9**	**18.1**	**31.0**

Notes to the accounts for the year ended 31 December 2016

19. Provisions for liabilities

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
At 1 January	3.8	3.9	2.7	3.4
Additions	6.5	4.3	3.4	3.3
Utilisation	(3.2)	(4.4)	(1.8)	(4.0)
At 31 December	**7.1**	**3.8**	**4.3**	**2.7**

Included in provisions is the FSCS levy of £1.4m (2015: £1.7m) which is the expected interest charge for scheme year April 2016 to March 2017.

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. In August 2010, the FSA released its Policy Statement PS10/12 on The Assessment and Redress of Payment Protection Complaints. The Group notes that the FCA is expected to finalise rules and guidance in relation to the handling of PPI complaints in relation to the 2014 Supreme Court decision in Plevin vs Paragon Personal Finance Ltd (Plevin). The Group will continue to monitor the developments on these proposed rules and guidance.

At 31 December 2016, provisions of £2.7m are held in relation to PPI (2015: £1.0m). The provision considers sales of PPI via direct channels as well as via brokers, some of whom are no longer trading.

Other provisions of £3.0m (2015: £1.1m) have been made in respect of various other customer claims.

The contingent aspect of such provisions is described in note 30.

20. Investments in subsidiary undertakings

	Society	
	2016 £m	2015 £m
Shares in subsidiary undertakings	0.1	0.1
Loans to subsidiary undertakings	328.2	451.7
	328.3	**451.8**

	Subsidiary undertakings	
	Shares £m	Loans £m
Movement in investments in subsidiary undertakings:		
At 1 January 2016	0.1	451.7
Loan repayment	–	(123.5)
At 31 December 2016	**0.1**	**328.2**

Notes to the accounts for the year ended 31 December 2016

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
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

Principality Building Society consolidates funding vehicles Friary No.1 Plc, Friary No.2 Plc and Friary No.3 Plc into the Group accounts. These companies are not wholly owned by the Society but the Society retains substantially all of the risk and reward of the assets, and so the Society's interests in these entities are in substance no different than if they were 100% held subsidiary undertakings and consequently they are consolidated into the Group accounts.

Loan Link Limited ceased trading in 2016 and further to the cessation of trading, the members resolved to place the entity into a Members Voluntary Liquidation.

Liquidators were appointed on 23 December 2016. Nemo Personal Finance Limited has agreed to take over responsibility for the activities carried out by Loan Link Limited.

The Society continues to participate in the Ely Bridge development, a scheme which aims to deliver an 800 house development on a brownfield site in Cardiff being a mix of affordable, social and private dwellings ultimately funded by the capital markets. Ely Bridge Development Company Limited was incorporated on 28 March 2012. The company is not for profit and limited by guarantee. The Society holds no beneficial interest in the company but has agreed to contribute £1 to the assets of the company in the event of it being wound up.

Notes to the accounts for the year ended 31 December 2016

20. Investments in subsidiary undertakings (continued)

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 and with the exception of Nemo Personal Finance Limited and Loan Link Limited, who's registered addresses is Trafalgar House, 5 Fitzalan Place, Cardiff CF24 0ED, all other companies are at the registered address of Principailty Buildings, Queen Street, Cardiff CF10 1UA.

Brokerpoint Limited
Energy Assess Wales Limited
Home Information Pack Wales Limited
Principality Limited
Principality Asset Management Limited
Principality Bank Limited
Principality Direct Limited
Principality Estate Agency Limited
Principality Financial Management Limited
Principality Group Limited
Principality Homes Limited
Principality (IFA Services) Limited
Principality Life Assurance Services Limited
Principality (Life and Pensions) Limited
Principality Mortgage Corporation Limited
Principality Mortgage and Insurance Services Limited
Principality Personal Loans Limited
Principality Property Development Services Limited
Principality Property Sales Limited
Principality Property Services Limited
Principality Property Solutions Limited
Principality Surveyors Home Condition Report Limited
Principality Surveyors Limited
Principality Syndicated Loans Limited
The Principality Home Information Pack Limited

21. Intangible assets

	Computer software		Total	
	Group £m	Society £m	Group £m	Society £m
Cost:				
At 1 January 2016	8.0	8.0	8.0	8.0
Additions	0.5	0.5	0.5	0.5
At 31 December 2016	8.5	8.5	8.5	8.5
Amortisation:				
At 1 January 2016	6.6	6.6	6.6	6.6
Charge for the year	0.6	0.6	0.6	0.6
At 31 December 2016	7.2	7.2	7.2	7.2
Net book value:				
At 31 December 2016	1.3	1.3	1.3	1.3
At 31 December 2015	1.4	1.4	1.4	1.4

	Computer software		Total	
	Group £m	Society £m	Group £m	Society £m
Cost:				
At 1 January 2015	7.7	7.7	7.7	7.7
Additions	0.3	0.3	0.3	0.3
At 31 December 2015	8.0	8.0	8.0	8.0
Amortisation:				
At 1 January 2015	5.9	5.9	5.9	5.9
Charge for the year	0.7	0.7	0.7	0.7
At 31 December 2015	6.6	6.6	6.6	6.6
Net book value:				
At 31 December 2015	1.4	1.4	1.4	1.4
At 31 December 2014	1.8	1.8	1.8	1.8

Notes to the accounts for the year ended 31 December 2016

22. Property, plant and equipment

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2016	65.6	64.4	27.6	20.3	93.2	84.7
Additions	2.1	2.1	3.3	3.3	5.4	5.4
Disposals	–	–	(0.1)	(0.1)	(0.1)	(0.1)
At 31 December 2016	**67.7**	**66.5**	**30.8**	**23.5**	**98.5**	**90.0**
Depreciation:						
At 1 January 2016	29.4	28.9	17.4	10.6	46.8	39.5
Charge for the year	1.9	1.9	4.2	3.8	6.1	5.7
Impairment in the year	1.2	1.2	–	–	1.2	1.2
Disposals	–	–	(0.1)	(0.1)	(0.1)	(0.1)
At 31 December 2016	**32.5**	**32.0**	**21.5**	**14.3**	**54.0**	**46.3**
Net book value:						
At 31 December 2016	**35.2**	**34.5**	**9.3**	**9.2**	**44.5**	**43.7**
At 31 December 2015	36.2	35.5	10.3	9.7	46.5	45.2

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2015	63.1	61.9	36.7	29.8	99.8	91.7
Additions	2.5	2.5	6.3	5.9	8.8	8.4
Disposals	–	–	(15.4)	(15.4)	(15.4)	(15.4)
At 31 December 2015	**65.6**	**64.4**	**27.6**	**20.3**	**93.2**	**84.7**
Depreciation:						
At 1 January 2015	27.2	26.7	28.7	22.4	55.9	49.1
Charge for the year	1.9	1.9	3.7	3.3	5.6	5.2
Impairment in the year	0.3	0.3	–	–	0.3	0.3
Disposals	–	–	(15.1)	(15.1)	(15.1)	(15.1)
At 31 December 2015	**29.4**	**28.9**	**17.3**	**10.6**	**46.7**	**39.5**
Net book value:						
At 31 December 2015	**36.2**	**35.5**	**10.3**	**9.7**	**46.5**	**45.2**
At 31 December 2014	35.9	35.2	8.0	7.4	43.9	42.6

Included within land and buildings additions is £2.3m (2015: £2.3m) on account of assets in the course of construction. Within the portfolio are properties considered as investment properties. The fair value of these properties is £11.8m (2015: £11.9m), and obtained from independent third party valuers. The value of assets subject to operating leases where the Group acts as lessor is £29.2m (2015: £29.4m).

Notes to the accounts for the year ended 31 December 2016

22. Property, plant and equipment (continued)

	2016		2015	
	Group £m	Society £m	Group £m	Society £m
Land and buildings:				
Freehold	32.3	31.6	33.1	32.5
Long leasehold	0.2	0.2	0.3	0.2
Short leasehold	2.7	2.7	2.8	2.8
	35.2	34.5	36.2	35.5
Occupied by the Society and subsidiary undertakings	18.5	18.5	18.3	18.3

23. Shares

	Group and Society	
	2016 £m	2015 £m
Held by individuals	6,149.6	5,610.2
Other shares	4.2	4.8
Fair value adjustment for hedged risk	11.4	6.8
	6,165.2	5,621.8

24. Amounts owed to credit institutions

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Amounts owed to credit institutions	611.2	543.1	1,148.8	886.7

Included in the above amount is £5.8m of collateral held under a Credit Support Annex (CSA) agreements (2015: £4.8m).

25. Debt securities in issue

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Certificates of deposit	15.6	8.0	15.6	8.0
Other debt securities	615.5	451.9	–	–
Fair value adjustment for hedged risk	–	3.6	–	3.6
	631.1	463.5	15.6	11.6

Notes to the accounts for the year ended 31 December 2016

26. Other liabilities

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Income tax	–	0.6	–	0.6
Other taxation and social security	0.9	1.0	0.9	1.0
Other creditors	5.9	6.2	4.3	5.2
	6.8	7.8	5.2	6.8

27. Deferred tax

The movement in net deferred tax is as follows:

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
At 1 January	(1.1)	(1.7)	(0.8)	(1.5)
Income statement (credit)/charge	(0.9)	(0.1)	(0.9)	(0.1)
Statement of other comprehensive income charge	(1.9)	0.7	(1.9)	0.7
At 31 December	(3.9)	(1.1)	(3.6)	(0.8)

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

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Deferred tax liabilities:				
Accelerated tax depreciation	–	–	–	0.3
Revaluations for available-for-sale financial assets	0.5	–	0.5	–
	0.5	–	0.5	0.3
Deferred tax assets:				
Retirement benefit obligation	(3.1)	(0.8)	(3.1)	(0.8)
Accelerated tax depreciation	(0.8)	–	(0.6)	–
Other	(0.5)	(0.3)	(0.4)	(0.3)
	(4.4)	(1.1)	(4.1)	(1.1)

The Finance No.2 Act 2015 provides that the rate of corporation tax for the 2017 Financial Year will be 19% and the rate from 1 April 2020 will be 17%. The Act also introduces from 1 January 2016 a banking surcharge of 8% on Society profits over £25m. The Group's future tax rate is therefore dependent on profitability in future years. The impact of this change in rate has been assessed and will not have a material impact on the Group's deferred tax position.

The statement of other comprehensive income includes a deferred tax gain of £2.2m (2015: £0.7m) arising from the actuarial gain on retirement benefit obligations. The charge reflected in the income statement is not material.

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within five years. More information on the triennial valuation can be found in note 11.

Notes to the accounts for the year ended 31 December 2016

28. Subordinated liabilities

	Group and Society	
	2016 £m	2015 £m
5 3/8% Subordinated Notes due 2016	-	92.3

The Society's subordinated liabilities were repaid in full on 8 July 2016.

29. Subscribed capital

	Group and Society	
	2016 £m	2015 £m
7.00% Permanent Interest Bearing Shares	60.0	60.0
Unamortised issue costs	(0.3)	(0.3)
Fair value adjustment for hedged risk	9.6	10.1
	69.3	69.8

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.

30. Financial commitments and contingent liabilities

a) Financial Services Compensation Scheme levy
The Financial Services Compensation Scheme (FSCS) provides compensation to depositors in the event that a financial institution is unable to pay amounts due. Following the failure of a number of financial institutions the FSCS raised borrowings from the UK Government to cover compensation in relation to protected deposits. These borrowings are expected to be largely repaid from the realisation of the assets of the failed institutions.

The FSCS recovers the interest cost of these borrowings, together with ongoing management expenses, by way of annual management levies on Members. The FSCS also raises levies to cover anticipated capital shortfalls.

b) Other provisions for liabilities and charges
At 31 December 2016, the Group holds a provision of £2.7m (2015: £1.0m), which it expects to be sufficient to meet obligations in relation to previous sales of Payment Protection Insurance ("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.

The Group notes that the FCA is expected to finalise rules and guidance in relation to the handling of PPI complaints arising from the 2014 Supreme Court decision in Plevin vs Paragon Personal Finance Ltd "Plevin". The Group will continue to monitor the developments on these proposed rules and guidance.

Notes to the accounts for the year ended 31 December 2016

30. Financial commitments and contingent liabilities (continued)

c) Commitments under non-cancellable operating leases:

	2016		2015	
	Property £m	Vehicles, plant and equipment £m	Property £m	Vehicles, plant and equipment £m
Group commitments in respect of operating lease rentals:				
Due within one year	1.5	0.2	1.5	0.2
Due between two and five years	4.4	0.2	5.0	0.4
Due after five years	3.2	-	2.2	-
	9.1	0.4	8.7	0.6
Society commitments in respect of operating lease rentals:				
Due within one year	1.0	0.2	0.9	0.2
Due between two and five years	3.0	0.2	2.8	0.3
Due after five years	3.2	-	2.2	-
	7.2	0.4	5.9	0.5

d) Income receivable under non-cancellable operating leases:

Property rental income earned during the year was £1.3m (2015: £1.1m).

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

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Receivable within one year	1.0	1.0	1.0	1.0
Receivable between two and five years	3.7	3.5	3.7	3.5
Receivable after five years	8.0	8.0	8.0	8.0
	12.7	12.5	12.7	12.5

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

On 30 July 2014, a 10 year lease of the Group's property in Culverhouse Cross was granted to Connells Group.

e) Capital commitments:

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Capital expenditure contracted for but not provided for	1.2	2.1	1.2	2.1

f) Loan commitments:

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
Loan commitments contracted but not paid	90.5	98.8	90.5	98.8

Notes to the accounts for the year ended 31 December 2016

31. Financial instruments

Categories of financial instruments

Financial assets and liabilities are measured on an ongoing basis either at fair value or at amortised cost.

The accounting policies note describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following tables analyse the financial assets and liabilities in the statement of financial position by the class of financial instrument to which they are assigned and by the measurement basis.

Group As at 31 December 2016	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Group assets					
Cash in hand and balances with Bank of England	585.7	-	-	-	585.7
Loans and advances to credit institutions	-	141.5	-	-	141.5
Debt securities	-	-	389.6	-	389.6
Derivative financial instruments	-	-	-	30.4	30.4
Loans and advances to customers	-	7,073.9	-	-	7,073.9
Total financial assets	585.7	7,215.4	389.6	30.4	8,221.1
Total non-financial assets					60.1
Total Group assets					8,281.2
Group liabilities					
Shares	6,165.2	-	-	-	6,165.2
Amounts owed to credit institutions	573.9	-	-	37.3	611.2
Amounts owed to other customers	226.5	-	-	-	226.5
Debt securities in issue	631.1	-	-	-	631.1
Derivative financial instruments	-	-	-	45.7	45.7
Subscribed capital	69.3	-	-	-	69.3
Total financial liabilities	**7,666.0**	**-**	**-**	**83.0**	**7,749.0**
Total non-financial liabilities					53.8
General reserve and other reserves					478.4
Total Group reserves and liabilities					8,281.2

Notes to the accounts for the year ended 31 December 2016

Categories of financial instruments (continued)

Society As at 31 December 2016	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Society assets					
Cash in hand and balances with Bank of England	585.7	-	-	-	585.7
Loans and advances to credit institutions	-	62.1	-	-	62.1
Debt securities	-	-	389.6	-	389.6
Derivative financial instruments	-	-	-	30.4	30.4
Loans and advances to customers	-	6,669.8	-	-	6,669.8
Loans to and investments in subsidiaries	0.1	328.2	-	-	328.3
Total financial assets	585.8	7,060.1	389.6	30.4	8,065.9
Total non-financial assets					58.5
Total Society assets					8,124.4
Society liabilities					
Shares	6,165.2	-	-	-	6,165.2
Amounts owed to credit institutions	1,111.5	-	-	37.3	1,148.8
Amounts owed to other customers	226.5	-	-	-	226.5
Debt securities in issue	15.6	-	-	-	15.6
Derivative financial instruments	-	-	-	43.6	43.6
Subscribed capital	69.3	-	-	-	69.3
Total financial liabilities	7,588.1	-	-	80.9	7,669.0
Total non-financial liabilities					46.7
General reserve and other reserves					408.7
Total Society reserves and liabilities					8,124.4

Notes to the accounts for the year ended 31 December 2016

31. Financial instruments (continued)

Categories of financial instruments (continued)

Group As at 31 December 2015	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Group assets					
Cash in hand and balances with Bank of England	357.6	-	-	-	357.6
Loans and advances to credit institutions	-	166.6	-	-	166.6
Debt securities	-	-	437.8	-	437.8
Derivative financial instruments	-	-	-	21.3	21.3
Loans and advances to customers	-	6,544.9	-	-	6,544.9
Total financial assets	357.6	6,711.5	437.8	21.3	7,528.2
Total non-financial assets					56.2
Total Group assets					7,584.4
Group liabilities					
Shares	5,621.8	-	-	-	5,621.8
Amounts owed to credit institutions	510.3	-	-	32.8	543.1
Amounts owed to other customers	280.9	-	-	-	280.9
Debt securities in issue	463.5	-	-	-	463.5
Derivative financial instruments	-	-	-	31.4	31.4
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	69.8	-	-	-	69.8
Total financial liabilities	7,038.6	-	-	64.2	7,102.8
Total non-financial liabilities					32.6
General reserve and ot her reserves					449.0
Total Group reserves and liabilities					7,584.4

Notes to the accounts for the year ended 31 December 2016

Categories of financial instruments (continued)

Society As at 31 December 2015	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Society assets					
Cash in hand and balances with Bank of England	357.6	-	-	-	357.6
Loans and advances to credit institutions	-	58.6	-	-	58.6
Debt securities	-	-	437.8	-	437.8
Derivative financial instruments	-	-	-	21.3	21.3
Loans and advances to customers	-	6,027.7	-	-	6,027.7
Loans to and investments in subsidiaries	0.1	451.7	-	-	451.8
Total financial assets	357.7	6,538.0	437.8	21.3	7,354.8
Total non-financial assets					53.7
Total Society assets					7,408.5
Society liabilities					
Shares	5,621.8	-	-	-	5,621.8
Amounts owed to credit institutions	853.9	-	-	32.8	886.7
Amounts owed to other customers	280.9	-	-	-	280.9
Debt securities in issue	11.6	-	-	-	11.6
Derivative financial instruments	-	-	-	30.7	30.7
Subordinated liabilities	92.3	-	-	-	92.3
Subscribed capital	69.8	-	-	-	69.8
Total financial liabilities	6,930.3	-	-	63.5	6,993.8
Total non-financial liabilities					27.6
General reserve and other reserves					387.1
Total Society reserves and liabilities					7,408.5

Notes to the accounts for the year ended 31 December 2016

31. Financial instruments (continued)

Carrying and fair values

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

	Note	2016		2015	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Group assets					
Cash in hand and balances with Bank of England		585.7	585.7	357.6	357.6
Loans and advances to credit institutions	i.	141.5	141.5	166.6	166.6
Debt securities	ii.	389.6	389.6	437.8	437.8
Derivative financial instruments	iii.	30.4	30.4	21.3	21.3
Loans and advances to customers	iv.	7,073.9	7,127.8	6,544.9	6,628.1
		8,221.1	8,275.0	7,528.2	7,611.4
Group liabilities					
Shares	vi.	6,165.2	6,215.9	5,621.8	5,644.7
Amounts owed to credit institutions	vii.	611.2	611.2	543.1	543.1
Amounts owed to other customers	vii.	226.5	226.5	280.9	280.9
Debt securities in issue	viii.	631.1	627.3	463.5	462.8
Derivative financial instruments	iii.	45.7	45.7	31.4	31.4
Subordinated liabilities	viii.	–	–	92.3	88.9
Subscribed capital	viii.	69.3	59.8	69.8	61.3
		7,749.0	7,786.4	7,102.8	7,113.1

	Note	2016		2015	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Society assets					
Cash in hand and balances with Bank of England		585.7	585.7	357.6	357.6
Loans and advances to credit institutions	i.	62.1	62.1	58.6	58.6
Debt securities	ii.	389.6	389.6	437.8	437.8
Derivative financial instruments	iii.	30.4	30.4	21.3	21.3
Loans and advances to customers	iv.	6,669.8	6,720.6	6,027.7	6,079.8
Loans and advances to subsidiaries	v.	328.3	328.3	451.8	451.8
		8,065.9	8,116.8	7,354.8	7,406.9
Society liabilities					
Shares	vi.	6,165.2	6,215.9	5,621.8	5,644.7
Amounts owed to credit institutions	vii.	1,148.8	1,148.8	886.7	886.7
Amounts owed to other customers	vii.	226.5	226.5	280.9	280.9
Debt securities in issue	viii.	15.6	15.6	11.6	11.6
Derivative financial instruments	iii.	43.6	43.6	30.7	30.7
Subordinated liabilities	viii.	–	–	92.3	88.9
Subscribed capital	viii.	69.3	59.8	69.8	61.3
		7,669.0	7,710.2	6,993.8	7,004.8

Notes to the accounts for the year ended 31 December 2016

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.
iv) The fair value of loans and advances to customers represents the discounted amount of estimated future cash flows expected to be received after taking account of expected loss provisions, expected levels of early repayment and discounting at current market rates.
v) The fair value of loans and advances to subsidiaries at a variable rate is considered to be to their carrying amounts.
vi) The fair value of customer accounts represents the discounted amount of estimated future cash flows expected to be paid.
vii) The fair values of amounts owed to credit institutions and amounts owed to other customers are considered to be to the amount payable at the date of the statement of financial position.
viii) The fair values of debt securities in issue, subordinated liabilities and subscribed capital are obtained from market prices.

	Group			
	2016 £m	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
Financial assets at fair value through profit or loss:				
Derivative financial instruments	30.4	-	28.3	2.1
Available-for-sale financial assets:				
Debt securities	389.6	389.6	-	-
Total	420.0	389.6	28.3	2.1
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	37.3	-	37.3	-
Derivative financial instruments	45.7	-	43.6	2.1
Total	83.0	-	80.9	2.1

	Society			
	2016 £m	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
Financial assets at fair value through profit or loss:				
Derivative financial instruments	30.4	-	28.3	2.1
Available-for-sale financial assets:				
Debt securities	389.6	389.6	-	-
Total	420.0	389.6	28.3	2.1
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	37.3	-	37.3	-
Derivative financial instruments	43.6	-	43.6	-
Total	80.9	-	80.9	-

Notes to the accounts for the year ended 31 December 2016

31. Financial instruments (continued)

Carrying and fair values (continued)

	Group			
	2015 £m	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
Financial assets at fair value through profit or loss:				
Derivative financial instruments	21.3	-	20.6	0.7
Available-for-sale financial assets:				
Debt securities	437.8	437.8	-	-
Total	459.1	437.8	20.6	0.7
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	32.8	-	32.8	-
Derivative financial instruments	31.4	-	30.7	0.7
Total	64.2	-	63.5	0.7

	Society			
	2015 £m	**Level 1 £m**	**Level 2 £m**	**Level 3 £m**
Financial assets at fair value through profit or loss:				
Derivative financial instruments	21.3	-	20.6	0.7
Available-for-sale financial assets:				
Debt securities	437.8	437.8	-	-
Total	459.1	437.8	20.6	0.7
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	32.8	-	32.8	-
Derivative financial instruments	30.7	-	30.7	-
Total	63.5	-	63.5	-

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

Hierarchy for fair value disclosures

Level	
1.	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
2.	Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices).
3.	Inputs for the asset or liability that are not based on observable market data.

The items included within Level 3 are interest rate swaps, the notional amounts for which track the amortisation profile of the mortgage assets within the RMBS structures. The valuations are provided by the counterparties using present value calculations based on market interest rate curves and projected mortgage prepayment amounts. The unobservable inputs relate to the projection of the notional amounts of the swaps, which change over time to match the balance of the underlying mortgage portfolio.

Notes to the accounts for the year ended 31 December 2016

32. Credit risk

The credit risk to which the Group is exposed is described in the Risk Management Report on pages 37 and 38. Credit risk in relation to loans and advances to customers including first and second charge retail credit risk and commercial lending credit risk is described in section a) below. Credit risk in relation to treasury financial instruments is described in section b).

a) Loans and advances to customers

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

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
In respect of loans and advances to customers:				
Secured by a first charge on residential property	6,325.9	5,693.6	6,325.9	5,693.6
Secured by a first charge on land	323.9	330.6	323.9	330.6
Secured by a second charge on residential property	418.9	529.1	–	–
	7,068.7	6,553.3	6,649.8	6,024.2
Provision for impairment losses	(45.4)	(49.2)	(30.1)	(31.0)
Effective Interest Rate adjustments	11.2	13.8	10.7	7.5
Fair value adjustments	39.4	27.0	39.4	27.0
	7,073.9	6,544.9	6,669.8	6,027.7

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	
	2016 £m	2015 £m	2016 £m	2015 £m
Retail financial services	5,858.3	5,244.9	5,858.3	5,244.9
Commercial lending	772.1	755.8	772.1	755.8
Secured personal lending	404.1	517.2	–	–
Fair value adjustments	39.4	27.0	39.4	27.0
	7,073.9	6,544.9	6,669.8	6,027.7

Notes to the accounts for the year ended 31 December 2016

32. Credit risk (continued)

a) Loans and advances to customers (continued)

i) Retail financial services and secured personal lending credit risk

Risk concentrations

The Group provides loans secured on residential property across England, Scotland and Wales and the Society, as a regional Building Society, has a geographical concentration in Wales.

The geographical concentration of first and second charge retail loans by account and value is shown below:

	Group by account		Group by value	
	2016 %	2015 %	2016 %	2015 %
In Wales	31.5	29.9	28.8	27.5
Outside Wales	68.5	70.1	71.2	72.5
	100.0	100.0	100.0	100.0

The Group holds a high quality buy-to-let portfolio of £1,494.3m (2015: £1,300.2m). At the end of the year, 77% of buy-to-let mortgages were on interest only products, 22% repayable by capital and interest repayments and 1% a combination of interest only and capital and interest.

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property. The average index linked LTV in respect of the Group's loans secured on residential property including mortgages under offer is estimated to be 56.8% (2015: 58.2%). Index-linked LTV banding is shown below:

	Group		Society	
	2016 %	2015 %	2016 %	2015 %
Less than 70%	72.2	70.3	72.7	71.7
More than 70% but less than 80%	13.5	14.2	13.3	13.8
More than 80% but less than 90%	8.7	9.2	8.6	8.7
More than 90% but less than 100%	3.6	4.1	3.5	3.9
More than 100%	2.0	2.2	1.9	1.9
	100.0	100.0	100.0	100.0

Notes to the accounts for the year ended 31 December 2016

Performance

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than three months is 0.63% (2015: 0.62%) which compares favourably with the industry average of 1.01% (CML arrears and possession data at 30 September 2016). Residential lending fully secured by a first charge which were six months or more in arrears had arrears balances of £0.9m (31 December 2015: £0.8m) with 184 (31 December 2015: 159) cases.

The percentage of secured personal loans currently in arrears of two months or more by number is 5.88% (2015: 6.87%), which by value is 6.69% (2015: 7.41%).

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

	Group			
	2016		2015	
	£m	%	£m	%
Current	6,152.1	98.2	5,646.2	98.0
Past due up to 3 months	60.9	1.0	61.5	1.1
Past due 3 months up to 6 months	22.8	0.4	24.7	0.4
Past due 6 months up to 12 months	15.5	0.2	18.4	0.3
Past due over 12 months	10.0	0.2	9.8	0.2
Possessions	1.1	–	1.4	–
	6,262.4	100.0	5,762.0	100.0

	Society			
	2016		2015	
	£m	%	£m	%
Current	5,781.1	98.7	5,173.7	98.7
Past due up to 3 months	43.5	0.7	39.4	0.8
Past due 3 months up to 6 months	16.2	0.3	15.3	0.3
Past due 6 months up to 12 months	11.4	0.2	12.4	0.2
Past due over 12 months	5.2	0.1	2.6	–
Possessions	0.9	–	1.4	–
	5,858.3	100.0	5,244.8	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 £15,732.6m (2015: £14,245.2m).

Notes to the accounts for the year ended 31 December 2016

32. Credit risk (continued)

a) Loans and advances to customers (continued)

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

Performance (continued)

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £1.7m (2015: £3.3m) of collateral is held against possession cases. Repossessed properties are made available for sale in accordance with statutory guidelines with proceeds used to reduce or repay the outstanding loan. The Group has a statutory duty to obtain the best reasonable price and to sell as soon as it reasonably can. Any collateral surplus on the sale of repossessed properties, after a deduction for costs incurred in relation to the sale, would be returned to the borrower. The percentage of the book with a collateral shortfall is reflected in the table on page 125.

Impairment 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:

	2016 £m	2015 £m
Retail financial services	5.6	6.3
Secured personal loans	15.3	18.2
	20.9	24.5

Forbearance

The Group uses a range of forbearance options which are considered based on the borrower's financial circumstances, agreed subject to set criteria and reviewed on a case-by-case basis. Forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. Repossession of a property will only take place once all alternatives have been reviewed and there are no other solutions available. 48 properties were taken into possession during 2016 (2015: 86) with balances of £3.0m (2015: £5.9m).

The table below sets out the mortgage balances which have had some form of forbearance over the last 12 months. Where accounts have had more than one form of forbearance we have categorised the balance based on the first instance of forbearance.

2016	Revised payment schedule £m	Transfer to interest-only £m	Term extensions £m	Other £m	Total £m
Current	16.3	10.6	0.6	2.5	30.0
Past due up to 3 months	11.9	0.8	-	0.5	13.2
Past due 3 months up to 6 months	3.0	0.3	0.1	0.4	3.8
Past due 6 months up to 12 months	2.1	0.1	-	1.5	3.7
Past due over 12 months	1.7	-	-	3.6	5.3
	35.0	11.8	0.7	8.5	56.0

Notes to the accounts for the year ended 31 December 2016

2015	Revised payment schedule £m	Transfer to interest-only £m	Term extensions £m	Other £m	Total £m
Current	24.6	11.6	1.1	1.6	38.9
Past due up to 3 months	13.7	0.7	0.1	1.0	15.5
Past due 3 months up to 6 months	4.5	0.2	-	0.6	5.3
Past due 6 months up to 12 months	2.0	0.1	-	1.5	3.6
Past due over 12 months	0.9	-	0.1	4.1	5.1
	45.7	12.6	1.3	8.8	68.4

The underlying performance of previous forbearance activities are reflected in the provisioning methodology and are not individually or collectively material. In addition to the specific provisions held against individual accounts, a collective provision of £0.6m (2015: £0.9m) is held in relation to accounts subject to previous forbearance.

ii) Commercial lending credit risk

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

Further detail of the Group's risk management strategy in relation to commercial lending is described in the Risk Management Report on pages 37 and 38.

Risk Concentrations

The Group's commercial loan portfolio, excluding impairment provisions and fair value adjustments, comprises the following:

	Group and Society			
	2016		2015	
	£m	%	£m	%
Loans to Registered Social Landlords secured on residential property	150.3	18.9	149.8	19.2
Other loans secured on residential property	331.3	41.4	308.5	39.4
Loans secured on commercial property	317.6	39.7	324.2	41.4
	799.2	100.0	782.5	100.0

Notes to the accounts for the year ended 31 December 2016

32. Credit risk (continued)

a) Loans and advances to customers (continued)

ii) Commercial lending credit risk (continued)

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			
	2016		2015	
	£m	%	£m	%
Office	96.9	30.5	98.2	30.3
Retail	114.5	36.0	112.0	34.5
Industrial	60.3	19.0	60.0	18.5
Leisure	21.2	6.7	21.9	6.8
Land	2.8	0.9	7.5	2.3
Other	21.9	6.9	24.6	7.6
	317.6	100.0	324.2	100.0

The Group provides loans secured on commercial property across England and Wales and the Society, as a regional Building Society, has a geographical concentration in Wales. An analysis of commercial property loans by geographical location is provided below:

	Group and Society			
	2016		2015	
Region	£m	%	£m	%
Wales	401.4	50.2	390.7	49.9
Greater London	214.6	26.9	187.4	24.0
South East/East of England	49.1	6.1	59.8	7.6
Midlands	31.1	3.9	35.4	4.5
South West/South of England	38.0	4.8	36.6	4.7
North West/North of England	37.6	4.7	38.1	4.9
Mixed/other	27.4	3.4	34.5	4.4
	799.2	100.0	782.5	100.0

The average loan to value (LTV) in respect of the Group's commercial loans is estimated to be 62.0% (2015: 63.2%). 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.

£33.3m of exposures have an LTV of greater than 100% (2015: £46.6m). Of these, £25.3m are already classified as impaired and a further £0.7m are on the watch-list, leaving £7.3m of exposures considered to be non-higher risk notwithstanding that they include an unsecured element. In these instances, management are satisfied that the cash flows generated by the underlying assets will be sufficient to fully repay the debt over time.

The largest exposure to one counterparty is £29.8m (2015: £29.9m) or 3.7% (2015: 3.8%) of gross balances.

Notes to the accounts for the year ended 31 December 2016

Performance

The commercial lending risk procedure for loans and advances to customers is described in the Risk Management Report on pages 37 and 38.

Using the commercial credit risk grading system the commercial loan portfolio is distributed as follows (the figures exclude provision for loan impairment and fair value adjustments):

	Group and Society			
	2016		2015	
Region	£m	%	£m	%
Exposures not classified as higher risk	757.0	94.7	708.1	90.5
Watch-list	14.5	1.8	37.8	4.8
Impaired (including past due up to 3 months)	27.7	3.5	36.6	4.7
	799.2	**100.0**	**782.5**	**100.0**

Watch-list exposures are categorised in line with the perceived severity of the risk to identify cases having the greatest potential cause for concern and to facilitate timely risk mitigation activity. Accounts in the watch-list are typically those which have had a material covenant breach, have persistent arrears (but are not presently past due) or where there are other concerns about the likelihood of eventual repayment. Defaulted accounts are described as impaired.

The table below provides further information on commercial loans and advances by defaulted and delinquency status:

	Group and Society			
	2016		2015	
Region	Region	%	£m	%
Unimpaired				
Current	771.4	96.5	745.9	95.3
Past due up to 3 months	-	-	1.3	0.2
Impaired				
Past due 3 to 6 months	-	-	-	-
Past due 6 to 12 months	-	-	-	-
Past due over 12 months	-	-	-	-
Defaulted but not past due	26.4	3.3	29.9	3.8
Law of Property Act (LPA) Receivers appointed	1.4	0.2	5.4	0.7
	799.2	**100.0**	**782.5**	**100.0**

There is one commercial case (2015: nil) three months or more in arrears. Total arrears balances are £57k (2015: £26k).

Notes to the accounts for the year ended 31 December 2016

32. Credit risk (continued)

a) Loans and advances to customers (continued)

ii) Commercial lending credit risk (continued)

Performance (continued)

The total collateral held against commercial loans is estimated to be £1,520m (2015: £1,442m). Lending is classified by sector according to the property type held as collateral. The current value of collateral is estimated based on the latest professional valuation adjusted for subsequent commercial property price movements. Where considered necessary, new professional valuations will be sought. In the case of watch-list exposures this will typically be at least annually.

Provisions are held against impaired loans as follows:

	Group and Society	
	2016 £m	2015 £m
Collective provisions	14.8	14.4
Specific provisions	9.7	10.3
Total provisions	**24.5**	**24.7**

Forbearance

In some cases of default, or in order to avoid a default, action plans are implemented which may require the granting of a concession involving amendments to the contractual terms of a loan, such as an extension of a maturity, reduction in interest rate or non-enforcement of covenants, recognising that providing such forbearance can often be the best way to avoid default and minimise losses, giving the customer time to take action to improve their situation. Such forbearance activity is always carefully considered with the aim of maximising the benefit and optimising the outcome for both the Group and the borrower. In 2016, 5 (2015: 10) accounts with balances totalling £1.4m (2015: £18.2m) in value were granted forbearance concessions. The total exposure in forbearance at December 2016 stands at £25.0m and 25 accounts (2015: £60.1m, 36 accounts). The potential for losses on these accounts is assessed and considered in the level of overall provisions held against the Commercial Lending portfolio. Additionally their status in terms of whether deemed impaired, or placed on the watch-list is also considered on a regular basis.

b) Credit risk: Treasury financial instruments

The treasury credit risk strategy is described in the risk report on page 38.

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.

Notes to the accounts for the year ended 31 December 2016

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
UK government securities	338.5	349.9	338.5	349.9
Supranational securities	10.1	51.0	10.1	51.0
UK financial institutions	212.9	224.8	133.5	116.7
	561.5	625.7	482.1	517.6

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 £5.8m (2015: £4.8m) is held over derivative financial instruments.

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

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
AAA to AA-	518.7	512.9	439.3	471.1
A+ to A-	29.9	96.6	29.9	30.3
BBB+ to BBB-	12.9	16.2	12.9	16.2
Unrated	-	-	-	-
	561.5	625.7	482.1	517.6

The geographical distribution of these exposures is as follows:

	Group		Society	
	2016 £m	2015 £m	2016 £m	2015 £m
UK	551.4	574.7	472.0	466.6
Multilateral Development Banks	10.1	51.0	10.1	51.0
	561.5	625.7	482.1	517.6

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.

Notes to the accounts for the year ended 31 December 2016

33. Liquidity risk

The following tables analyse the gross contractual principal cash flows payable under financial liabilities. These balances will not agree directly to the balances in the consolidated statement of financial position as the table incorporates only principal amounts and does not reflect accrued interest or fair value adjustments.

2016	Undefined maturity £m	Less than 3 months £m	Between 3 months and 1 year £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Group						
Non-derivative liabilities						
Shares	–	3,796.2	971.6	1,331.3	–	6,099.1
Amounts owed to credit institutions	5.8	131.8	201.4	266.7	–	605.7
Other customers	–	114.0	108.2	3.1	–	225.3
Debt securities in issue	–	41.6	128.4	459.7	–	629.7
Subscribed capital	–	–	–	60.0	–	60.0
	5.8	4,083.6	1,409.6	2,120.8	–	7,619.8
Society						
Non-derivative liabilities						
Shares	–	3,796.2	971.6	1,331.3	–	6,099.1
Amounts owed to credit institutions	5.8	153.6	292.2	691.7	–	1,143.3
Other customers	–	114.0	108.2	3.1	–	225.3
Debt securities in issue	–	3.0	12.5	–	–	15.5
Subscribed capital	–	–	–	60.0	–	60.0
	5.8	4,066.8	1,384.5	2,086.1	–	7,543.2
Group						
Derivative liabilities						
Interest rate swaps	–	–	3.7	25.5	16.5	45.7
	–	–	3.7	25.5	16.5	45.7
Society						
Derivative liabilities						
Interest rate swaps	–	–	3.7	25.5	14.4	43.6
	–	–	3.7	25.5	14.4	43.6

Notes to the accounts for the year ended 31 December 2016

33. Liquidity risk (continued)

2015	Undefined maturity £m	Less than 3 months £m	Between 3 months and 1 year £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Group						
Non-derivative liabilities						
Shares	-	3,505.0	631.0	1,420.5	-	5,556.5
Amounts owed to credit institutions	4.8	168.5	161.8	207.5	-	542.6
Other customers	-	105.9	120.4	53.5	-	279.8
Debt securities in issue	-	36.0	155.9	266.7	-	458.6
Subordinated liabilities	-	-	92.3	-	-	92.3
Subscribed capital	-	-	-	60.0	-	60.0
	4.8	3,815.4	1,161.4	2,008.2	-	6,989.8
Society						
Non-derivative liabilities						
Shares	-	3,505.0	631.0	1,420.5	-	5,556.5
Amounts owed to credit institutions	4.8	178.1	225.0	478.2	-	886.1
Other customers	-	105.9	120.4	53.5	-	279.8
Debt securities in issue	-	4.0	4.0	-	-	8.0
Subordinated liabilities	-	-	92.3	-	-	92.3
Subscribed capital	-	-	-	60.0	-	60.0
	4.8	3,793.0	1,072.7	2,012.2	-	6,882.7
Group						
Derivative liabilities						
Interest rate swaps	-	-	1.9	15.1	14.3	31.3
	-	-	1.9	15.1	14.3	31.3
Society						
Derivative liabilities						
Interest rate swaps	-	-	1.9	15.1	13.5	30.5
	-	-	1.9	15.1	13.5	30.5

34. Market 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 £1.9m (2015: £7.8m favourable impact on reserves).

Notes to the accounts for the year ended 31 December 2016

35. Related party transactions

The remuneration of the directors (including Non-Executive Directors), who are the key management personnel of the Group, is set out in the Report of the Remuneration Committee on pages 62 to 69.

Loans to and shares held by Directors

There was an aggregate of £0.6m (2015: £0.3m) 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 28 April 2017.

As required by the Society's Rules, each Director has a share account. The Society's duty of confidentiality to its Members precludes individual disclosure of these details; the aggregate total of deposits held by Directors was £0.1m (2015: £0.1m).

Directors' transactions

There were no other transactions with Directors during the year.

Transactions with Group companies

The Society undertook the following transactions with Group companies during the year:

	Interest paid to Society £m	Fees paid to Society £m
Year ended 31 December 2016		
Nemo Personal Finance Limited	13.5	1.0
	13.5	1.0
Year ended 31 December 2015		
Nemo Personal Finance Limited	15.6	1.2
	15.6	1.2

At the year-end the following balances were outstanding:

	Loans owed to Society 2016 £m	Loans owed to Society 2015 £m
Nemo Personal Finance Limited	328.2	451.7
	328.2	451.7

Annual business statement for the year ended 31 December 2016

1. Statutory percentages

	At 31 December 2016	At 31 December 2015	Statutory limit
	%	%	%
The lending limit	5.1	5.6	25.0
The funding limit	19.3	18.7	50.0

The percentages are calculated in accordance with, and the statutory limits are those prescribed by, Sections 6 and 7 of the Building Societies Act 1986 (as substituted by the Building Societies Act 1997) and are based on the consolidated statement of financial position.

2. Other percentages

	2016 %	2015 %
As a percentage of shares and borrowings:		
Gross capital	7.2	8.8
Free capital	7.0	8.6
Liquid assets	14.6	13.9
As a percentage of mean total assets:		
Profit for the year as a percentage of mean total assets	0.49	0.51
Management expenses as a percentage of mean total assets	1.04	1.13

Gross capital is the aggregate of general reserve, available for sale reserve, subscribed capital and subordinated liabilities.

Free capital is gross capital plus collective impairment provisions less intangible assets and property, plant and equipment.

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

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.

3. Directors

Details of Directors are contained on pages 48 to 52.

Details of Directors' service contracts are included in the Report of the Remuneration Committee on page 69.

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

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

Nemo Personal Finance Limited
Chief Executive:
Iain Mansfield

Section 3

Glossary

Glossary

Additional Tier 1 capital	A component of regulatory capital comprising permanent interest-bearing shares (PIBS) and other qualifying instruments after regulatory adjustments.
Arrears	A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan payment is overdue. Such a customer can also be said to be in a state of delinquency.
Basel III	In December 2010, the Basel Committee on Banking Supervision issued the Basel III rules text, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity.
Buffer eligible liquid assets	Includes high quality debt securities issued by a government or central bank, securities issued by a designated multilateral development bank or reserves in the form of sight deposits with a central bank in an EEA State or Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.
Business assets	The total assets of the Society and its subsidiary undertakings as shown in the statement of financial position plus provision for loan impairment, less fixed assets and liquid assets.
Capital Requirements Directive (CRD IV)	European legislation to implement Basel III, which includes the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD).
Commercial lending	Secured loans to a commercial borrower.
Commercial property	Includes office buildings, industrial property, medical centres, hotels, retail stores, shopping centres, multifamily housing buildings, warehouses, garages and industrial properties.
Contractual maturity	The final payment date of a loan or other financial instrument, at which point the entire remaining outstanding principal and interest is due to be repaid.
Common Equity Tier 1 capital	The highest quality form of capital as defined in the Capital Requirements Directive IV, comprising accumulated reserves and qualifying instruments after regulatory deductions.
Common Equity Tier 1 capital ratio	Common Equity Tier 1 capital as a proportion of risk-weighted assets.
Core liquidity ratio	Buffer eligible liquid assets as a proportion of savings, deposits and loans.
Cost income ratio	A ratio that represents the proportion of management expenses (i.e. administrative expenses, depreciation and amortisation) to total income.
Covered bonds	A type of wholesale funding backed by cash flows from mortgages.
Credit risk	The risk of financial loss arising from a failure of a customer or counterparty to settle their financial and contractual obligations as they fall due.

Glossary (continued)

Credit Valuation Adjustment (CVA)	An adjustment that represents an estimate of the change to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures.
Debt securities in issue	Transferable certificates of indebtness including certificates of deposits, and fixed and floating rate notes.
Defined benefit pension scheme	A scheme that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary.
Defined contribution pension scheme	A scheme into which the Group and the employee pay fixed contributions without any obligation to pay further contributions.
Delinquency	See Arrears.
Effective Interest Rate method (EIR)	The Group uses the EIR method to recognise income for certain financial instruments held at amortised cost. To calculate the appropriate EIR, the Group makes assumptions of the expected lives of financial instruments and the anticipated level of early redemption charges.
Expected Loss (EL)	A regulatory capital calculation to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.
Exposure	The maximum loss that a financial institution might suffer if a borrower or counterparty fails to meet its obligations to the Group.
Exposure At Default (EAD)	A regulatory capital parameter used to estimate the amount outstanding at the time of default.
FCA	The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from 1 April 2013. The FCA also has responsibility for protecting consumers and promoting healthy competition.
Financial Services Compensation Scheme (FSCS)	A protection fund for depositors of failed institutions. This is funded by the financial services industry and each firm, including the Society, is obliged to pay an annual levy.
Forbearance strategies	Strategies to assist borrowers in financial difficulty, such as extending loan terms, temporarily converting loans to an interest-only basis and agreeing a temporary reduction in payments. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.
Funding limit	The proportion of shares and borrowings not in the form of customer accounts held by individuals.
Individual Liquidity Adequacy Assessment (ILAA)	The Group's internal assessment of the levels of liquidity that need to be held by the Society to meet its regulatory liquidity requirements.

Impaired loans	Loans where there is evidence to suggest a measurable decrease in the present value of expected cash flows that has occurred after initial recognition of the asset, but before the statement of financial position date.
Individually/collectively assessed impairment allowances	Impairment is measured individually for assets and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available. Collective assessment also covers losses that have occurred but are not yet individually identified on loans subject to individual assessment.
Individual Liquidity Guidance (ILG)	Guidance from the PRA on the required quantity of a firm's liquidity resources and the firm's funding profile.
Internal Capital Adequacy Assessment Process (ICAAP)	The Group's internal assessment of the levels of capital that need to be held by the Society to meet its regulatory capital requirements.
International Swaps and Derivatives Association (ISDA) master agreement	A standardised contract developed by ISDA and used to enter into bilateral derivatives transactions. The contracts grant legal rights of set-off for derivative transactions with the same counterparty. This reduces the credit risk of the derivatives to the extent that negative values offset positive values.
Internal Ratings Based (IRB)	An approach for measuring exposure to credit risks. IRB approaches are more sophisticated and risk sensitive than the standardised approach and may be Foundation or Advanced. IRB approaches may only be used with PRA permission.
Lending limit	The proportion of business assets not in the form of loans fully secured on residential property.
Leverage ratio	A Basel III ratio which measures Tier 1 capital against total on and off balance sheet assets.
LIBOR	London Inter Bank Offered Rate.
Liquid assets	Cash or other assets that can be readily converted to cash without loss of value.
Liquidity Coverage Ratio (LCR)	A liquidity metric which aims to ensure that a firm maintains an adequate level of liquidity to meet its needs for a 30 calendar day time horizon under a severe stress scenario.
Liquidity and funding risk	The risk that the Group does not hold sufficient liquidity, in terms of quantity and quality, to meet its liabilities as they fall due.
Loan To Value ratio (LTV)	A ratio showing outstanding loan balance as a percentage of the value of the security.
Loss Given Default (LGD)	The difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.
Management Expense Ratio	A ratio that measures cost as a proportion of mean assets

Glossary (continued)

Member	A person who has a share investment or a mortgage loan with the Society.
Net interest income	The difference between the interest received on assets and the interest paid on liabilities.
Net Stable Funding Ratio (NSFR)	A liquidity ratio, currently proposed under Basel III, to calculate the proportion of long-term assets that are funded by stable, long-term funding sources (customer deposits and long-term wholesale funding).
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
Overnight Indexed Swap rate (OIS)	A rate reflecting the overnight interest typically earned or paid in respect of collateral exchanged. OIS is used in valuing collateralised interest rate derivatives.
Permanent Interest-Bearing Shares (PIBS)	Unsecured, Sterling denominated Additional Core Tier 1 capital instruments repayable at the option of the Society.
Plevin	In November 2014, the Supreme Court ruled in Plevin v Paragon Personal Finance Ltd (Plevin) that a failure to disclose a commission payment on a PPI policy made the relationship between a lender and the borrower unfair under the Consumer Credit Act.
Prudential Regulation Authority (PRA)	The UK prudential regulator, which is a part of the Bank of England and alongside the FCA has responsibility for the oversight of building societies, banks and insurers. The PRA's objective is to promote the safety and soundness of regulated firms.
Probability of Default (PD)	A regulatory capital parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.
Regulatory capital	Capital allowable under regulatory rules, less certain required regulatory adjustments and deductions.
Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)	A repurchase agreement (repo) is a transaction in which the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the counterparty to the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or (reverse repo).
Residential Mortgage Backed Securities (RMBS)	A category of asset backed security that represents interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).
Retail loans	Loans to individuals rather than institutions, including residential mortgage lending.

Risk appetite	The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's Members whilst achieving business objectives.
Risk-Weighted Assets (RWA)	A regulatory measure that adjusts the value of assets to reflect their level of risk when calculating capital requirements.
Securitisation	A process by which a group of assets, usually loans, 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	Money deposited by Members in a retail savings account with the Society and held as a liability in the statement of financial position.
Shares and borrowings	The total of shares, deposits from banks, other deposits, amounts due to customers and debt securities in issue.
Solvency ratio	A component of regulatory capital measuring of the Group's total regulatory capital as a proportion of the Group's risk weighted assets.
Special Purpose Entities (SPEs)	Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses an SPE set up under securitisation programme. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results. This term is used interchangeably with special purpose vehicle (SPV).
Standardised approach	The basic method used to calculate credit risk capital requirements under Basel III. In this approach the risk weights used in the capital calculation are determined by PRA supervisory parameters. The standardised approach is less risk-sensitive than IRB.
Stress testing	Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.
Subscribed capital	See permanent interest-bearing shares (PIBS).
Subordinated debt/ liabilities	A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors and investing Members but before the claims of holders of permanent interest-bearing shares (PIBS).
Tier 1 capital ratio	Tier 1 capital as a proportion of risk-weighted assets.
Tier 2 capital	A further component of regulatory capital comprising subordinated debt less certain regulatory deductions.
Value At Risk (VAR)	A technique that estimates the potential loss that could occur on risk positions as a result of future movements in market rates and prices over a specified time horizon and to a given level of statistical confidence.

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