ANNUAL REPORT
AND ACCOUNTS

2017







Building your future

Principality
Building Society
Cymdeithas Adeiladu

Where home matters
principality.co.uk

Key highlights of 2017

We were busy in 2017 building the future for our Members

5000+ first time buyers

We helped more than 5000 first time buyers get onto the property ladder

Members savings balances grew to over

£6.5 billion

(2016: £6.1bn)

We invested over **£90k** to support **131** community groups and school projects across Wales

Our net retail mortgage lending grew by

£917.2 million

(2016: £613.5m)

Pre-tax Profits **£57.6 million**

We had pre-tax profits of £57.6m

(2016: £50.3m)

We raised **£134,000** for our charity partners

Through colleague fundraising and match funding

74.8%

Customer service net promoter score of 74.8%

(2016: 72.7%)

26.14%

Strong capital ratios with a Common Equity Tier 1 ratio of 26.14% (2016: 23.47%)

1.44%

Net interest margin

(2016: 1.57%)

Welcome

CONTENTS

Performance and Strategy

Governance

Financial Statements

Other information

Page 8

Chief Executive's review of the year

Page 32

Meet your Board of Directors

Page 72

Financial statements

Section 1

Performance and Strategy

Building your future

Chairman's review of the year

for the year ended 31 December 2017

I am pleased to report that Principality Building Society has continued to make significant strategic progress in 2017 despite a backdrop of political and economic uncertainty in the UK and the wider world.

Laurence Adams
Chairman

Strong performance

Steve Hughes was appointed as Chief Executive Officer (CEO) in March and together with his executive team has brought a clear focus on growing the core business of mortgages and savings. Our focus on a clear ambition to grow our business has resulted in Principality's strong performance, with an excellent retail lending performance which is outlined in our CEO's review. Our strong profitability and robust capital position places the Society in a good position as we look to the future.

It is important that we continue to meet the demands and needs of our Members in terms of improving our savings and mortgage product range. Also, we know the way in which people interact with financial services is changing and in particular how consumers are demanding choice with increasing digital interactions. So we are at the start of a medium term plan to improve our propositions and digital offering to bolster the excellent customer service we already offer. This will in all likelihood mean that our headline profitability will fall in the future as we invest and make these necessary changes for the benefit of our Members.

Supporting our Members, Colleagues and Communities

Principality prides itself on being purpose led with a strong culture and values and a desire to deliver a personal service to our Members and customers which makes us stand out as a trusted brand on the high street. We strive to promote diversity and inclusion allowing our colleagues to bring their individuality and to have a workforce that represents the Members that we serve.

Great service from our colleagues has led to us receiving a number of customer services awards this year, of which we are immensely proud. We are aware of the challenges faced by the communities we serve and we recognise the role our branches, our people and our activities provide in helping these communities prosper.

Our ongoing commitment to the high street, when others are making decisions to close branches, has maintained our strong relationship and engagement with our Members. We will continue to invest in developing our multi-channel capability so we can adopt flexible ways of interacting with our customers. We are in the process of investing heavily in bringing our business in line with the changing demands of our Members and customers to strengthen the service we offer. From how our branches are designed, to the range of products available to Members, the personal service and expertise from our branch advisors will be balanced with the utilisation of technology and digital.

Once again our colleagues have done some great things for our three charities, schools and community projects and you can read all about their outstanding efforts in the Members, Colleagues and Communities section. The entire Board is immensely proud of the work our colleagues have put in over the year.

Leadership

A strong Board, management team and skilled workforce is vital to an organisation's success and at Principality that is no different. We ensure that we have people of the highest calibre to represent the Society from a variety of different backgrounds. We have made some important senior appointments in the past year as Steve bolstered his executive team.

Tom Denman was appointed Chief Financial Officer and a member of the Board earlier this year, following a rigorous recruitment process. He has held a number of roles with the Society following his initial arrival at the Society in 2009, most recently as Deputy Finance Director. Tom will provide strong financial leadership to the Board and the wider business. He'll be responsible for ensuring profitable growth, strong financial control and driving cost efficiency. Above all, Tom has a strong understanding of mutuality and in putting our Members and customers' interests first.

Iain Mansfield was recently appointed as the Chief Operating Officer. Having clearly demonstrated his capability to the Board over the past year as CEO of Nemo, Iain will be accountable for ensuring we continue to provide fantastic service to our customers and Members but will also drive the delivery of our process improvement and technology initiatives.

Pictured: Inside our new Newport branch, which opened in December 2017.

Our former Head of Human Resources Rhian Langham became the Chief People Officer (CPO). The CPO role will be a pivotal role in supporting the business to drive investment in our culture, leadership and people capability. Rhian brings a wealth of experience, a strong track record of delivery and a passion for organisational development, leadership and cultural transformation. I am confident Rhian will be a strong and effective member of the executive team.

We strongly believe in growing and developing our staff at all levels. It is therefore very pleasing to note that all our senior appointments this year have been internal promotions following open and rigorous recruitment processes. We continue to prioritise colleague development and training.

Governance

Our priority is to provide a safe and secure home for our Members' savings and to run the business prudently in the interests of our Members. The Society has maintained a prudent approach towards risk management and our business model and strong Member focus leaves us well placed to meet any headwinds in 2018.

Thank you

I would like to extend my thanks to all of the hard-working colleagues in our branches, agencies and Cardiff offices who serve our Members' interests day in, day out. 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 have resulted in great success. Finally, I would like to thank you, our Members, for your continued support.

C. P. Adams

Laurence Philip Adams
Chairman
6 February 2018

Meet your Board of Directors 〉 Page 32

Financial Statements 〉 Page 72

Pictured: Primary school children building money skills with our branch colleagues.

Pictured: Pupils get training on digital skills and broadcasting with Sean Holley and Aspire 2Be.

Pictured: Supporting Financial Capability Week 2017 by delivering 44 lessons to schools across Wales.

Chief Executive's review of the year

for the year ended 31 December 2017

I am pleased to announce an excellent performance from Principality Building Society in 2017. We have continued to provide a safe and secure home for our Members' savings, provide market leading customer service and build financial resilience through strong residential mortgage growth and robust profitability.

Steve Hughes
Chief Executive Officer

Building for your future

We are a proud mutual organisation that will continue to focus on running the business in the long term interests of our Members.

Grounded in mutuality we will be a challenger organisation, challenging ourselves to build a stronger business for the long term. This will be achieved through competing effectively with new entrants and existing providers whilst responding appropriately to the changing needs of consumers. We will continue to invest in branches whilst competition retreats, providing a personal service that rivals the best on the High Street. Our aim is to provide our Members with choice and seek true differentiation in the service we offer them.

We have an ambitious growth strategy with a clear focus on transforming our mortgage and savings business. To achieve this it means that headline profitability is likely to fall in the next few years as we invest in technology, process management and competitive propositions to future proof our organisation for existing and future generations of Members.

Our strong performance and profitability supports the significant investment in our technology, branches and our people to meet the changing demands of our Members. Digital technology is evolving at a rapid pace and our Members have told us they want flexibility and to be afforded the opportunity to do business with us through their channel of choice. Technology will be used to complement our personal service, which

Pictured: Left: Branch staff celebrating our Which? award.

Right: Julie-Ann Haines with representatives from our three charity partnerships.

Pictured: Right: Strade School pupils on an athletics track in Llanelli.

Far right: Superhero fundraising walk from Barry Island to Principality Stadium.

our Members and customers tell us, makes us stand out. Our Members always tell us of the importance their branch has in their local communities and that our colleagues play a valuable role.

The transformation of our business has begun in earnest and we have already improved our online service to complement our great branch network. Members are also benefiting from the rollout of our Principality Connected video conference service which means the equivalent of face-to-face interviews can take place anywhere throughout our retail network. The feedback from users has been very positive.

Performance

Our total assets have risen to £9.3bn and this has been achieved by a strong retail lending performance. Overall pre-tax profits increased to £57.6m reflecting robust margin and strong arrears performance, providing resilience and security for our Members. Our capital and liquidity is strong and provides a firm platform for growth and investment in our business.

I am especially pleased that in the past year our net residential mortgage lending increased by £917m and our focus on improving our service has resulted in great feedback from our Members, customers and intermediary partners. Growing the residential mortgage business is important and benefits our Members through building a sustainable business and providing the scale to allow us to invest for the future. In order to support the growth in lending we have attracted an additional £399m in savings, proving our ability once again to offer competitive interest rates and stand out service to Members. Our maturity products were launched in the summer to allow us to reward existing customers. As a result our retention rates have improved and feedback from Members and colleagues has been positive.

Our Commercial lending business is important in delivering financial dividends to our Members, and Principality Commercial has again performed strongly, recording a pre-tax profit of £17.9m. Commercial has played a significant role in funding more social and affordable housing in Wales, announcing £50m of loans for housing associations. Our second charge loans business, Nemo, stopped offering new customer loans in 2016 but has again made a meaningful contribution to the overall results with a pre-tax profit of £17.1m and has consistently delivered strong service to customers.

We have continued to manage the costs of running the business effectively and if the impact of transformation and property impairments are excluded, our cost income ratio would have been 56.7%, broadly in line with 2016. More detail on this can be found in the Strategic Report on page 11.

Pictured: Above: A branch colleague supporting Financial Capability Week in a Pontypool primary school.

Right: Easter Egg Appeal – over 400 Easter Eggs were donated to Llamau.

Below: Steve Hughes with singers from Only Boys Aloud.

It is also testament to our financial strength and brand that we were able to secure £475m of wholesale funding in the year, through our fourth residential mortgage backed securities issuance, and £300m through our first unsecured issuance since 2006. It's great to see the backing of institutional investors in the Principality name and also to receive recognition from our rating agencies, resulting in a Moody's upgrade.

Members, Colleagues and Communities

Supporting our local communities and helping them prosper is a key part of what we do as a mutual building society. Our colleagues have yet again put in considerable effort to raise £134k for our three chosen charity partners (Llamau, School of Hard Knocks and Cancer Research Wales). They have also volunteered more than 1,000 hours to help us achieve our Corporate Social Responsibility objectives of helping people live and stay in a home for longer; health and wellbeing and financial education. The Society has also invested over £90k to support 131 community groups and school projects across Wales.

We have continued to build on the partnerships we have developed with schools in our communities and I am especially proud of the efforts our branch colleagues made, to deliver more than 44 financial education lessons to well over 1,000 primary school children the length and breadth of Wales. It makes a real difference to people's lives and we are committed to continuing to invest in our communities.

Our culture, values and continued investment in our colleagues is crucial to ensuring consistency and improvement in our performance. Thanks to their superb efforts in 2017 we received Recommended Provider status by consumer champion Which? for our savings accounts.

It would be impossible to achieve such recognition without the fantastic work of all our colleagues who look after the best interests of our Members everyday. We have had great feedback from our Members on how they value our excellent personal service. In 2017, we received an outstanding Net Promoter Score of 74.8% from our Members and customers, which is market leading. This score is based on people recommending us as a provider to other people, probably the best compliment you can get.

Outlook

Looking ahead, we are very well placed to continue to grow and invest in future proofing the business to improve our Member proposition. The Bank of England has predicted that there will be further Base Rate rises in the next few years, while political uncertainty has undoubtedly affected the financial landscape as the shaping of the Brexit deal continues to dominate headlines and people's thoughts. Principality's balance sheet is strong, meaning we are confident in our ability to withstand economic headwinds, while enabling us to offer customers and Members some of the most competitive products on the High Street. The protection of our Members' interests is of paramount importance to us. We will continue to put our Members first, provide them with a stand out experience, whilst investing in our business for long term sustainability.

Thank you for your loyalty and continued support.

Steve Hughes

Steve Hughes
Chief Executive Officer
6 February 2018

Strategic Report

for the year ended 31 December 2017

Strategy

Principality is the sixth largest building society in the UK with over 500,000 customers and 1,000 colleagues.

The Society has a clear purpose "to help people prosper in their homes at every stage of life". This underpins how we do things as a business and has informed the strategic thinking which was undertaken in 2017. The strategy is one of focus on the core mortgage and savings business, driving sustainable growth through customer focused propositions, differentiated service and efficient manufacture. This will drive our key activities and the success of the strategy measured through a clear set of strategic KPIs as we seek to become the best mortgage and savings business in the UK.

This vision will be delivered, and success measured, across three key areas:

Strategic Pillars	Key Activity	Performance Indicators
 **"We'll be a Purpose Led Organisation helping customers prosper in their homes at every stage in life."**	We'll transform and continually innovate our mortgage and savings products that will help people to prosper in their home. We'll be famous in Wales and beyond so we can become a Challenger Building Society. We'll actively manage our costs to ensure we provide maximum value to our Members. We'll drive communities forward supporting economic growth and improving home lives.	Net Mortgage Growth Brand Consideration Cost Income Ratio
 **"We'll inspire Brilliant People across the Society with a customer focused culture."**	We'll be an employer of choice in Wales, continuing to attract and retain talented and passionate people. We'll inspire a strong customer focused culture with improved ways of working that will empower colleagues to live our values. We'll champion our diversity, and support colleagues to build careers, helping them to prosper.	Employee Engagement Score
 **"We'll provide our Members with a Stand-Out Experience focused on customer service and the safety and security of their Society."**	We'll put customer experience at the heart of what we do, using insight to drive the right actions and decisions. We'll invest in all our channels including digital to provide convenient access, and interact through our customers' channel of choice. We'll do the basics right, providing safety, security and reliability.	Net Promoter Score Profit Before Tax Net Interest Margin Common Equity Tier 1 Ratio

Business model

Principality's business model is to use funds raised from Members by way of savings and deposit accounts, together with funding raised from wholesale markets, to make loans secured against residential and commercial property. These loans generate income through the interest received; this income is used to pay interest to Members and to other funding providers, and to build the capital base of the Society through profitability.

Principality will deliver its strategy primarily across two lines of business, retail financial services and commercial lending. The secured personal lending business, Nemo, stopped offering new customer loans in 2016. Nemo is focused on delivering excellent customer service, and continues to deliver a meaningful contribution to the group results. A summary of the key products and channels offered is set out below:

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

Transforming the Society

Principality has continued its programme of transformation through 2017, enabled by the continued strong financial performance of the Society. This programme has delivered benefits across the business. Investment in the Society's mortgage broker proposition has driven consistent growth with more people taking Principality mortgages than ever before, and on the savings side a new retail savings range has given customers more choice and helped attract new customers from across the UK. Awareness of the Principality brand continues to grow, focused around the sponsorship of Principality Stadium with increasing exposure through rugby internationals and highly successful concerts such as Coldplay and Robbie Williams. The focus on improving processes for customers and colleagues has driven significant efficiency in the Society's operations as well as enhancing the customer experience. The Society continues to develop its colleague proposition and invest in their working environment through ongoing redevelopment of Principality House as well as refurbishment of its branch network led by the development of a flagship branch in Newport.

Principality continues to pride itself on the stand-out experience its Members receive from colleagues. Technology is, however, changing how customers interact with financial services providers, and investment in this area is important to ensure the Society remains relevant and successful in the rapidly changing marketplace. The Society has laid the foundations in 2017 for the start of the transformation of its digital experience in 2018. This transformation will take a number of years with the Member experience at its heart. The Society is dedicated to delivering the same stand-out experience that Members currently receive, whilst utilising the new technology offerings.

Key Performance Indicators

The group's Key Performance Indicators align with the PBS structure and measure the progress made against our strategy.

	2017	2016
Purpose Led Organisation		
Net Mortgage Growth	£816.7m	£516.5m
Brand Consideration	29.0%	28.0%
Cost Income Ratio	65.0%	58.5%
Brilliant People		
Employee Engagement Score	78.0%	-
Stand-Out Experience		
Net Promoter Score	74.8%	72.7%
Profit Before Tax	£57.6m	£50.3m
Net Interest Margin	1.44%	1.57%
Common Equity Tier 1 Ratio	26.14%	23.47%

*The above Key Performance Indicators, apart from Profit Before Tax, are Alternative Performance Measures (APMs) which are internally used to inform with key management decisions. Further information on these APMs can be found below, with definitions included within the glossary.

Member experience

Customer Service Net Promoter Score measures the likelihood of a Member to act as a promoter of the Society, based on internally designed instant feedback surveys. 2017 has seen a further increase in this measure, with the overall score increasing from 72.7% to 74.8%. Brand consideration, a measure of how potential customers view Principality when choosing a financial services provider, has also increased in the year.

Income statement overview

Continuing operations:	2013* £m	2014 £m	2015 £m	2016 £m	2017 £m
Net interest income	116.4	133.8	134.1	124.9	125.9
Other income	13.2	8.1	6.8	9.7	7.5
Fair value (losses)/gains	(1.2)	(1.5)	0.9	1.6	4.3
Operating expenses	(65.3)	(64.7)	(83.7)	(82.1)	(89.6)
Impairment provisions (charge)/release	(22.4)	(13.5)	(4.8)	2.7	10.0
Other provisions	(12.5)	(8.7)	(4.3)	(6.5)	(0.5)
Profit before tax from continuing operations	28.2	53.5	49.0	50.3	57.6

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

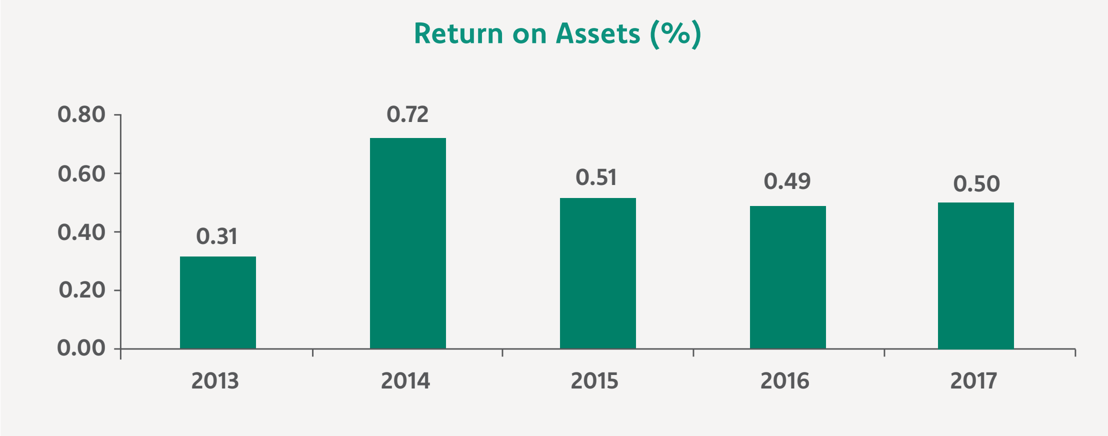
The financial performance of the group was strong in 2017, with a pre-tax statutory profit of £57.6m (2016: £50.3m). Underlying profit, which adjusts for one off factors, or those not reflective of current trading performance, decreased to £58.1m (2016: £59.2m). Both measures reflect the ongoing robust performance of the group, which supports the ability to invest for the longer term.

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

	2017 £m	2016 £m
Statutory profit before tax from continuing operations	57.6	50.3
Nemo strategic review and restructuring costs	–	2.4
Provisions for other liabilities and charges	0.5	6.5
Underlying profit	58.1	59.2

An adjustment is made to statutory profit for Nemo strategic review and restructuring costs, as these costs related to a specific, non-recurring event. An adjustment is made for Provisions for other liabilities and charges, as these items are either related to the FSCS industry wide levy, or to historic remediation programmes, and in neither case reflect the underlying performance of the group.

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

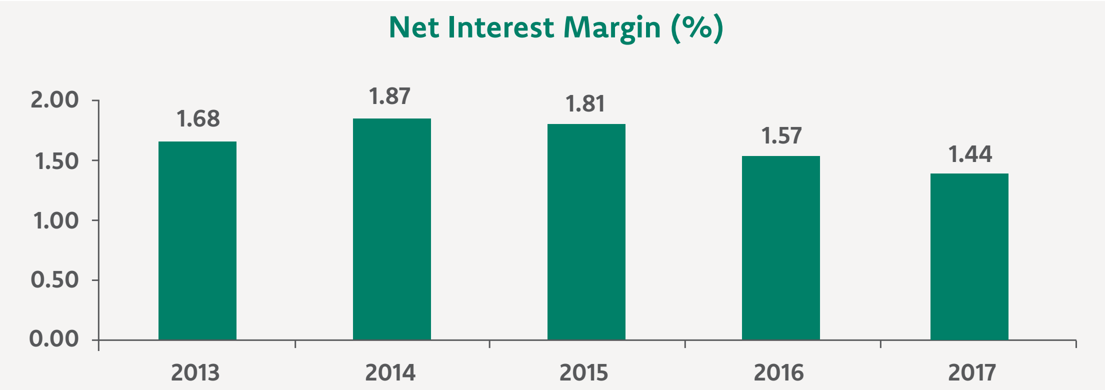


Net Interest Margin

The group's Net Interest Margin for the year was 1.44% (2016: 1.57%). The primary reason for the reduction is the decrease in the secured personal lending portfolio following the cessation of new business in 2016. Together with other financial services organisations, the group has experienced further pressures on margin due to the ongoing competitiveness of the residential and commercial lending markets, driving the replacement of older, higher margin loans with lower margin acquisition and re-mortgage lending.

Following an extended period of historic low rates, many retail savings rates started to rise at the end of 2017, following the Bank of England's decision to increase the Base Rate by 0.25%. The Society continued to offer better than average rates, and aims to support savers in the continued 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 Society.

The group's lending continues to be primarily funded by Members' retail savings, with 83.5% (2016: 87.2%) of loans and advances to customers funded in this way. However, in order to maintain a diverse range of funding sources, and to ensure the Society can continue to offer competitive savings rates, the Society also utilises lower cost wholesale funding. In 2017 the Society completed two market issuances, consisting of Residential Mortgage Backed Securities (RMBS) and senior unsecured notes, ensuring the funding position is robust in uncertain market conditions. Further details in respect of these transactions are set out in the 'Funding' section on page 21.



Other income

Other income at £7.5m (2016: £9.7m) has decreased from the prior year, driven primarily by lower levels of profit share income in respect of the group's general insurance partnerships.

Fair value movements

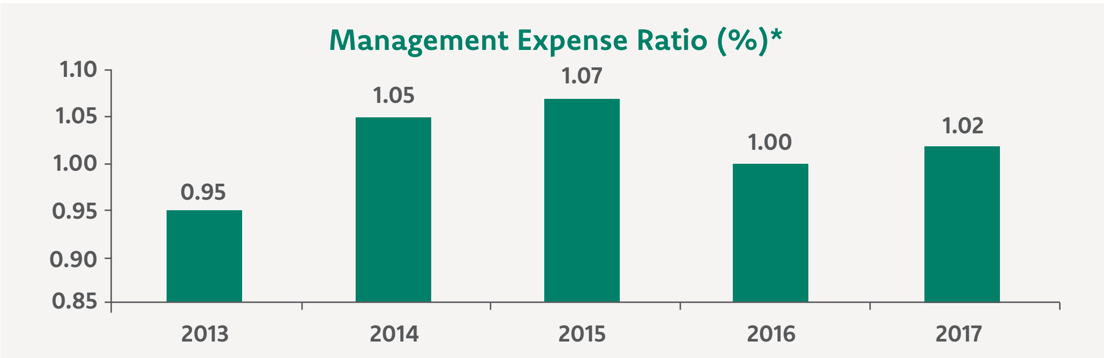
Fair value movements represent the change in value of certain assets and liabilities to reflect underlying market rates. These movements are primarily timing differences, which will reverse as the asset or liability approaches maturity. During the year the group recognised a gain of £4.3m in the income statement (2016: £1.6m gain) in relation to these movements in fair value.

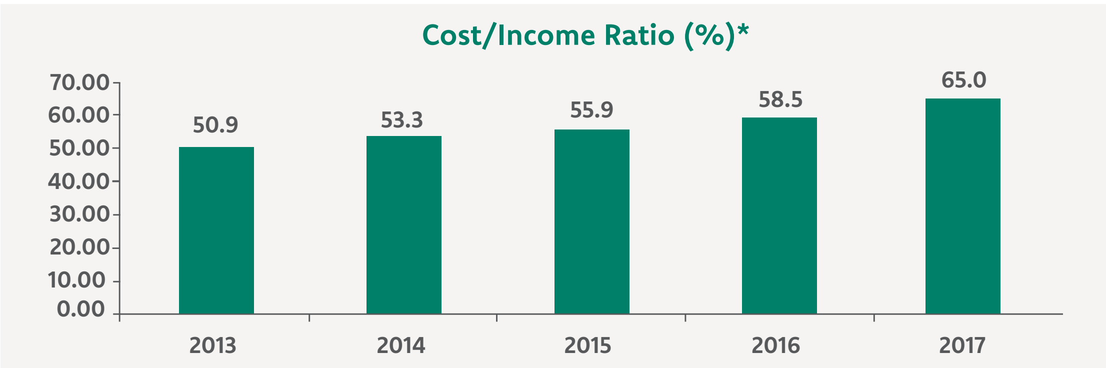
Operating expenses

The Society recognises that operating efficiently is a key factor in achieving optimal Member value, and as such operating expenses remain a key focus. Operating expenses increased in the year to £89.6m (2016: £82.1m), driven by a number of specific items including an impairment charge of £5.8m against the Society's head office building, Principality House, and a £1.1m loss on disposal of other property, plant and equipment. Further detail on the impairment charge is included in note 22. The group also invested further on strategic programmes during the year, totalling £4.6m (2016: £1.9m). Excluding these items, the group's cost/income ratio would be 56.7% (statutory cost income: ratio 65.0%), reflecting the continued focus on managing the core cost base of the Society. The year on year operating expenses comparison is set out in the table below:

		2017 £m	2016 £m
Retail financial services		80.5	67.7
Commercial lending		3.6	3.7
Secured personal lending		5.5	8.3
Underlying operating expenses		**89.6**	**79.7**
Nemo strategic review and restructuring costs		–	2.4
Total operating expenses		**89.6**	**82.1**
Management expense ratio	Underlying cost basis	1.02%	1.00%
	Statutory cost basis	1.02%	1.04%
Cost/Income ratio	Underlying cost basis	65.0%	58.5%
	Statutory cost basis	65.0%	60.3%

*The above key performance indicators, are Alternative Performance Measures (APMs) which are internally used to inform with key management decisions. Further information on these APMs can be found within the glossary.





*Stated on an underlying cost basis

Impairment provisions for losses on loans and advances

In 2017 the group experienced a net release of impairment provisions of £10.0m (2016: £2.7m release).

	2017 £m	2016 £m
Retail mortgage lending	0.3	0.2
Commercial lending	(5.0)	(0.7)
Secured personal lending	(5.3)	(2.2)
Total	**(10.0)**	**(2.7)**

Impairment charges against both retail mortgage lending and secured personal lending have been favourably impacted by moderate house price growth, low levels of arrears and the overall reduction in the secured personal lending book. The low level of arrears reflects the prudent affordability, credit quality and underwriting standards applied by the group, and these standards mean the business is well positioned to deal with future economic uncertainty and the impact on affordability of a rising interest rate environment.

Impairment charges against commercial loans have also decreased in the year, reflecting both the improvement in the commercial lending market in the year, the improving quality of the book, and the work undertaken over recent years to bring to resolution the remaining legacy low credit quality or distressed loans.

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

	2017 £m	2016 £m
Retail mortgage lending	5.5	5.6
Commercial lending	15.0	24.5
Secured personal lending	9.8	15.3
Total	**30.3**	**45.4**

Provisions for other liabilities and charges

At 31 December 2017, the group held a provision of £3.8m (2016: £2.7m) in relation to customer redress issues, including Payment Protection Insurance (“PPI”). The FCA has finalised 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”, and a further provision of £1.5m has been made during the period in relation to previous sales of PPI. The provision considers sales of PPI via direct channels as well as via brokers, some of whom are no longer trading, as well as recent customer behaviour and reopening previously closed complaints.

The group has recognised a Financial Services Compensation Scheme (FSCS) interest charge of £0.5m in respect of scheme year April 2017 to March 2018 (2016: interest charge of £1.4m). This was offset by a release of previously accrued amounts of £0.4m in relation to prior scheme years, giving a net charge of £0.1m.

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 from 20.0% to 19.0% from 1 April 2017. In addition, the Society was subject to the Bank Corporation Tax surcharge, resulting in an additional tax charge of 8.0% for Society profits over £25.0m. The actual effective tax rate from continuing operations for the group was 24.5% (2016: 22.3%) compared with the statutory rate of tax of 19.3% (2016: 20.0%). 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.

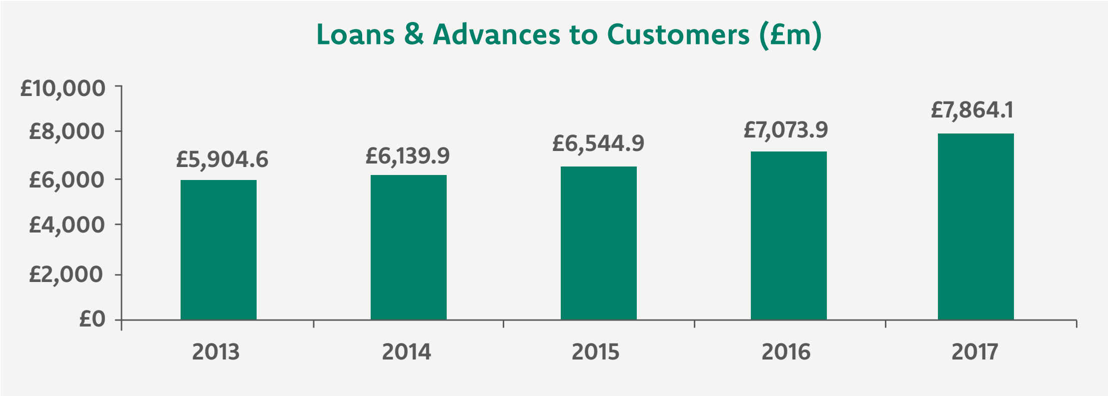
Statement of financial position

Total statement of financial position assets increased by £981.4m to £9,262.6m.

	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m
Liquid assets	1,042.1	1,037.4	962.0	1,116.8	1,320.0
Loans and advances to customers	5,904.6	6,139.9	6,544.9	7,073.9	7,864.1
Other assets	111.4	87.7	77.5	90.5	78.5
Total assets	**7,058.1**	**7,265.0**	**7,584.4**	**8,281.2**	**9,262.6**
Retail savings	5,562.6	5,613.0	5,621.8	6,165.2	6,563.8
Wholesale funding	902.8	1,001.7	1,287.5	1,468.8	2,035.9
Other liabilities	238.0	239.0	226.1	168.8	142.5
Total liabilities	**6,703.4**	**6,853.7**	**7,135.4**	**7,802.8**	**8,742.2**
Reserves	354.7	411.3	449.0	478.4	520.4
Total liabilities and equity	7,058.1	7,265.0	7,584.4	8,281.2	9,262.6

Loans and advances to customers

The Society continues to focus on the core business of prime lending against residential and commercial property. This has delivered an increase in loans and advances to customers of £790.2m (2016: £529.0m) to £7,864.1m (2016: £7,073.9m). The Society has achieved this profitably and in line with risk appetite. Net retail mortgage lending in the year was £917.2m (2016: £613.4m).



The retail mortgage portfolio has seen the majority of the increase to loans and advances to customers and remains the largest portfolio of the business at £6,775.5m (2016: £5,858.3m). This includes both lending to homeowners and a high quality buy-to-let portfolio of £1,696.6m (2016: £1,494.3m). The support for both residential mortgages and buy-to-let mortgages helps provide a broad range of products to the Society's current and any future Members. 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 of £311.8m (2016: £404.1m), secured against residential property by a second charge; this business is in run off with balances reducing by £92.3m in the year.

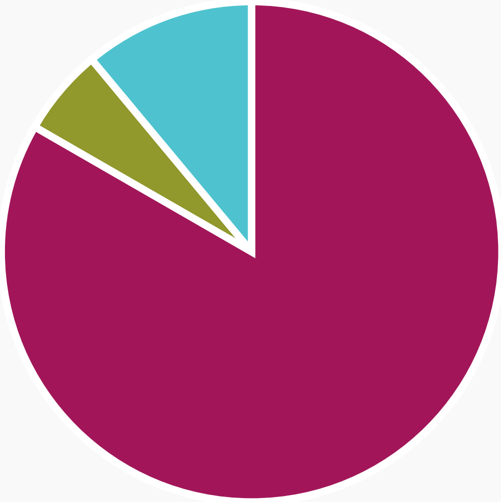
Loans & Advances to Customers by Portfolio (£m)*

Commercial, £763.9

Secured Personal Lending, £311.8

Retail Mortgages, £6,775.5

*Figures in the graph opposite exclude fair value adjustments.



The group's retail mortgage and secured personal lending portfolios reflect the prudent nature of its lending policies, with 71% (2016: 72%) of exposures having a loan to indexed valuation of less than 70% and 85% (2016: 86%) less than 80%.

The exposures are well spread by geographical area within the UK, albeit with a larger share of lending in Wales, which by value makes up 29.8% of lending (2016: 28.8%) in the retail mortgage and secured personal lending portfolios.

The strong credit quality of loans issued is reflected in the low value and volume of the arrears against first and second charge residential lending. The percentage of retail mortgage lending cases fully secured by a first charge currently with arrears of more than three months is 0.53% (2016: 0.63%) which compares favourably with the industry average of 0.86%*. The number of properties taken into possession during the year was 53 (2016: 48).

The percentage of secured personal loans currently in arrears of two months or more by number is 4.63% (2016: 5.88%), which by value is 5.66% (2016: 6.69%).

The commercial lending portfolio is made up of commercial property exposures representing 41.4% of balances, and lending against residential property and to registered social landlords of 58.6%. The Society provides loans secured on commercial property across England and Wales, with 48.5% of lending situated in Wales.

The commercial lending portfolio had no exposure greater than three months in arrears at the year-end (2016: one). 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.

*CML arrears and possession data at 30 September 2017.

Defined benefit pension scheme

The Society operates a defined benefit pension scheme, which is closed to new entrants and to further accrual. During the year, the pension scheme deficit (the difference between the scheme assets and scheme liabilities) decreased to £8.9m (2016: £15.3m).

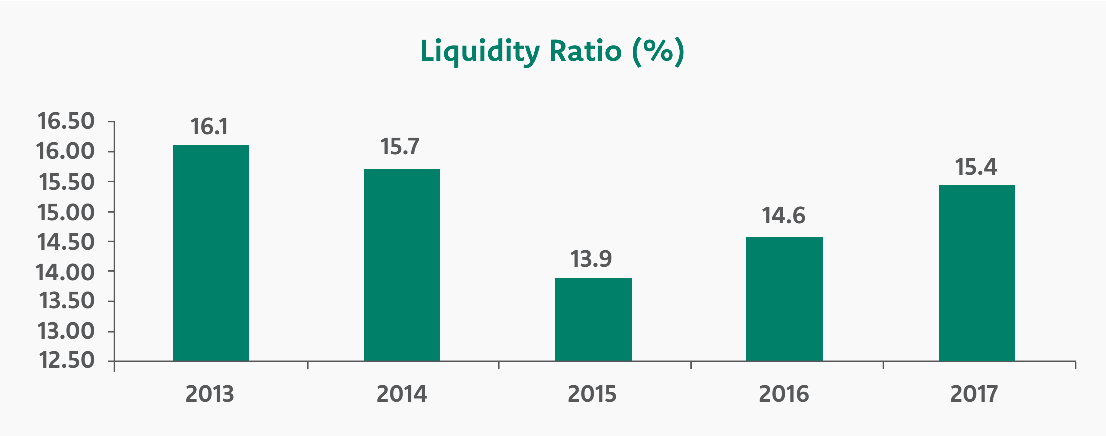
The defined benefit scheme was subject to a triennial valuation on 30 September 2016 which was subsequently completed in December 2017. The scheme at the end of 2017 is in deficit, and the Society has agreed an increased contribution plan to close the deficit over a period of five years. The Society continues to work closely with the Trustees of the scheme to ensure the investment plan for the scheme assets is effective in both generating returns and mitigating risks, and thereby that the pension risk to the Society is appropriately managed.

The Society made contributions to the scheme in the year of £6.7m (2016: £1.5m).

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 and continues to maintain a robust liquidity position, with liquid assets at the year end of 15.4% (2016: 14.6%) as a proportion of shares, deposits and loans (SDL).

The group's liquidity is made up of cash and balances with the Bank of England, UK Government and other high quality securities, and loans and advances to credit institutions.



The Liquid Asset Buffer as defined by the Prudential Regulatory Authority (PRA) includes highly liquid assets, typically central bank and sovereign exposures. At the year end, the proportion of the group's available liquidity which was buffer eligible was 85.8% (2016: 84.1%). Of the total liquid assets, 1.2% (2016: 1.2%) were less than A rated under Fitch credit ratings.

The PRA monitors liquidity using the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), measures introduced as part of the CRD IV regulatory changes. The group's Liquidity Coverage Ratio, a measure of the group's ability to withstand a short-term liquidity stress, was 203.0% at the year end (2016: 161.2%), well above the regulatory requirement. The NSFR is a longer-term stable funding metric, which measures the sustainability of the group's long-term funding. Based on current interpretations of the regulation, the 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:

	2017 £m	2016 £m
Cash and balances with the Bank of England	1,026.3	585.7
Securities issued by the UK Government and Multilateral Development Banks:		
On balance sheet	85.9	348.6
Off balance sheet	-	30.7
Total buffer eligible assets	**1,112.2**	**965.0**
Loans and advances to credit institutions and other debt securities	207.8	182.5
Total	**1,320.0**	**1,147.5**

Funding

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

The Society 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 £6,563.8m (2016: £6,165.2m) represent 83.5% (2016: 87.2%) of all mortgage and loan balances. Retail savings balances have increased by £398.6m in the year (2016: £543.4m), reflecting the continued focus on offering attractive products to Members.

In June 2017 the Society completed its fourth RMBS issuance, raising £475m of funding. In November 2017 the Society completed an issuance of senior unsecured notes, raising £300m of funding with a term of six years. The utilisation of wholesale funding in each of these cases furthers the Society'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 £931.3m (2016: £615.5m).

During the year the Moody's credit rating on Long Term and Short Term debt was upgraded from Baa3 to Baa2 and Prime-3 to Prime-2 respectively. This is a positive reflection of the group's strong performance.

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

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

Asset encumbrance

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, 20.3% (2016: 19.3%) of the group's assets were encumbered, representing £1,719.2m (2016: £1,470.1m) of residential mortgage assets and £158.0m (2016: £129.9m) 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.

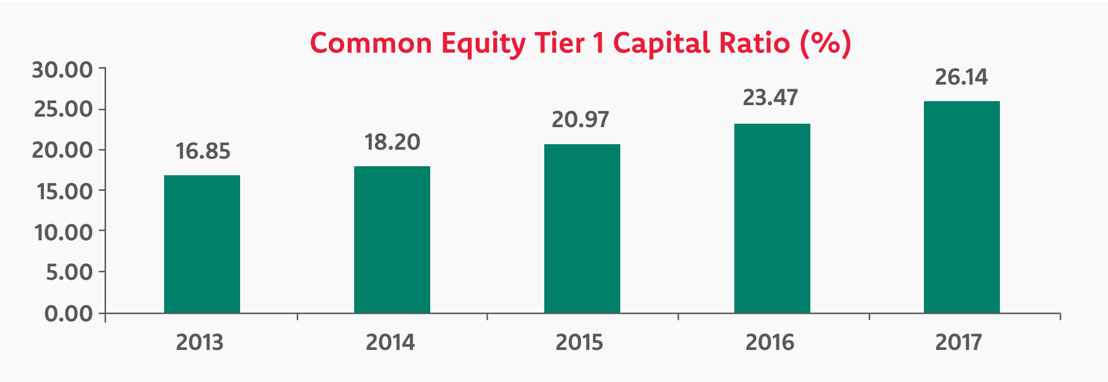
The group holds capital in both of the regulatory tiers: the group's general reserve qualifies as Common Equity Tier 1 capital, the very highest quality of capital. Under Basel III transitional rules, the PIBS qualify as Additional Tier 1 capital, but amortise on a straight line basis over eight years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

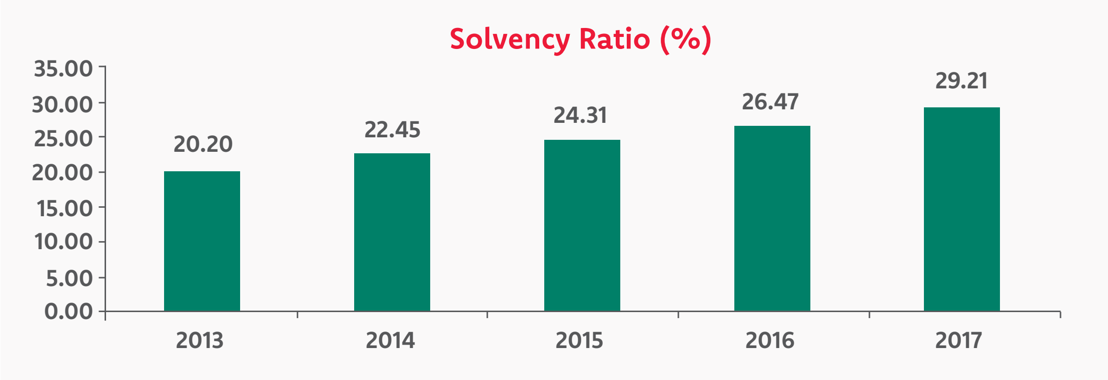
The group's primary measure in assessing capital adequacy is the Common Equity Tier 1 (CET1) ratio, which expresses the highest quality capital as a proportion of the sum of the risk weighted assets of the group. The risk weighting for each asset is calculated either through the use of internal models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

The group's CET1 ratio has increased to 26.14% (2016: 23.47%) due to the impact of the increased capital generated by the profitability in the year combined with a decrease in total risk weighted assets associated with the de-risking of the commercial portfolio and the run-off of the Nemo portfolio. This means 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 29.21% (2016: 26.47%).

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 5.32% (2016: 5.47%).





Anti-Corruption and Anti-Bribery matters

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

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

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

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

Member, Colleague and Community

Member, Colleague and Community are the subject of a separate report on pages 24 to 28, which includes further detail in respect of the Employee Engagement score on page 28.

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 46 to 57.

Tom Denman
Chief Financial Officer
6 February 2018

Member, Colleague and Community

for the year ended 31 December 2017

Member

We pride ourselves on listening to our Members so colleagues can understand how to meet their needs and expectations. Our Members often tell the Society that they value the friendliness and helpfulness of our colleagues. We reward colleagues for providing great service to our Members, and encourage the sharing of experience and expertise with others.

By opening up a savings account of £100 or more (and providing you are 18 years old or over) or taking out a mortgage with us, you become a Member of the Society.

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

Talkback events

Our senior leadership team holds regular Talkback events all over Wales and the Borders which are open to all Members. The events give our Members the opportunity to ask our senior leadership teams questions about the way they run the Society and hear about the priorities of the Board.

Annual General Meeting (AGM)

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

Member Forum

The Member Forum is made up of six Members, who act as a collective voice for all Principality Members. They attend meetings on a quarterly basis to share their thoughts and tell us what they think of our products, initiatives and help us to make the right decisions for all our Members. To gather alternative forms of feedback we also use online surveys with the Customer Research Panel which consists of 7,400 Members and customers.

Net Promoter Score

To ensure we consistently deliver an excellent service to our Members we use a number of customer research surveys to track our Net Promoter Score. After a customer has interacted with us 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 Member 'How likely or unlikely would you be to recommend Principality to anyone?' following the service they recently experienced. The combined NPS score from all tracking surveys for 2017 is one of the highest in the industry at 74.8% (2016: 72.7%).

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

Member Rewards

Members tell us that spending time with their families and friends is what matters to them the most. Our Member Rewards scheme is our way of saying thank you to all loyal Members. Members who sign up to Your Account online are able to receive benefits from us.

They can start enjoying exclusive benefits, including:

- Priority ticket access to selected events at Principality Stadium.
- 15% discount at the Welsh Rugby Union online shop.
- Exclusive competitions to music and sporting events.
- Automatic entry into all of our prize draws.

More than 12,000 Members have registered, with more than 1,500 benefitting from prizes for events held at the stadium. We've also supported events in North Wales including the sold out National Eisteddfod evening concerts.

Pictured: Left: Young prize winners receiving their signed Wales Rugby jersey at the Principality's stand at the National Eisteddfod.

Above: Principality's Llanelli Branch Manager Jeremy Evans providing the Strade School (Llanelli) Athletics Team with new kits.

Pictured: Right: One of our Members pictured with Wales rugby star Dan Lydiate at Principality's Annual General Meeting 2017.

Pictured: Above: Branch staff celebrating the opening of Principality's new Newport branch.

Sponsorship and partnership

Supporting the prosperity of the communities where our Members live and work across Wales and the Borders is important to us. We've sponsored the Principality Rugby Premiership since 2005. Our aim was to help the WRU to increase the profile of grass roots rugby and to bring communities together.

Our partnership with the Only Boys Aloud Charity began in 2010. This project builds skills and self-confidence among teenage boys across Wales. We now support all 14 choirs in Wales.

We've also developed strong relationships with our rural communities at the Royal Welsh Show as well as sponsoring the National Farmers' Union's Woman Farmer of the Year. We have sponsored the National Eisteddfod for 38 consecutive years, a record of which we are very proud, as people of all backgrounds celebrate Welsh language and culture.

Corporate social responsibility

Our Corporate Social Responsibility policy aims to position the Society's community activities closely with our purpose which is to help people prosper at every stage of their lives. The themes included helping people get a home and stay in their homes for longer, and health and wellbeing by helping them to spend more time with loved ones. We also place a big focus on financial education which will help prepare younger generations to save for the things that matter to them, such as getting their first home. Throughout 2017 we have proudly been working to bring these themes to life with new partnerships and initiatives.

- 3,500 pupils supported through the Business Class educational partnerships across Wales.

- 18 Principality Achievement Awards have been awarded to school children for community and academic achievements.

- 1, 000 hours of colleague volunteering completed – helping local communities (including volunteering at Foodbanks and helping at the DIY SOS Big Build for Children in Need).

- £134,000 fundraised for charity partners (which includes a matched amount of £57,000).

- 276 tickets have been provided to Principality's charity and educational partners for events at Principality Stadium.

- Over 130 community groups/projects have been supported with a combined investment of over £90,000.

Financial education

Principality is committed to building the financial skills of young people and this year has been a remarkable one in which our colleagues demonstrated all the values which capture what the Society is about. More than 3,500 school children have benefited from either financial education or careers based support through our Business Class school partnerships, all across Wales. The Business Class programme which is run by Careers Wales and Business in the Community on behalf of Welsh Government, teams up schools with businesses for a three-year support period.

A major success story was at Tonypandy Community College where we sponsored 50 pupils to complete a level 2 online qualification in personal finance. All 50 pupils achieved either an A* or A grade. We also recognised 18 secondary pupils with Principality Achievement Awards, for brilliant academic performance and positive contributions in the local community.

In November, Principality branch colleagues participated in Financial Capability Week all around Wales. They helped to deliver more than 40 lessons to more than 1,000 primary school children aged 5-11 in a week where we also partnered with Money Advice Service to launch their national research on financial education at Principality Stadium. It was another great example of how the Society and our colleagues have a great impact on the communities we serve.

Focus on digital skills

This year we have also teamed up with Aspire 2Be to run innovative digital and broadcasting training camps for young people called i-Broadcast, including Principality Stadium and Zip World Stadium in Colwyn Bay. The pupils from Ysgol y Strade, Llanishen High School, Bro Myrddin, Ysgol y Grango and Tonypandy Community College and their teachers learned about media interviews, sports commentary, sports analysis, and put together their very own panel shows. Many of the pupils or broadcast teams have gone back to their schools and have used their media skills to help promote sports and cultural events.

Helping out at the DIY SOS Big Build for Children in Need

In September, a team of Principality volunteers swapped their desks and branches for a day of volunteering as part of the DIY SOS Big Build for Children in Need. They helped with the build for the Roots Foundation in Swansea along with hundreds of other volunteers, specifically helping on the outside space. The Roots Foundation provides support for children in care and following the show they have a new learning space, self-contained accommodation and a beautiful garden. Colleagues even received help from Welsh Rugby Captain Alun Wyn Jones who came down to meet all the volunteers. Throughout 2017 colleagues invested more than 1,000 hours of volunteer time to help communities across Wales.

Colleague

Principality has a clear people strategy in place to deliver our aspiration of being the employer of choice for Wales, which will continue to support our growth strategy.

To achieve this, we are focusing on:

- Attracting, retaining, developing, rewarding and inspiring colleagues.

- Being recognised for equality, diversity and inclusion.

- Embedding the values and culture and ensuring high colleague engagement.

Our ambition is for our colleagues to give their best, putting great service to Members first. By doing this consistently, our aim is that our Members will recommend Principality to their friends and family.

Creating the right culture

Our people strategy seeks to promote a high performing organisation through our colleagues living the Society's values throughout their everyday interactions with one another and with our Members. Principality is 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.

The values and the way that our people behave, drive the culture of the organisation. Creating the right culture means having an organisation that people want to join and develop, which drives colleague satisfaction and, in turn, drives Member satisfaction.

The five values that underpin Principality's culture are:

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

Promoting diversity

We embed colleague diversity through our employment practices, policies and culture. The Society signed up to the Women in Financial Services Charter and we have set ourselves the target of having 33.3% of our senior managers as women by 2021.

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

	2017 Female (%)	2017 Male (%)	2016 Female (%)	2016 Male (%)
Directors (including Non-Executive Directors)	30.0%	70.0%	30.0%	70.0%
Senior Managers	20.0%	80.0%	19.0%	81.0%
Colleagues	62.0%	38.0%	65.0%	35.0%

Staff turnover, which measures how many colleagues are leaving of their own choice, has marginally reduced from 10.0% to 9.6%. A number of factors contribute to this outcome:

- Colleague engagement.
- Job satisfaction.
- A focus on developing leadership skills and capabilities.
- Personal development of colleagues to enhance their skills.

Principality 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

The Principality people strategy seeks to ensure that all employees feel connected to the business and understand the strategic direction and purpose in their everyday roles. Colleague surveys are an important way to listen to our colleagues, to find out how the Society is working together and to see how well it is building a first class service culture.

In October 2017 a total of 85% of Principality Colleagues completed the Great Place to Work survey. This survey showed that 81% of our colleagues feel that their Managers are available for support and 87% of colleagues are proud to work for us. This year we reached colleague engagement levels of 78%.

Rewarding colleagues fairly

Principality's 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 the business strategy.

In April 2017 new regulations were introduced around gender pay gap reporting, further information on this can be found within the Remuneration Committee Report on page 62.

Investing in talent to realise potential

Principality's people strategy seeks to build strong leadership and management capability whilst ensuring operational competence across the organisation.

The Society continues to undertake more direct recruitment than via third party agencies, placing a much higher value on cultural fit as well as skills and experience. Once colleagues successfully join, the induction programme runs for a full calendar year to ensure that all new starters feel fully supported in their new role.

Learning and development helps leaders and colleagues to develop their ability to provide the best customer service for Members. Both the Society and colleagues benefit from maximising the potential of its colleagues, so promotion from within and internal recruitment are strong aspects of the Society's culture with almost half of our vacancies throughout 2017 filled internally. We actively encourage secondments to enable people to experience other areas of the organisation and share their knowledge.

As we transform as a business, the role of leaders will be key to the delivery of long-term, sustainable results. Our leadership development team provides a core offering of workshops, designed specifically to support transformation and upskill leaders by presenting a clear picture of what a great leader is at every level of leadership throughout Principality.

In addition, we offer a wider selection of leadership development workshops and bespoke individual and team learning interventions, designed to transfer theory into practice.

Pictured: Left: Some of the Principality Commercial team at the Horizon site, Ogmore.

Right: Branch staff delivering a financial education session to primary school children.

Below: A member of staff playing financial education games with children at the Royal Welsh Show.

Slavery and Human Trafficking

for the year ended 31 December 2017

At Principality Building Society we fully support the introduction of the Modern Slavery Act 2015 and the way it encourages businesses to tackle issues around modern slavery.

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 Principality Building Society and its subsidiary business Nemo Personal Finance Limited (collectively "the Society") 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.

About Principality

Principality Building Society is the UK's sixth largest building society and collectively with Nemo Personal Finance Limited employs over 1,100 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 Society has in place 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 Society 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 Society. This commitment extends to the products, goods and services provided by suppliers.

It is important to the Society 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.

During 2017 we introduced a Supplier Code of Practice. We expect all suppliers to adhere to our Supplier Code of Practice. This code addressed a number of 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.

Our Whistleblowing Policy encourages an environment in which our colleagues can speak up confidentially about any concerns that they have, including any concerns which might relate to the occurrence of modern slavery. We take these incidents seriously and investigate any such reports.

Our supply chain risk

Our supply chain encompasses over 600 suppliers of goods and services. We purchase a wide variety of goods and services from the external market including professional services (such as conveyancing services), office consumables, corporate clothing and IT software. As the Society 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 Executive 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 Society monitors the content of those statements.

Due diligence processes for slavery and human trafficking

As part of the Society'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. If a supplier uncovers any concern about the incidence of modern slavery, we're committed to support them in tackling the problem, instead of simply stopping working with them. This approach, which encourages suppliers to actively find and resolve any modern slavery without the fear of losing our business, is consistent with the approach promoted by the Act.

Training

The Society 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 Society'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.

Governance and oversight

Governance and oversight in relation to procurement matters is provided by the Society's Operational Risk Committee. Senior managers with responsibility for managing supply chain risks attend a quarterly Supplier Management Forum which helps to ensure that a consistently high ethical standard is maintained across all procurement work. The Society's Secretary together with the Head of Procurement are responsible for monitoring industry developments and championing innovation within the Society to minimise the risk of modern slavery and human trafficking. This work is supported by the Executive team.

National living wage/low pay

The Society 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
6 February 2018

Section 2

Governance

Building your future

Laurence Philip Adams
MA

Chairman, Non-Executive Director

Age: 61

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.

As Chairman I am very aware of the important role that the Society plays within the communities which it serves and the importance of maintaining the trust and confidence of Members. I am responsible for leading the work of the Board, ensuring the Board operates effectively, ensuring that robust succession plans are in place, ensuring that the Society maintains the highest standards of corporate governance and a transparent and open culture.

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 Exane Limited.

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

Non-Executive Director

Age: 59

I joined the Board of Principality as a Non-Executive Director in October 2013. I now serve as Chairman of the Board's Customer and Conduct Committee. Since November 2017 I have re-joined the Board Risk Committee having stepped down as a member of the Audit Committee at that date.

I also serve as a member of the Governance and Nominations and Remuneration 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 Canal and 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.

Tom Denman
BSc (Econ) [Hons], ACA

Chief Financial Officer

Age: 43

I was appointed Chief Financial Officer on 1 June 2017 and joined the Board in August 2017. I have worked for the Society for eight years after joining in February 2009.

Initially I held a senior finance role in the subsidiary businesses and later for the Society covering business partnering, planning and strategy. I was appointed Deputy Finance Director in March 2016 with responsibility for all of finance, treasury operations, procurement and legal services. I chair the Asset and Liability Committee and am a member of Executive Committee and the Executive Risk Committee. I also attend all meetings of the Board Audit and Board Risk Committees.

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

I was born to Welsh parents in 1974 and after spending my childhood years in Germany where my parents were teachers, I returned to Wales to study at Cardiff University. After four years working in Australia I returned to Cardiff in 2004 and lived north of the city with my wife and two children. Sport plays a big part of my life and I juggle competing in triathlons with watching my son play football and rugby and my daughter compete in athletics!

My principal role as CFO is to ensure we plan and manage our capital, liquidity and funding in the long term interests of our Members.

Natalie Elphicke
LLB

Non-Executive Director

Age: 47

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

I am the Chief Executive of The Housing and 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 specialising in banking and finance, in particular housing finance. I was appointed an OBE in the Queen's Birthday Honours 2015 for services to housing. I am a Board member of the Student Loan Company and more recently I have become Chair of that organisation's Audit and Risk Committee. I also act as an independent member of the Audit and Risk Committee of the Department of Education.

At Principality, I chair the Board Risk Committee and also serve as a member of the Governance and Nominations Committee.

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

Julie-Ann Haines
MSC, BA [Hons]

Chief Customer Officer

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 Chief Customer Officer I am responsible for strategy, marketing, distribution and leading the Society's transformation programme as Executive Business Sponsor.

I am responsible for savings and mortgages as well as the Commercial Lending portfolio within the Society. My role is designed to ensure that the Society adapts to the fast-paced environment in which we operate, ensuring we have a business that meets the needs of our Members and customers through fantastic customer experience, a range of channels and products which help Members prosper at every stage of their life. As part of my role I am 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 Mortgage Committee, Cymru, for UK Finance which represents mortgage lenders and promotes sustainable housing finance in Wales. I also sit on the End Youth Homelessness Steering group, to ensure that young people in Wales have the support required in very challenging circumstances.

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.

Derek Anthony Howell
BSc [Hons], FCA

Senior Independent Non-Executive Director

Age: 63

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 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 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 PricewaterhouseCoopers (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.

Stephen Hughes
ACMA

Chief Executive Officer

Age: 45

I was appointed Chief Executive Officer in March 2017 which was a proud moment for me and my family. I joined the Society as Group Deputy Finance Director in December 2011 and was appointed to the Society's Board in March 2013 as Group Finance Director with responsibility for Finance, IT and Business Change.

I chair the Executive Committee and am a member of the Executive Risk Committee. I also attend all meetings of the Board, Audit, Customer and Conduct, Remuneration and Risk Committees. I am responsible for reporting to the Board on all aspects of the Society's strategy, performance, risk management and our people agenda. I am committed to ensuring that the Society adapts to the changing environment in which it operates, that we future proof our business for current and future generations of Members and create a great place to work, all of which will underpin our fantastic personal service to Members and customers.

I am a qualified Management Accountant and bring over 25 years' experience in finance from a range of industries including manufacturing, retail and insurance. Prior to joining the Society I performed the role of Finance Director of the Lloyds Banking Group General Insurance business. As CEO of Principality and as Chairman of the Wales Advisory Board for Business in the Community (BITC). 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. I believe in the mutual model, we are a Member owned organisation and I believe my role as CEO is to ensure we run the business in the long term interests of our Members. I am clear that our people are the organisation's greatest asset and I am committed to investing in our culture, leadership and talent development.

Robert Michael Jones
BA [Hons] MBA, ACIB

Chief Risk Officer

Age: 59

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

I have attended full Board meetings since September 2009 and attend all meetings of the Board Audit and Board Risk Committees. I am a member of the Executive Committee and chair the Executive Risk Committee. I also attend meetings of the Model Governance Committee and the Asset and Liability Committee.

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 Chief Financial Officer 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.

Sally Jones-Evans
FCIB, MSC, MBA

Non-Executive Director

Age: 51

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.

In addition with effect from 1 November 2017 I now serve as a member of the Society's Audit Committee. As Chair of the Remuneration Committee I am responsible for ensuring that the Society'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 believe that helps me to support the Executive Leadership team to shape the Society's ongoing change agenda. I am always impressed by the dedication and skills of our teams in 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. More recently I have become a board member of the Tearfund humanitarian and development organisation.

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: 54

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

In addition I am Chairman of Nemo Personal Finance Limited, a wholly owned subsidiary of Principality Building Society, and with effect from 1 November 2017 now serve as a member of the Customer and Conduct Committee.

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.

Corporate Governance Report

for the year ended 31 December 2017

Dear Member

As Chairman I am 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. As a mutually owned organisation the Board is answerable to the Society's Members. The Board is responsible for promoting the long term success of the Society which means it has a responsibility to act in the best interests of both current and future Members. This is why in the past year the Board has devoted a considerable amount of time overseeing the progress of the Society's on going transformation programme. This topic will continue to be an area of continued Board focus in 2018 and beyond. As Chairman I am responsible for ensuring that the Board operates effectively within a sound governance framework based on best practice. So we seek to adhere to the UK Corporate Governance Code (the Code) issued by the Financial Reporting Council in so far as its provisions are relevant to building societies. Aspiring to the highest standards of corporate governance helps us to protect the interests of our Members.

The Board is committed to and proud of the Society's mutual status and proactively works to balance Member interests with those of other stakeholder groups such as the communities 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. The Chief Executive Officer 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 proper conduct of all aspects of the Society's affairs;
- Fostering transparency and honesty and ensuring that good standards of behaviour permeate throughout all levels of the organisation;
- Ensuring the sustainability of the Society's business model; and
- Maintaining a sound system of control and setting the Society's appetite for risk. The Board delegates the responsibility for monitoring performance against appetite to the Board Risk Committee. The Board delegates responsibility for reviewing the adequacy and effectiveness of the Society's internal controls to the Audit Committee.

Corporate governance framework

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

Chairman: Laurence Adams

Responsible for setting the Board's agenda, leading the Board and ensuring the Board's effectiveness.

Group Board: 10 Directors

Responsible for the overall conduct of the Society's businesses and setting strategy.

Governance and Nominations Committee
CHAIRMAN: Laurence Adams

Board Risk Committee
CHAIRMAN: Natalie Elphicke

Audit Committee
CHAIRMAN: Derek Howell

Customer and Conduct Committee
CHAIRMAN: Nigel Annett

Remuneration Committee
CHAIRMAN: Sally Jones-Evans

CHIEF EXECUTIVE OFFICER: Stephen Hughes

Nemo Personal Finance

Executive Committee

How the Board operates

At 31 December 2017, the Board comprised six Non-Executive Directors and four Executive Directors. The offices of Chairman and Chief Executive Officer are separate and held by different individuals. In accordance with the Code all Directors stood for election or re-election in 2017 and were duly elected or re-elected. All Directors will again stand for election or re-election at the 2018 Annual General Meeting.

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

As Chairman I am not involved in the day-to-day management of the Society. My role profile is subject to review and approval by the Board. The Senior Independent Director (Derek Howell) is responsible for acting as a sounding board for me as Chairman. He also serves 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, Chief Executive Officer or other Executive Directors or for which such contact is inappropriate. The Chief Executive's responsibilities are set out in a role profile which is again approved by the Board. He is responsible for managing the day to day operation of the Society, implementing the Board approved strategy and policies, and chairing the Executive Committee. He maintains a close working relationship with me as Chairman.

The Board discharges some of its duties directly and delegates certain responsibilities to its Committees to assist it in carrying out its function of ensuring independent oversight. The Board focuses its work on setting the longer term strategic direction of the Society, challenging the performance of the Senior Management Team in the day to day management and control of the business, monitoring adherence to the Board agreed risk appetite limits and the maintenance of effective risk management systems. Performance against key performance indicators (KPIs) and key risk indicators (KRIs) is reviewed at each Board meeting. The Chief Executive Officer, Chief Financial Officer, Chief Customer Officer and Chief Risk Officer report on performance and risk matters at each Board meeting. The Board also receives regular reports from Non-Executive Directors on Member and colleague engagement activities.

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

Responsibility: Strategy and Performance
Key Activity: The Board has reviewed the Society's strategy and remains committed to continuing to focus on delivering an improved proposition for Members across both the retail savings and mortgage product lines.
Responsibility: People, Culture and Remuneration
Key Activity: The Board has continued to support the work being taken forward by the Executive to put in place a more modern working environment and to develop a culture where Diversity and Inclusion is fully embedded where everyone, regardless of background, is able to fulfil their potential.
Responsibility: Members and Customers
Key Activity: The Board has continued to receive regular reports from Non-Executive Directors on attendance at Member Talkback and Member Forum meetings.
Responsibility: Risk Management
Key Activity: The Board has continued to oversee the setting of the Society's appetite for risk and the implementation of an Enterprise Wide Risk Management Framework.
Responsibility: Finance
Key Activity: The Board approved the completion of a further RMBS issue and the issue of a senior unsecured bond during the year as part of the diversified funding strategy.
Responsibility: Technology and Change
Key Activity: The Board has previously recognised the need to invest to modernise the business in order to respond to an increasingly competitive operating environment, to adapt to new/changing technology and changes in customer behaviour. The Board has agreed a five year investment programme which will allow the Society to modernise and develop the product proposition for Members whilst creating more flexibility to accommodate future change.
Responsibility: Governance
Key Activity: The Board continues to receive an annual report on adherence and compliance with the Corporate Governance Code and continues to monitor and authorise Directors' outside interests.

The Board has a formal schedule of matters reserved for its decision which is reviewed annually.

To enable the Board to use its time effectively it maintains a scheduled forward programme of meetings and a rolling agenda. There is sufficient flexibility in the Board's programme to ensure that the Board can address emerging matters in a timely manner. A framework of delegated authority is in place, which extends to the Society's officers, management and management committees. During the year the Board also receives regular presentations from members of the Society's senior leadership team and Non-Executive Directors have the opportunity to meet and interact directly with members of that team throughout the year.

Board composition

The Board consists of ten Directors including the Chairman, five of whom are 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 Society'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 Chief Executive Officer and Executive Directors;
- Scrutinise and challenge operational performance;
- Assess the integrity of the financial information and controls;
- Assess the adequacy of the Society's risk management framework;
- Assess whether current and future resources are commensurate with future plans;
- Determine the broad policy for executive remuneration and the remuneration packages for Executive Director and the Chairman; and
- Be satisfied that an appropriate culture is in place.

During the year Graeme Yorston retired from the Board and was succeeded by Steve Hughes as Chief Executive Officer. Following an externally facilitated recruitment process using independent search consultants Tom Denman (formerly the Society's Deputy Finance Director) was appointed to the role of Chief Financial Officer in June 2017. He was subsequently appointed to the Board in August 2017. He will stand for election for the first time in accordance with the Society's Rules at the 2018 Annual General Meeting. Candidates to fill Non-Executive vacancies on the Board are sought in various ways, including through press advertisements and with the assistance of external search consultants. Candidates must meet the tests of fitness and propriety as prescribed by the FCA and must receive approval from the 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 (AGM) 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 2017 AGM.

Membership of Board committees is reserved to Non-Executive Directors. As Chairman I am responsible for regularly reviewing and refreshing the membership of Board committees in order to broaden the experience of Non-Executive Directors. This is also an important aspect of the succession planning process. Executive Directors and members of the Senior Management Team continue to attend meetings of those committees as appropriate.

Tenure of Non-Executive Directors

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

	Date first joined the Board	Considered to be independent by the Board
Natalie Elphicke	July 2012	Yes
Nigel Annett	October 2013	Yes
Derek Howell	April 2014	Yes
Sally Jones-Evans	February 2015	Yes
David Rigney	March 2015	Yes

Directors' fitness and propriety

The Society has a framework in place to ensure that individuals appointed to relevant senior manager positions have the appropriate fitness and propriety to properly discharge their responsibilities both at the time of their appointment and during the tenure of their appointment. As Chairman, I am responsible for assessing the fitness and propriety of the Society's independent Non-Executive Directors and the Chief Executive Officer. Annual fit and proper assessments were carried out in respect of each independent Non-Executive Director and the Chief Executive Officer during the course of 2017. The Senior Independent Director is responsible for evaluating my own performance annually and did so during the course of 2017. He is also responsible for conducting the annual fit and proper assessment in my case.

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

The implementation in March 2016 of the Financial Conduct Authority and Prudential Regulatory Authority's Senior Managers and Certification Regime provided an opportunity to review the allocation of responsibilities, and ensure that individual accountabilities are allocated appropriately and are fully understood by those individuals within the business whose roles fall within the scope of the Senior Managers Regime. The Board continues to receive regular assurance on this topic from the Chief Risk Officer and his team.

Conflicts of interest

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

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

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

At the time of my appointment as Chairman, the Board was satisfied that I met the independent criteria. As Chairman I commit a substantial proportion of my time to the affairs of the Society and consequently I am not expected to remain independent following my 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.

In order to ensure that adequate time is devoted to Board business, the Board operates through a number of Board committees. The Board delegates a number of oversight activities to five committees – Audit, Remuneration, Governance and Nominations, Risk and Customer, and Conduct and receives regular reports from the Chair of each committee on the matters being considered by those committees. Each committee has written terms of reference which are reviewed annually. The terms of reference for all Board committees can be found on the Society's website: www.principality.co.uk

Board and committee membership and attendance

	Board	Audit	Customer and Conduct	Board Risk	Governance and Nominations	Remuneration
Laurence Adams	10/10	-	-	-	4/4	6/6
Natalie Elphicke	10/10	-	-	5/5	4/4	-
Nigel Annett	10/10	5/5	6/6	-	4/4	6/6
Derek Howell	10/10	6/6	-	5/5	4/4	-
Sally Jones-Evans	10/10	1/1	6/6	-	4/4	6/6
David Rigney	10/10	6/6	1/1	5/5	4/4	-
Graeme Yorston	2/2	-	-	-	-	-
Steve Hughes	10/10	-	-	-	-	-
Mike Jones	10/10	-	-	-	-	-
Julie-Ann Haines	10/10	-	-	-	-	-
Tom Denman	4/4	-	-	-	-	-

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 and better understand the priorities of the Society's Members. 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 HR, Compliance and Conduct and 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.

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

Board Information

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

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

Board induction and ongoing training programme

All new Non-Executive Directors receive extensive formal and tailored induction programmes to enable them to function effectively as a Board member as quickly as possible while developing an understanding of the Society's operations, culture and regulatory framework. The induction programme includes a series of meetings with both Executive and Non-Executive Directors and the Society's Secretary. As well as briefings from members of the Senior Management Team, new Non-Executive Directors also have the opportunity to attend key management meetings and to visit all key areas of the business.

The Society maintains a programme for meeting on going refresher training requirements. Keeping up to date with key business developments is essential in order that Non-Executive 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.

The Society's Secretary maintains an ongoing Board training and development programme and during 2017 the Board attended training on a wide ranging number of areas taking into account the current and emerging regulatory landscape. This training has been aligned to the Society's strategy and approach to risk management.

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 the final quarter of 2018. The last independently facilitated evaluation of the Board's own performance was completed in the final quarter of 2015. This work was undertaken by Lintstock Limited (a firm of specialist corporate advisors) who have no other relationship with the Society. The outcome of that review was reported on in the 2016 Annual Report. In the fourth quarter of 2016 an internally facilitated review of the Board's performance was undertaken. The main areas identified in the course of that review were as follows:

- Considering further whether the Board would benefit from appointing an additional Non-Executive Director with recent experience in the digital/IT areas;
- Assessing further how the Board operates as a team;
- Taking further forward the in-flight review of MI, governance and Board agendas;
- Re-assessing the content of Board Away Days to ensure an appropriate strategic and external focus is achieved; and
- Taking further steps to achieve greater visibility of Non-Executive Directors within the business.

Good progress has been made with work to address a number of these areas during 2017 with further work planned to take place in 2018.

A further internally facilitated review of the Board's own performance and of each Board Committee was commenced in the final quarter of 2017. The output from that work once assessed will contribute to the development of appropriate plans to address areas identified for improvement in quarter one 2018.

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 two Member Talkback sessions with groups of Members. These meetings were attended by a number of the Society's Executive and Non-Executive Directors. These meetings provide valuable means for Members' opinions about the Society to be canvassed directly by members of the Board.

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
6 February 2018

Pictured: Principality colleague with a Member at last year's AGM.

Report of the Governance and Nominations Committee

for the year ended 31 December 2017

As Chairman I am pleased to introduce the annual report on the work of the Governance and Nominations Committee. In 2017 the main activities of the Committee have been to oversee the appointment of a new Chief Financial Officer following the appointment of Steve Hughes to the role of Chief Executive Officer (in December 2016), agree a number of proposed changes to the composition of the Executive team and to make sure that overall the Board continues to have the right balance of skills, diversity and independence to enable it to operate effectively.

The Governance and Nominations Committee is responsible for oversight of the Board and Executive Management Succession Plan and making recommendations for new appointments to the Board. All Non-Executive Directors serve as members of the Committee. Although the Committee is made up solely of independent Non-Executive Directors, meetings of the Committee are also usually attended by the Chief Executive Officer, Chief People Officer and the Society's Secretary. The Committee meets on not less than three occasions each year.

During the year the Committee appointed Odgers Berndtson to lead the recruitment process which resulted in the appointment of the Society's new Chief Financial Officer. Odgers Berndtson have no other relationship with the Society.

The Committee is responsible for determining the skills and experience required to ensure that the Board is well placed to address the future needs of the business and for maintaining the Board and Executive Management Succession Plan. These plans are reviewed at least annually. The Board Skills Matrix is used to help evaluate candidates for Board appointments.

During 2017 the Committee met on four occasions and continues to monitor whether the existing complement of Non-Executive Directors is sufficient. In line with accepted good practice Natalie Elphicke will stand down from the Board in July 2018 having served six years on the Board. Consequently during the year the Committee commenced the process leading to the appointment of a new Non-Executive Director to fill that vacancy. The appointment process is designed to ensure that the Board collectively possesses the right range of skills and expertise to oversee the full range of business activities undertaken by the Society and brings appropriate objectivity and independent judgement. Accordingly the recruitment process is rigorous and involves the use of independent search consultants. All Board vacancies are advertised in the national press. All appointments are subject to extensive external checks and regulatory approval. All new Non-Executive Directors undergo a tailored and comprehensive induction programme on appointment.

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 could ultimately progress to Executive Committee and Board positions. The Executive Succession Plan encompasses potential succession to all senior roles including that of Chief Executive Officer and is regularly reviewed by the Executive Management Committee.

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

The Committee is responsible for monitoring progress with work to meet the gender diversity targets set out in the Board Diversity Policy and the wider target for gender diversity put in place by the Board on agreeing to support the Women in Financial Services Charter. In September 2016 the Board agreed to establish a five year diversity target of having 33.3% of our senior managers as women by 2021, alongside a minimum floor threshold at 25.0%.

At 31 December 2017 30% of Board members were women. The Society continues to make good progress with wider work to address equality, diversity and inclusivity particularly in relation to raising awareness of these issues and through providing appropriate training for colleagues. The table below shows the ratio of women to men in senior management positions within the Society over the period 1 January 2017 to 31 December 2017:

Diversity Target Ratio (Sept 2021)	Ratio as at 01.01.17	Ratio as at 31.12.17
33.3%	23.1%	23.5%

Laurence Philip Adams
Chair of the Governance and Nominations Committee
6 February 2018

Risk Management Report

for the year ended 31 December 2017

Risk overview

In executing the Society's strategy and in undertaking day-to-day business, the Society is exposed to a diverse range of risks. The Society 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 Society's strategy. The Society addresses these risks by:

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

The three lines of defence

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

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

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

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

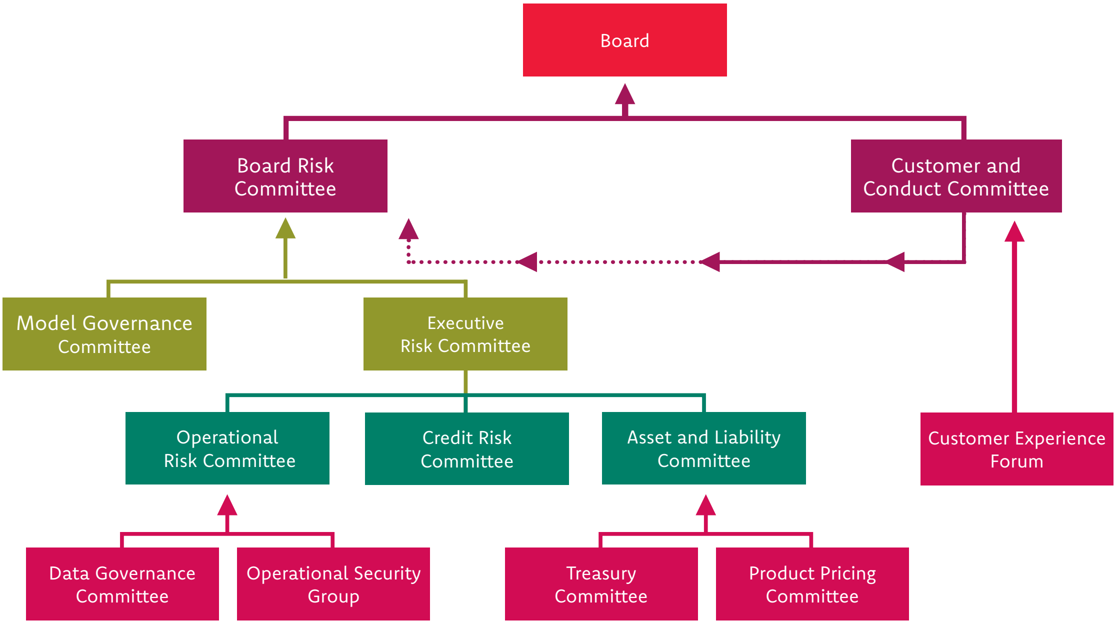
Risk management and governance

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

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

- **Board Risk Committee (BRC)** is chaired by a Non-Executive Director, and has responsibility for ensuring a Society-wide coordinated approach towards the oversight and management of Principal risks.
- **Executive Risk Committee (ERC)** is chaired by the Chief Risk Officer and is responsible for oversight of all prudential and conduct risks across the Society and monitoring and reviewing risk exposures.
- **Model Governance Committee (MGC)** is chaired by the Chief Financial Officer and is responsible for the approval and oversight of models used by the Society to assess and quantify exposure to credit risk.
- **Credit Risk Committee (CRC)** is chaired by the Head of Credit Risk and is responsible for monitoring and reviewing exposure to credit risks in the Society's retail and commercial loan portfolios.
- **Asset and Liability Committee (ALCO)** is chaired by the Chief Financial Officer 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.
- **Operational Risk Committee (ORC)** is chaired by the Head of Customer Oversight 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 ORC 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 Society's Business Conduct framework and strategy. Key conduct risks are reviewed by the Committee and reported to the Board Risk Committee.



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

The Society's Internal Audit function provides independent assurance regarding the activities of the strategic business units and the specialist functions across the Society and reports on the effectiveness of the control environment to the Audit Committee on a quarterly basis. The GRC monitors the arrangements for assessing risk inherent in the Society's business activities on behalf of the Board which 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 macro-economic environment, changes in regulation, competitor strategy, customer preferences and emerging technology.

Enterprise Risk Management Framework

During the year the Society enhanced its existing risk management framework, migrating to a business wide Enterprise Risk Management Framework (ERMF). The primary purpose of the ERMF is to set out the Board's approach to managing risk and the provision of oversight by defining and documenting the Society's purpose and objectives; risk appetite and risk tolerance; governance and control systems; linked to the principles upon which the framework is based.

The focus in 2018 will be the ongoing development of the ERMF, taking account of emerging best practice, regulatory guidance and policy. The Society's approach to how it controls and manages risks is set out in the sections that follow.

Risk appetite

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

- Identify and define the types and levels of risks it is willing to accept both qualitatively and quantitatively in pursuit of strategic goals; and
- Establish a framework for business decision making.

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

Risk culture

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

Stress testing and planning

The Society engages in thorough stress testing, scenario analysis and contingency planning programmes, allowing it to understand the impact of remote but potentially severe risks and to ensure it remains resilient. This includes a range of Society-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 Society's risk appetite. Outputs from stress testing are used to inform capital and liquidity appetite and planning, articulate potential management actions within contingency plans, and further improve the management of the Society's risk profile.

The Internal Capital Adequacy Assessment Process (ICAAP) is the Society'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 Society. As part of that process, the ICAAP assesses capital requirements both against the Society'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 Society'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 by the Prudential Regulation Authority (PRA). In addition the Society undertakes its own stress tests and sets limits on these which tend to extend beyond minimum regulatory requirements.

Reverse stress testing is a key component of the Society's existing stress testing framework considering extreme events that could result in failure of the Society. As such it complements the existing ICAAP and ILAAP processes, helping to improve risk identification and risk management more generally. A qualitative approach is used to explore potential scenarios which, if crystallised, could have the capacity to result in failure of the Society. 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 are sufficiently plausible to necessitate a change to the Society'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 both the risk and impact of failure on the wider economy. The recovery plan outlines the steps the Society 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 Society's affairs, in the event that recovery cannot be achieved. The process of preparation for such extreme events enables the Board to plan actions it would take to recover from adverse conditions which would otherwise lead to failure. The recovery plan represents a 'menu of options' for the Society to deal with firm-specific or market-wide stresses and which can be incorporated into a credible and executable plan.

Assessment of current threats

The Society's exposure to current and emerging risks is closely tracked through the formal risk governance structure. The Society continues to keep these risks under close observation through risk reporting and measuring performance against key risk indicators. The Society conducts regular horizon scanning activity to identify any new or emerging risks which could impact delivery of the Board's strategy, or threaten the long-term viability of the business. The Society 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 Society regularly reviews economic factors, including undertaking periodic assessments of how economic stresses might impact its business model. Factors including the UK vote to leave the EU, geopolitical tensions, and European and domestic political changes are considered. While the Society's business model means it has no direct exposure to the EU, should the UK leave the EU without a transitional agreement in place, the Society could be exposed to secondary impacts through:

- A possible deterioration in the UK economy accompanied by falling house prices. This could result in credit losses. In addition, a loss of public confidence in the UK economy could reduce the demand for new mortgage lending resulting in the Society's growth strategy becoming unachievable; and
- A loss of investor confidence could potentially lead to dislocation in wholesale markets and an increase in funding costs.

Whilst the Bank of England has raised the Base Rate, interest rates remain at a historically low level. The Board continues to monitor closely and discuss the impact of any change in interest rates, competitor activity, and associated risks on growth and margin. The announcement of the closure of the Bank of England's Term Funding Scheme (TFS) could increase competition in the retail and wholesale funding markets and thereby reduce the margin earned on the group's core products.

The Board continues to balance carefully affordability with credit supply to support Members, and monitors key indicators for customer affordability and credit losses as the value of real wages falls through higher levels of inflation.

Innovation and business resilience

The pace of technological development continues to create significant opportunities and risks for the financial services sector. The Society is exploring the possibility of adopting new technology to ensure that it can continue 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:

- Over recent years there has been a dramatic increase in the demand for digital products and services. This has seen an influx of innovative new product offerings in the market place and the number of new entrants to the financial services sector has increased. These changes may pose a challenge to the Society's core markets and product pricing. The Board continues to monitor the potential impact on the Society's business model, and continues to invest in its digital channels and payment technologies;

- 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, respond and recover from any threat or attack. In recognition of the cyber risk facing both the Society and the financial sector in general, the Society continues to focus its efforts on investing in appropriate technology, processes and controls;

- Payment Services Directive 2 (PSD2) will be transposed into UK law in January 2018 and will bring new payment service providers into the scope of regulation, open up access to payment accounts through authorised third parties, and require enhanced security and authentication measures. Whilst the Society does not currently offer payment accounts within the scope of PSD2, the way that customers choose to interact with their savings providers may change over time and the Society will need to ensure it is able to respond to changes in customer behaviour;

- The recent Competition and Markets Authority (CMA) retail banking market investigation concluded that older and larger banks do not have to compete hard enough for customers' business, and smaller and newer banks find it difficult to grow. This means that many people are paying more than they should for their banking activities and are not benefiting from new services. To tackle these problems, the CMA is implementing a wide-reaching package of reforms. One of the remedies is Open Banking. Open Banking is intended to allow personal customers and small businesses to share their data securely with other banks and third parties, allowing them to compare products on the basis of their own requirements and to manage their accounts without having to use their bank. This simpler approach to banking, along with PSD2, may result in significant shifts in customer behaviour away from traditional relationship-led banking arrangements to commoditised banking where the relationship is held with the third party Open Banking provider rather than the bank or building society itself; and

- The scale and pace of required change may outstrip the Society's capacity to achieve its transformation programme. This could create delivery challenges and may lead to disruption of the Society's operating environment and distribution strategy or require process enhancements on legacy systems. The Society continues to recruit and deploy experienced change management and IT resource to ensure that these risks are managed and mitigated.

Principal Risks

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

Credit risk
The risk that borrowers or counterparties do not meet their financial obligations to the Society as they fall due.
Market risk
The risk that the value of or income derived from the Society's assets and liabilities may change adversely as a result of changes in market prices, principally interest rates.
Liquidity and funding risk
The risk that the Society 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
The risk that the Society does not treat its customers fairly resulting in inappropriate or unfair outcomes.
Operational risk
The risk of loss arising from inadequate or failed internal processes, systems, human error or from external events.
Business risk
The risk arising from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, geographical, regulatory or other factors.
Solvency risk
The risk that the Society does not maintain a sufficient capital buffer in excess of minimum regulatory requirements.
Legal and regulatory risk
The risk that the Society does not comply with legislation and regulation.

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

Credit risk

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

Market background and uncertainties

The current global political and economic outlook remains uncertain. In addition ongoing Brexit negotiations further impact consumer sentiment which is starting to manifest itself in lower demand for housing and falling property values, particularly in the South East of England. High levels of Consumer Price Index (CPI) and relatively low wages growth is reducing real incomes, making mortgages less affordable for existing homeowners, and making those wishing to purchase their first home defer their plans. These factors pose a threat to longer-term prosperity in the UK. For that reason the Society's forecasts and plans continue to take account of scenarios that model stresses on the ability of customers and counterparties to meet their financial obligations. These stress factors include 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, 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 Society's lending strategy. The quality of individual lending decisions and subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the Society, have a direct impact on the achievement of the Society's strategy. Each of the four 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 working in each business area using credit risk management techniques adopted as part of the Society's overall approach to measure, mitigate and manage credit risk in a manner consistent with the risk appetite approved by the BRC 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 Society 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 CRC receives regular reports on the performance of retail credit risk portfolios with further oversight provided by the BRC. The Society assesses affordability using a stressed, higher interest rate to protect the borrower from entering into a mortgage commitment which could prove unsustainable in a higher interest rate environment.

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

Regular stress testing 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 Society continues to remain within its retail credit risk appetite. These stress tests primarily consider the impact of economic events on the probability of default and on house price movements.

The Society's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. The Society 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 the best outcome for the customer and the Society. Repossession of a property is only sought where all reasonable efforts to regularise matters have failed or the mortgage is unsustainable in the longer term.

Regular reviews of the Society's arrears management function and processes are independently undertaken to ensure that borrowers are being treated fairly, appropriately 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 a formal annual review. The Society remains cautious with regard to commercial lending which is undertaken on a prudent basis and where management continues the strategy of maintaining long term relationships whilst ensuring no overly significant exposure to single counterparties. 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 not only engage in extensive dialogue with customers and advisors but also enlist external professional support where required to ensure that the optimal approach is chosen taking account of the needs of all stakeholders.

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

Treasury credit risk

Treasury credit risk arises from the investments held by Society 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 Society'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 Society'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 Society is not able to meet its financial obligations as they fall due, or can do so only at excessive cost. Funding risk is the inability to access sources of funding or to do so only at excessive cost.

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

Market background and uncertainties

The Society has demonstrated a strong track record of being able to attract and retain retail funding. The external credit ratings held by the Society continue to support access to wholesale funding markets, with the ratings provided by Moody's having been upgraded by one notch to Baa2. In June, the Society issued a £475m Residential Mortgage Backed Security (RMBS), and £300m through our first unsecured issuance since 2006, to ensure continued diversity of funding.

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 provide participants with a cost effective source of funding in the form of central bank reserves to support additional lending to the real economy. The Society became a participant in the TFS in October 2016 and has drawn down a total of £500m from the Scheme.

In 2015, the PRA introduced 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 increased to 90% in January 2017. The requirement will be set at 100% from January 2018. The PRA 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. This was originally due for implementation from January 2018 but has been delayed by the PRA and European regulators. The revised implementation date has not yet been set.

Risk mitigation

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

The Board determines the level of liquid resources required to support the Society's strategy through undertaking an annual ILAAP as part of the development of the Society's Corporate Plan. Stress tests consider a range of severe but plausible scenarios and their impact on the Society, particularly with respect to retail saving outflows. The most recent ILAAP was approved by the Board in June 2017.

As at 31 December 2017 the Society held an LCR ratio well in excess of 100%. Based on current interpretations of the NSFR regulatory guidance, the Society held an NSFR ratio well in excess of the full 100% ratio requirement.

Market risk

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

The Treasury department is responsible for managing the Society's exposure to all aspects of market risk within the operational limits set out in the Society's Treasury Policies. Oversight is provided by the Treasury Committee, the Treasury Risk function, ALCO, and BRC 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 Chief Financial Officer covering significant issues dealt with by ALCO.

The Society'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 Society is exposed to interest rate risk, principally arising from the provision of fixed rate lending and savings products. The various interest rate features and maturity profiles for these products, and the use of wholesale funds to support their delivery, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments 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. This is referred to as basis risk. The basis risk on the Society's statement of financial position arises from administered rate liabilities, the pricing of which is influenced by competition for retail 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 Society 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 Society 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's expectation, and a view shared by many economists, is that rates will remain low but may rise slowly in the medium term. Any resulting increase in CPI materially above the Bank of England's own target, however, may necessitate a rate rise sooner in order to restore CPI to an acceptable level.

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

The Board believes that it has the necessary tools to manage a protracted low rate environment and the Society's 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 product related terms and conditions, offer procedures, and close analysis of the mortgage pipeline and early redemption behaviour. Derivative instruments are used to manage various aspects of interest rate risk including the net basis positions where appropriate.

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

Use of derivatives

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

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 Society's non-sterling funding. The majority of currency balances arise from transactions instigated by Society 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 Society as almost all transactions are conducted in sterling.

Conduct risk

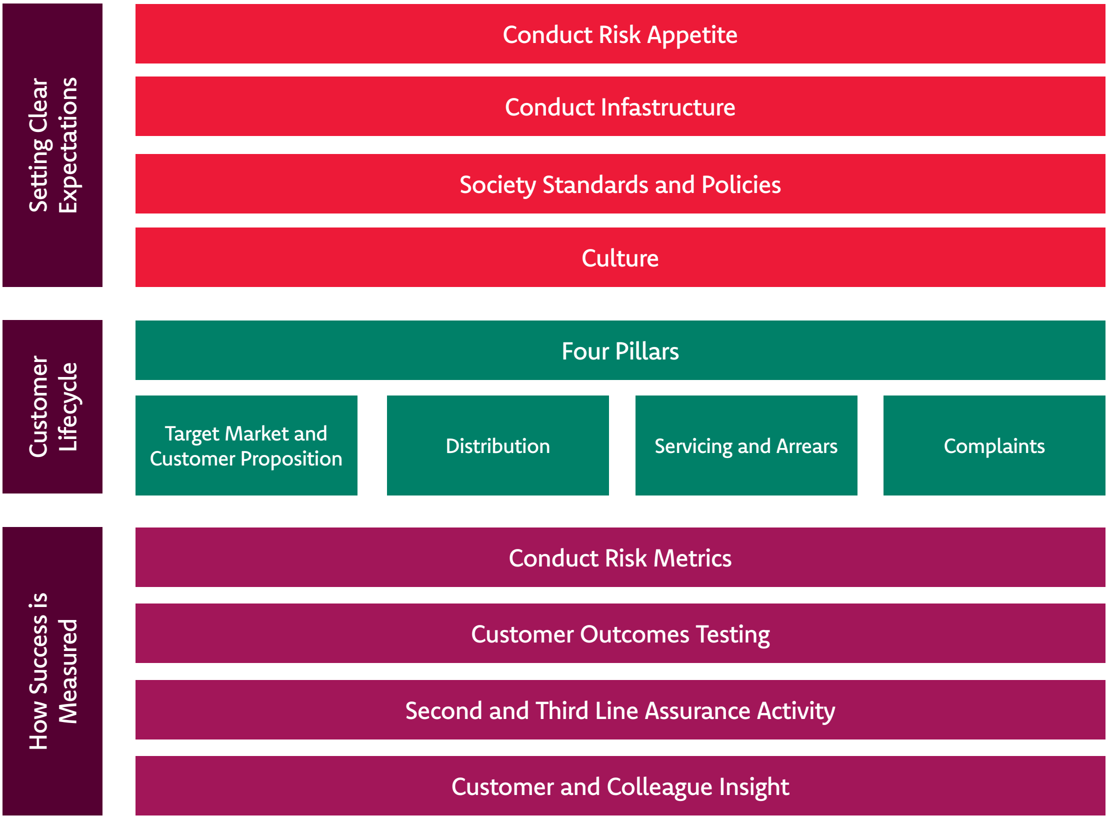
Conduct risk is the risk of the Society treating its customers unfairly resulting in the delivery of inappropriate outcomes.

Market background and uncertainties

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

Risk mitigation

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



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

The Society's Compliance and Conduct function advises on the management of conduct risks and oversees the effectiveness of controls in place to manage the risk of unfair customer outcomes. The Society'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 Society'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 management of conduct risk is measured in a variety of ways. Key conduct metrics which align to the Society's conduct risk appetite and the four pillars outlined on page 53, are reported on a monthly basis to key committees and the Board. In addition, outcome testing enables an assessment of the extent to which the Society is achieving its aim of consistently delivering fair outcomes for Members and customers. Regular feedback from Members and customers is also obtained.

Operational risk

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

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

Risk category	Brief definition
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.
Information and financial management	The risk of losses or reputational damage arising from the mismanagement of personal data, poor quality data, weak financial management or inadequate management information to support decision-making.
Infrastructure and resilience	The risk of loss arising from an inability to service customers and key stakeholders due to a cyber-attack, failure of operational IT infrastructure including the protection of information from unauthorised access, use, disclosure, modification or destruction.
People	The risk of failure to maintain and develop the appropriate level of skilled resource, maintain employee relations, provide a safe environment in line with legislative requirements and comply with ethical, diversity and discrimination laws.
Physical assets, safety and security	The risk of loss arising from the ownership, management and security of, and threats to, the property and facilities used in the Society.
Supplier and procurement	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 challenges arising from technological innovation, increased customer expectations and emerging regulatory standards. The sector as a whole has become exposed to increased levels of operational risk, with greater reliance placed upon the resilience and security of technology platforms and staff capability. Growing levels of financial and cyber-crime require the adoption of increasingly sophisticated anti-fraud controls. The Society recognises that the cyber threat remains a key industry concern and will continue to adopt additional controls in line with industry best practice. Notwithstanding recent and substantial investments by financial institutions in technological solutions aimed at combatting the more sophisticated financial crime and cyber threats, there is a continuing trend of financial deception targeting consumers directly. The Society continues to strengthen its control environment to protect those who are most vulnerable to financial abuse, and 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 Society's Enterprise Risk Management function is to ensure appropriate strategies are in place to manage and mitigate the risks that could impact the ability of the Society to achieve its strategy while protecting its reputation and the interests of its Members.

The Society manages its exposure to operational risk by assessing the nature of external incidents, information sharing with peer organisations and by the review of internal risk events analysed by the operational risk categories described above. In addition to any direct loss attributable to risks in these categories, the reputational impact of such an event may damage the Society leading to secondary impacts.

The Society's operational risk management framework sets out the strategy to identify, assess and manage operational risk, with senior management having responsibility for understanding the nature and extent of the impact on each business area and for embedding appropriate controls to mitigate those risks. The framework is updated periodically to take account of changes in business profile, new product development, the external operating environment and best practice guidance.

Oversight is provided by the ORC, and the assessment of the Society's exposure to operational risks is based on both quantitative and qualitative considerations. The Data Governance Committee provides specialist oversight in relation to this specific area of operational risk and reports directly to the ORC. The Operational Security Group provides specialist oversight in relation to operational decisions that affect the security of the Society's information, information systems and information assets.

The crystallisation of operational risks is captured through the recording of risk events including those which result in financial losses or near misses. The analysis of events is used to identify any potential systemic weaknesses in operational processes. The ICAAP includes a series of hypothetical scenarios designed to assess the ability of the Society to mitigate or withstand the impact of a range of operational failures. The scope and relevance of this analysis is reviewed not less than annually by the ORC, 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 Society considers strategic risk, the risk to delivering the Society's Corporate Plan, to be the principal business risk. Whilst all business areas are responsible for managing their own risks, management of strategic risk is primarily the responsibility of the Board and the BRC whose remit encompasses all risk categories on a Society-wide basis.

The management of strategic risk is intrinsically linked to the corporate planning and stress testing processes, 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 Society. 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 Society's business model.

Market background and uncertainties

In the short term, the Society 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 banking activities. Whilst the Society will continue to focus on efficiency and cost control through its Continuous Improvement Programme, cost pressures within the business will continue to arise from the pace and complexity of regulatory change, required levels of investment in technology and organic growth.

In the longer term, the Society acknowledges that in order to meet the needs of a more technologically demanding customer demographic, it must 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 in progress.

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.

The Society 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.

Legal and Regulatory risk

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

Market background and uncertainties

The Society's business model and strong Member focus ensures it is well placed to meet current and emerging requirements. The following matters pose potential risks to the achievement of the Society's goals:

- Unknown legacy conduct issues may emerge. Regulation relating to the fair treatment of Members and customers continues to be a focus for the financial services industry and the interpretation of fair treatment evolves over time or is influenced by developing case law;
- The regulatory landscape continues to evolve and may lead to as yet unidentified increased risks. As a customer and Member focused business operating in highly regulated markets, the Society is subject to complaints in the ordinary course of business. In addition, at a sector level, the incidence of regulatory reviews, challenges and investigations is increasing. Regulatory expectations in respect of conduct standards increase the risk of future sanctions, fines or customer redress; and

GOVERNANCE

- The General Data Protection Regulation (GDPR) is the most significant 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 the export of personal data from outside the EU. The primary objectives of the GDPR are to ensure individuals have control of their personal data, enhance privacy rights and to simplify the regulatory environment for businesses by unifying the regulation within the EU. The Information Commissioners' Office (ICO) has recommended that businesses should proceed with GDPR readiness in spite of the uncertainty arising as a consequence of the UK's departure from the EU. The main changes include:
  - Mandatory data breach notifications within 72 hours to the ICO;
  - 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;
  - Burden of proof on organisations to prove compliance; and
  - Fines for non-compliance up to 4% of worldwide turnover or €20m, whichever is the greater.

The Society will need to be compliant with the requirements of GDPR by May 2018 and our plans in this respect are well advanced.

Risk mitigation

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

Solvency risk and capital management

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

- A risk weighted capital requirement;
- A stress testing process to assess capital required to provide resilience against future adverse scenarios;
- A leverage ratio set in proportion to exposures regardless of their relative risk; and
- A minimum requirement for eligible liabilities and own funds (MREL) to be phased in by 2022.

Risk Weight Capital Requirements

In 2013 the Society obtained permission to use the Internal Ratings Based (IRB) approach for 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.

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

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

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

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

Leverage ratio

CRD IV introduces a non-risk based leverage ratio that is supplementary to the risk based capital requirements and was originally proposed as a 'backstop' measure. The calculation determines a ratio based on the relationship between Tier 1 capital and total exposures, including off-balance sheet items. The leverage ratio does not distinguish between unsecured and secured loans, nor recognise the ratio of loan to value of secured lending. A binding requirement is expected to be introduced at the EU level in 2018. The Society does not meet the asset size requirement of £50 billion of retail deposits to be captured in the scope of the UK leverage ratio framework.

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

Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

The Bank of England announced rules in November 2016 designed to manage the failure of banks and building societies in a more orderly and effective way. These represent one element of a series of wider reforms intended to prevent future taxpayer bail-outs in the UK.

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

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

To meet Basel III Pillar 3 requirements, the Society publishes further information about its exposures and its risk management procedures and policies. This will be published on the Society's website (www.principality.co.uk) in April 2018.

R.Michael Jones
Chief Risk Officer
6 February 2018

Report of the Audit Committee

for the year ended 31 December 2017

As Chairman of the Audit Committee I am pleased to be able to introduce the 2017 report on the work of the Audit Committee which contains the necessary disclosures required of the Audit Committee under the UK Corporate Governance Code. As in prior years the Committee has continued 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. In addition during the year the Committee has also focused on work being taken forward to prepare for the introduction of the IFRS 9 regime which takes effect from 1 January 2018.

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 2017. Nigel Annett served as a member of the Committee until October 2017 with Sally-Jones Evans joining the Committee in succession to him. As Chairman I am grateful to Nigel for the contribution he has made to the affairs of the Committee since becoming a member in 2016. All members of the Committee are independent Non-Executive Directors.

As Chairman I have recent and relevant experience as demanded by the Corporate Governance Code. David Rigney is a Chartered Management Accountant and Sally-Jones Evans has previous audit committee experience. As Chairman of the Committee I am 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 Chief Executive Officer, the Chief Financial Officer, the Chief Risk Officer, the Society's Secretary, the Chief Internal Auditor, and representatives of Deloitte, the external auditor, attend each meeting. Other relevant colleagues from across the business are also invited to attend meetings of the Committee in order to provide a deeper level of insight into key issues and developments. The Committee acts as an Audit Committee for both the Society and its subsidiary company business Nemo Personal Finance Limited.

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

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, the risk management framework, internal control systems 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 reported to 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 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 Chief Financial Officer outlining the basis on which it is reasonable for the group to continue to prepare its financial statements on a going concern basis and has continued to be satisfied that it is appropriate to consider the Viability Assessment over a three year planning horizon. As part of this process the Committee monitors closely the scale of off-balance sheet contingency funding available to the Society and has satisfied itself as to the quality of the assets in which 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**
  During the year the Committee has monitored the performance of the group's loan books closely. 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. The Committee continues to be satisfied that the scale of the provision recognised for this purpose is appropriate.

- **Financial Services Compensation Scheme levy**
  The Committee continues to give careful consideration to the methodologies used by management to identify relevant trigger events and assess the Society'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 consistent 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.

- **Carrying Value of Property Portfolio**
  The Committee concurred with management's judgement that an impairment to the carrying value of Principality House should be recognised.

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

Deloitte as the group's external auditor has reported on both the interim and year-end financial statements, and those reports were considered by the Committee prior to recommending approval of the financial statements to the Board. Deloitte has reported to the Committee on the work 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. The Committee is also responsible for considering the annual Management Letter prepared by Deloitte and has received reports from Management on progress with work to address findings set out in the Management Letter.

During the year the Committee has received regular reports from Management and the Society's external auditor 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; further detail on this can be found in note 1. 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 work undertaken by the Committee during the year has enabled it to be satisfied that the Society is well placed to complete the necessary transition.

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. As part of the reporting process the Chief Internal Auditor provides the Committee with a summary of the most significant matters being monitored by the Internal Audit team and items of thematic interest which warrant the Committee's attention.

The Committee is responsible for approving the annual 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 Chief Executive Officer 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 each of the Chief Internal Auditor and Deloitte during the year. In addition the Committee also monitors the effectiveness of the Internal Audit function. This work includes monitoring the progress of the Internal Audit team against the Audit Plan and reviewing progress with work to implement audit recommendations. During the year the Committee received an independent report on the effectiveness of the Internal Audit function and has reviewed the Internal Audit Charter.

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 Chief Financial Officer and members of his Senior Management Team. The Committee is satisfied that senior members of the Finance team are fully familiar with the fair, balanced and understandable requirement. Members of that team are responsible for the overall co-ordination, verification, detailed review and challenge of the content of the Annual Report itself. The Committee receives assurance from members of the Executive team that they consider the content for which they are responsible is fair, balanced and understandable. The Committee also receives an early draft of the Annual Report to enable Members of the Committee to conduct a timely review and challenge the content of the report. The Committee is committed to continually improving the transparency of reporting to Members.

Auditor independence

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

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 Finance team consider a number of relevant questions. The Committee conducts this evaluation without the auditor being present. Deloitte have been the external auditor for Principality Building Society for ten years. 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.

After serving a term of five years Matt Perkins of Deloitte retired as the audit engagement partner after the conclusion of the 2016 audit. He has been succeeded as audit engagement partner by Kieren Cooper who is responsible for leading the 2017 audit, following a successful re-tendering process during 2016.

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 was 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 £345k. Non-audit fees, mainly in relation to assurance services for wholesale funding issuances, were £80k.

Other matters

Following each Audit Committee meeting, the Chairman of the Audit Committee provides an oral update to the Society's Board on matters considered by the Committee. In addition, the Board receives a summary of the minutes of meetings of the Committee which sets out the principal matters considered by the Committee.

The Committee conducts an annual review of its own effectiveness, the results of which are 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, a review of its relationship with the Board and arrangements for reporting to Members on the work of the Committee. Members of the Committee receive training on current topics as appropriate in each year. In 2017 this included updates on future changes as a result of the transition to the IFRS 9 regime, regulatory themes and financial statement disclosures.

Derek Howell
Chair of the Audit Committee
6 February 2018

GOVERNANCE

Report of the Remuneration Committee

for the year ended 31 December 2017

I am pleased to present the Remuneration Committee report including detail of the Directors' and Non-Executives' pay for 2017. Our role as a committee is to ensure that all of our remuneration policies align with the Board-approved strategy to ensure that the business is run safely and successfully for our Members.

Change in Chief Executive

Last year Graeme Yorston announced his intention to retire as CEO. We are grateful for Graeme's successful leadership over the past five years. He leaves the Society in a strong position and in the careful stewardship of Steve Hughes, who was promoted to Chief Executive Officer from the role of Group Finance Director following a thorough recruitment process. Details of Graeme's leaving arrangement and the remuneration package for Steve are described in this report.

Arising from Steve's promotion, a second thorough recruitment process led to the appointment of Tom Denman as Chief Financial Officer. As Tom was appointed as a Board Director on 10 August 2017 his remuneration is reported here for the first time.

Performance in 2017

As you have read in other sections of this annual report, the Society's performance has been strong despite a challenging external environment. Assets and new lending have been grown successfully, profitability is strong, customer and Member feedback is very positive, and important steps have been taken to invest for the future of the Society over the coming years. This performance is reflected in the Directors' remuneration as shown in the table on page 65.

Variable pay

In 2017 our two variable pay schemes again operated; the Rewarding Excellence Award (a single scheme for all staff including Nemo colleagues) and the Long Term Incentive Plan (for Executive Directors and a small number of senior members of staff). These schemes are linked to financial and customer measures to align with Member interests. Details of these schemes are shown on pages 66 to 67. The awards made to Executive Directors under both schemes are shown in the tables on page 65.

As the long-term strength and safety of the Society is paramount to our strategy, initial risk 'gateways' are 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 have been made under both schemes. For our hard working staff this means an award of 12.0% of their salary to thank them for their considerable contribution to this success.

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
6 February 2018

Gender Pay Gap

In April 2017, new regulations were introduced which require all organisations with over 250 colleagues to report on their gender pay gap. Principality has to report on the mean hourly pay rate and mean bonus payment for both men and women, the median hourly pay rate and median bonus payments; the proportion of men and women who received a bonus payment; and the proportion of men and women in each of the pay quartiles.

There are more women than men working at Principality with 61% of colleagues being female and with more women than men in customer facing and office-based roles overall. Women make up the majority of three out of the four pay quartiles, although men make up the greatest proportion of the highest pay quartile, as shown below:

	Q1 (Lowest)	Q2	Q3	Q4 (Highest)
Men	22.05%	26.88%	44.09%	60.63%
Women	77.95%	73.12%	55.91%	39.37%

However, because there are more men than women in senior management (and therefore more highly paid) positions, when figures are calculated it shows that the average salary for men is at a higher level than women. Principality is aware that its gender pay gap is a result of its demographics rather than an equal pay issue. Policies and processes are in place that ensure roles are evaluated fairly and consistently with no gender bias and regular equal pay audits are carried out. Principality is committed to encouraging a more gender-balanced workforce at every level throughout the Society and is taking active steps to address this.

Principality's gender pay gap as at 5 April 2017 was:

Mean hourly pay gap – 31.33% and median hourly pay gap – 31.52%

Proportion of women that received a bonus payment – 93.70% and proportion of men – 93.16%

Mean bonus pay gap – 38.03% and median bonus pay gap – 32.24%

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 Long Term Incentive Plan (LTIP) scheme for senior executives rewards consistent performance over multiple years.

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

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

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

The Chairman and Non-Executive Directors are paid a fee for Board participation and additional fees for serving on Board committees. These fees are reviewed annually and in February 2017 the Board fees were increased by 2% in line with colleagues' basic pay increase. In November to address succession planning and provide continuing professional development, the membership of Non-Executives on Board committees was reviewed. As a consequence, the committee fees, which had not been assessed since 2011, were reviewed. Committee membership fees have been realigned and the Chair of Board Risk and Senior Independent Director fees have been increased. Overall, the cost of this review was 1.78% per annum.

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 business 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 2017's performance compared with 2016;
2. What the Executive Directors can earn for 2018; and
3. What the Chairman and the Non-Executive Directors were paid in 2017 compared with 2016.

What the Executive Directors earned for 2017's performance

The following table shows a single total figure of remuneration for the 2017 financial year for each of the Executive Directors and compares this figure to the prior year. In February 2017, 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 Business.

Steve Hughes' salary increased to £310,000 from 3 March 2017 when he assumed the role of Chief Executive Officer, reflecting his increased responsibilities in that role.

Tom Denman's salary increased to £190,000 from 10 August 2017 when he assumed the role of Chief Financial Officer, reflecting his increased responsibilities in that role.

Julie-Ann Haines' salary was also reviewed and was increased from 1 October 2017 to £220,000 reflecting her increased responsibilities in her new role of Chief Customer Officer.

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 2017 will be assessed over 2016 and 2017 's performance only.

Individual	Year	Salary and fees[1] £000	Benefits[2] £000	Pensions[3] £000	Annual variable pay £000	Total £000
Chief Executive Officer Steve Hughes	2017	300	14	45	114	473
	2016	250	12	37	94	393
Chief Financial Officer Tom Denman (from 10/08/17)	2017	75	4	11	27	117
	2016	n/a	n/a	n/a	n/a	n/a
Chief Risk Officer R Michael Jones	2017	244	12	37	n/a	293
	2016	239	12	36	n/a	287
Chief Customer Officer Julie-Ann Haines (from 01/05/16)	2017	215	12	32	82	341
	2016	131	7	20	49	207
Former Chief Executive Officer[7] Graeme Yorston (to 03/03/17)	2017	235	15	35	62	347
	2016	341	14	51	129	535

1. The review date for salary is 1 February 2017.
2. Benefits comprise a car allowance, life assurance, critical illness insurance and private medical insurance.
3. A cash allowance of equal value (15% of salary) may be taken in lieu of pension.
4. Awards under the variable pay schemes are non-pensionable.
5. The Chief Risk Officer, Chief Internal Auditor and Chief Compliance and Conduct Officer do not participate in the variable pay scheme.
6. Graeme Yorston was not required to work his full notice period. The above 2017 figures include a gross payment of £173k together with a cash allowance of £35k for pension, as pay in lieu of his contractual notice period.
7. Under the terms of his departure agreement, Graeme Yorston is entitled to receive awards under the 2016 Rewarding Excellence Award and Long Term Incentive Plan which will be pro-rated by reference to service. For 2017 the award will be £62k, which will be paid in February 2018. He is also entitled to receive further awards in 2018 and 2019 under the LTIP, calculated pro rata based on the Remuneration Committee award for those years.

How the annual variable pay for 2017 was calculated

The 2017 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 2017

Variable pay scheme target	Proportion of variable pay	Actual 2017 performance	Threshold	Target	Stretch	Award %
Group Profit before tax*	50%	£55.4m	£37.6m	£44.2m	£50.8m	6%
Customer Service Net Promoter Score	50%	74.8%	Below 65%	71%	74% or above	6%

Long Term Incentive Plan 2017

Variable pay scheme target	Proportion of variable pay	Actual 2017 performance	Threshold	Target	Stretch	Award %
Return on Assets	50%	0.48%	0.41%	0.43%	0.45%	14%
Net Promoter Score	50%	Top 19%ile	Below 60%ile	Top 25%ile	Top 15%ile	11.3%

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

What the Executive Directors can earn for 2018

Base salary

The Committee reviews the Executive Directors' base salaries on 1 February of each financial year, taking into account factors such as individual and corporate performance, an assessment of market conditions, and the salary increases applicable to other colleagues. For 2018, they have awarded a 2.0% increase, the same as to all other colleagues.

Following this review, the Executive Directors' 2018 salaries are:

- Steve Hughes - £316,200
- R Michael Jones - £248,960
- Tom Denman - £193,800
- Julie-Ann Haines - £224,400

Benefits

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

Pension

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

Annual variable pay

The all-colleague annual incentive plan, the Rewarding Excellence Award, will continue to operate from 1 January 2018. A summary is set out below:

Performance period	1 January 2018 to 31 December 2018
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 conditions	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 2019 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 2018 to 31 December 2020
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 conditions	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 on target performance 28% of salary for attaining highly stretching targets.
Duration	Three years – 2018 to 2020 inclusive.
Payment date	Subject to Audit and Remuneration Committee approval, in February 2021 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 Chief Risk Officer 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 2017.

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

No variable pay awards at the Society are pensionable.

Directors’ service contracts

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

The Chairman and Non-Executive Directors’ fees for 2017

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	
	2017 £000	2016 £000
Laurence Philip Adams	114	112
Nigel Annett CBE (Chair of Customer and Conduct Committee)	60	60
Natalie Elphicke OBE (Chair of Board Risk Committee)	52	53
Derek Howell (Chair of Audit Committee and Senior Independent Director)	70	69
Sally Jones-Evans (Chair of Remuneration Committee)	58	56
David Rigney (Chair of Nemo Board)	63	59
Total	417	409

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 2017

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 2017. 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 into the accounts to verify accuracy and consistency, including review by senior management; and
- 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 32 to 36.

During the year Tom Denman 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, Nigel Annett retired as a member of the Audit Committee and has become a member of the Board Risk Committee; Sally Jones-Evans has become a member of the Audit Committee; and David Rigney has become a member of the Customer and Conduct 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 28 April 2017 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 72-79, 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.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have elected to prepare the financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. The Directors are also 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 Society and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

So far as each Director is aware, there is no relevant audit information of which the Society's auditors are unaware. Each of the Directors, whose names and functions are listed in the Governance section on pages 32-36 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. These scenarios take into consideration the closure of the Bank of England's Term Funding Scheme (TFS) to drawdown in February 2018, the market repayment of those TFS facilities over time, and the associated impact on the availability and cost of funding.

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 11 to 23.

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 2017.

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

On behalf of the Board of Directors.

Laurence Philip Adams
Chairman

Section 3

Financial Statements

Building your future

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

for the year ended 31 December 2017

In our opinion the financial statements:

- **give a true and fair view of the state of the group's and the Society's affairs as at 31 December 2017 and of the group's and Society's income and expenditure for the year then ended;**
- **have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;**
- **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.**

We have audited the financial statements of Principality Building Society (the 'Society') and its subsidiaries (the 'group') which comprise:

- the Group and Society Income Statements;
- the Group and Society Statements of Comprehensive Income;
- the Group and Society Statements of Financial Position;
- the Group and Society Statements of Movements in 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.

Basis for opinion

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

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

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

Summary of our audit approach

Key audit matters	The key audit matters that we identified in the current year were: • Revenue Recognition • Loan Loss Provisioning • Defined benefit Pension Scheme Valuation Within this report, any new key audit matters are identified with and any key audit matters which are the same as the prior year are identified with
Materiality	The materiality that we used in the current year was £2,880,000 which was determined on the basis of 5% of income before tax as per the consolidated income statement.
Scoping	All material entities in the group are within our audit scope and audited to a local materiality for the purpose of individual entity reporting. Audit work to respond to the risks of material misstatement was performed directly by the group audit engagement team.
Significant changes in our approach	After an evaluation of the group's defined benefit pension scheme, its material nature and the finalisation of the scheme's triennial valuation report, we have identified the valuation of the group's defined benefit pension scheme as a new key audit matter. In addition, following their inception in the year, we have identified one new material entity to be in scope for the group audit: Friary No.4 Plc.

Conclusions relating to Principal risks, going concern and viability statement

We have reviewed the Directors' statement on page 70 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the group's and Society's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

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

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

- the disclosures on pages 49 to 56 that describe the Principal risks and explain how they are being managed or mitigated;
- the Directors' confirmation on pages 46 to 57 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 Directors' explanation on page 70 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 report, add or draw attention to in respect of these matters.

Basis for opinion

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

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

Revenue recognition	
Key audit matter description	The recognition of revenue on loans under IAS 39 requires the use of an effective interest rate method. Judgement is applied by management to determine key assumptions related to the behavioural life of each loan and the associated directly attributable cash flows (primarily fee and interest cash flows). Such assumptions are also sensitive to changes in the economic environment. Given the degree of judgement involved in determining key assumptions, we also identified that there is a potential for fraud risk through possible manipulation of this balance. The group held £21.4m of unamortised origination fees on the statement of financial position at year-end which is amortising over the behavioural lives of the associated loan books (2016: £11.2m). Management's associated accounting policies are detailed on page 87 to 96 with detail about judgements in applying accounting policies and critical accounting estimates on page 97 to 98. The corresponding area in the Audit Committee report is on pages 58-59.
How the scope of our audit responded to the key audit matter	We first obtained an understanding of management's processes and key controls around revenue recognition through discussions and walk-throughs. Following identification of the key controls, we evaluated the design and tested the implementation of such controls. We have challenged management's methodology around how reversionary interest cash flows have been incorporated into the effective interest rate model. This included assessment of the quantitative and qualitative factors for non-inclusion. We have reviewed the ongoing treatment of fees and charges arising on mortgages and the appropriateness of their inclusion or exclusion in the group's effective interest rate models.
Key observations	The results of our testing were satisfactory and the underlying methodology used for the calculation of EIR is considered materially accurate in the context of the accounting policies and the requirements of the relevant accounting standards. Our review and testing of the ongoing treatment of fees and charges did not identify any issues. Overall we consider the judgements applied by management are at the conservative end of a reasonable range.

Key audit matters (continued)

Loan loss provisioning	
Key audit matter description	The group held £30.3m of impairment provisions at year-end (2016: £45.4m) against total loans and advances to customers of £7,864.1m (2016: £7,703.9m). Determining impairment provisions against loan to customers is a judgemental area, requiring an estimate to be made of the losses incurred within the group's: • Residential mortgage book; • Commercial book; and • Secured personal lending book. Estimating these incurred losses requires judgement and estimation on assumptions relating to customer default rates, future property values, forced sale discounts and potential impairment indicators, all of which may be sensitive to changes in the economic environment. Specific commercial lending provisions are based on a case by case assessment for individual accounts considered to be in default. The remainder of losses that have been incurred but not yet reported are considered by a collective provision based on individually assessed credit risk factors. Residential mortgage and secured personal lending provisions are based predominantly on recent historical arrears behaviour. Additionally, management include overlays in these provisions to take into consideration additional impairment indicators, highlighted by credit bureau data, caused by excessive levels of indebtedness and bankruptcy. The group's loan loss provision balances are detailed within note 16. Management's associated accounting policies are detailed on pages 87 to 96 with detail about judgements in applying accounting policies and critical accounting estimates on pages 97-98.
How the scope of our audit responded to the key audit matter	We first obtained an understanding of management's processes for the group's loan loss provision balances, and evaluated the design, and tested the implementation and operating effectiveness of key internal controls in place. For the group's commercial book, we have undertaken detailed case reviews of accounts deemed to have defaulted. These case reviews have been carried out in conjunction with review of relevant committee minutes, as well as attendance at the group's provision forum. In addition, we have assessed the valuation of the underlying property collateral of selected cases using property valuation specialists. Following analysis performed by data analytics specialists, we have performed detailed file reviews of a sample of accounts across the book with potentially increased credit risk indicators not considered to be in default in order to obtain assurance over completeness of the group's specific provision. We challenged the value of the collective provision by independently developing a reasonable range using historical credit loss behaviour in the commercial book over varying emergence periods. For the group's residential mortgage and secured personal lending books, we have made an assessment of the collateral valuation techniques used by management to estimate an appropriate provision balance. In addition, we have tested the accuracy of the probabilities to default applied to the group's secured personal lending collective provision. We tested the completeness and accuracy of the data used to calculate management's overlays by independently obtaining credit bureau data and agreeing to management's calculations and recalculating the associated provisions. We challenged, through testing of experiential data and benchmarking, the appropriateness of management's key assumptions used in the impairment calculation. This included impairment trigger point, forced sale discount and likelihood of repossession. We reconciled each book to the general ledger and substantively tested a sample of loans to assess whether the data used in the provision calculation was complete and accurate.

Loan loss provisioning (continued)	
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. The judgements applied to determine the group's collective provision held against the commercial and secured personal lending book was considered to be at the conservative end of a reasonable range.

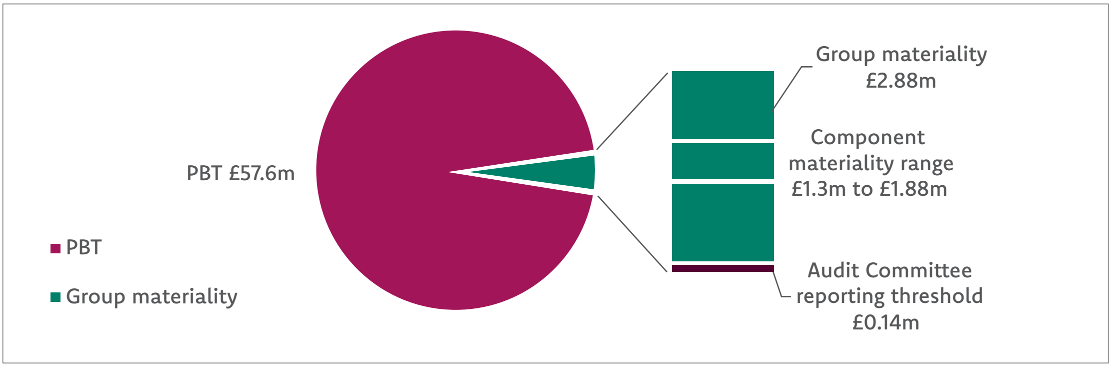
Defined benefit pension scheme valuation	
Key audit matter description	The group's defined benefit pension scheme obligations under IAS 19 Employee Benefits accounting requirements total £72.3m at year-end (2016: £73.4m). Defined benefit pension scheme liability valuations are highly sensitive to key assumptions such as discount rate, inflation, and mortality. The calculation of the group's obligations is carried out by the scheme's actuaries. However, management are responsible for the final key assumptions used within the calculation. Due to the complex nature in the derivation and estimation of such key estimates, this area can be subject to high levels of management judgement. Pension scheme balances are detailed within note 11. The Audit Committee's assessment of pension scheme valuation as a key area of judgement is detailed on page 59. Management's associated accounting policies are detailed on pages 87 to 96 with detail about judgements in applying accounting policies and critical accounting estimates on page 97-98.
How the scope of our audit responded to the key audit matter	Following an assessment of the processes in place for the pension scheme valuation within the group, and its links to the scheme's actuaries, we evaluated the design and tested the implementation of key internal controls identified in this area. We engaged our actuarial specialists to assess the financial and demographic assumptions used in the calculation of the scheme's obligation, reviewed the consistency in approach with prior years, and compared to benchmark assumptions being seen across peer pension scheme valuations. In addition, we assessed the competency of the scheme's actuaries who calculate the valuation of the obligation based on the key assumptions, as well as the relevant controls they have in place.
Key observations	We have found the underlying methodology used in estimating key assumptions to be reasonable. The approach used in derivation of key assumptions has be found to be consistent when compared to prior years, and benchmark at a mid-point within an appropriate range to peer pension scheme valuation assumptions. In our review, no issues have been identified in relation to the competency of the scheme's actuaries and their controls relevant to the calculation of the scheme's obligations.

Our application of materiality

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

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

	Group financial statements	Society financial statements
Group materiality	£2,880,000 (2016: £2,515,000)	£1,883,000 (2016: £1,402,850)
Basis for determining materiality	5% of income before tax (2016: 5%)	5% of income before tax (2016: 5%)
Rationale for the benchmark applied	The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the group to invest in activities for its Members. We have therefore selected profit before tax as the benchmark for determining materiality.	The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the Society to invest in activities for its Members. We have therefore selected profit before tax as the benchmark for determining materiality.



We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £144k (2016: £115k) for the group and £94k (2016: £100k) for the Society, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. This threshold is determined as 5% (2016: 5%) of materiality. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

All material entities in the group are within our audit scope and have been audited to a local materiality for the purpose of individual entity reporting. All balances in the group that are above our materiality threshold have been audited for the purpose of group reporting. We have performed testing over the consolidation of group entities. These audits were performed directly by the group audit team and executed at levels of materiality applicable to each individual entity which were lower than group materiality and ranged from £1,310,000 to £1,883,000 (2016: £880,000 to £2,001,000).

Other information

The Directors are responsible for the other information. The other information comprises the information included in the annual report including the Chairman's statement, the Group Chief Executive's review, the Strategic report, the Risk management report, the Corporate governance report, the Report of the Audit Committee, the Report of the Remuneration Committee and the Directors' report other than the financial statements and our auditor's report thereon.

We have nothing to report in respect of these matters.

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

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

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

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

- Fair, balanced and understandable – the statement given by the Directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for Members to assess the group's and Society's performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or
- Audit committee reporting – the section describing the work of the audit committee does not appropriately address matters communicated by us to the audit committee; or
- Directors' statement of compliance with the UK Corporate Governance Code – the parts of the Directors' statement relating to the Society's compliance with the UK Corporate Governance Code containing provisions specified for review do not properly disclose a departure from a relevant provision of the UK Corporate Governance Code.

Responsibilities of Directors

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

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

Auditor's responsibilities for the audit of the financial statements

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

Auditor's responsibilities for the audit of the financial statements (continued)

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

Use of our report

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

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Building Societies Act 1986

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

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

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

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

In our opinion the information given on page 71 for the financial year ended 31 December 2017 has been properly prepared, in all material respects, in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

Adequacy of explanations received and accounting records

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

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

We have nothing to report in respect of these matters.

Other matters

Audit tenure

Following the recommendation of the Audit Committee, we were appointed at the Annual General Meeting by the Members of the Society on 27 April 2007 to audit the financial statements for the year ending 31 December 2007 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 11 years, covering the years ending 31 December 2007 to 31 December 2017.

Consistency of the audit report with the additional report to the audit committee

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

K. J. Cooper

Kieren Cooper (Senior statutory auditor)
for and on behalf of Deloitte LLP Statutory Auditor
Cardiff, United Kingdom
6 February 2018

Consolidated income statement for the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Interest receivable and similar income	4	214.2	229.1
Interest payable and similar charges	5	(88.3)	(104.2)
Net interest income		**125.9**	**124.9**
Fees and commission receivable	6	7.1	9.0
Fees and commission payable		(1.0)	(0.9)
Net fee and commission income		**6.1**	**8.1**
Other operating income		1.4	1.6
Other fair value gains	7	4.3	1.6
Net operating income		137.7	136.2
Administrative expenses	8	(76.4)	(74.2)
Depreciation and amortisation	21 & 22	(13.2)	(7.9)
Operating expenses		**(89.6)**	**(82.1)**
Impairment provision release on loans and advances	18	10.0	2.7
Provision for other liabilities and charges	19	(0.5)	(6.5)
Operating profit and profit before taxation		57.6	50.3
Taxation expense	12	(14.1)	(11.2)
Profit for the year		43.5	39.1

Consolidated statement of other comprehensive income

	Notes	2017 £m	2016 £m
Profit for the year		43.5	39.1
Items that will not be reclassified subsequently to profit and loss:			
Actuarial (loss)/gain on retirement benefit obligations	11	-	(12.6)
Taxation	12	-	2.5
Items that may be reclassified subsequently to profit and loss:			
(Loss)/gain on available-for-sale assets		(1.9)	0.6
Taxation	12	0.4	(0.1)
Total comprehensive income for the year		42.0	29.5

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 87 to 96 form part of these accounts.

Income statement of the Society for the year ended 31 December 2017

	Notes	2017 £m	2016 £m
Interest receivable and similar income	4	195.6	205.7
Interest payable and similar charges	5	(88.3)	(104.0)
Net interest income		**107.3**	**101.7**
Fees and commission receivable	6	6.8	8.7
Fees and commission payable		(0.9)	(0.7)
Net fee and commission income		**5.9**	**8.0**
Other operating income		2.0	2.5
Other fair value gains	7	1.4	3.0
Net operating income		**116.6**	**115.2**
Administrative expenses	8	(71.7)	(64.9)
Depreciation and amortisation	21 & 22	(13.0)	(7.4)
Operating expenses		**(84.7)**	**(72.3)**
Impairment provision release on loans and advances	18	4.6	0.6
Provision for other liabilities and charges	19	1.0	(3.4)
Operating profit and profit before taxation		**37.5**	**40.1**
Taxation expense	12	(10.8)	(8.8)
Profit for the year		**26.7**	**31.3**

Statement of other comprehensive income of the Society

	Notes	2017 £m	2016 £m
Profit for the year		26.7	31.3
Items that will not be reclassified subsequently to profit and loss:			
Actuarial loss on retirement benefit obligations	11	-	(12.6)
Taxation	12	-	2.5
Items that may be reclassified subsequently to profit and loss:			
(Loss)/gain on available-for-sale assets		(1.9)	0.6
Taxation	12	0.4	(0.1)
Total comprehensive income for the year		**25.2**	**21.7**

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 87 to 96 form part of these accounts.

Consolidated statement of financial position as at 31 December 2017

	Notes	2017 £m	2016 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		1,026.3	585.7
Loans and advances to credit institutions	13	168.8	141.5
Debt securities	14	124.9	389.6
		1,320.0	1,116.8
Derivative financial instruments	15	29.6	30.4
Loans and advances to customers:			
Loans fully secured on residential property		7,582.4	6,766.7
Other loans		281.7	307.2
	16	7,864.1	7,073.9
Intangible fixed assets	21	0.8	1.3
Property, plant and equipment	22	32.7	44.5
Non current assets classified as held-for-sale	23	4.2	–
Deferred tax assets	28	3.5	4.4
Other assets		1.6	1.7
Prepayments and accrued income		6.1	8.2
Total assets		9,262.6	8,281.2
Liabilities			
Shares	24	6,563.8	6,165.2
Deposits and debt securities:			
Amounts owed to credit institutions	25	573.5	611.2
Amounts owed to other customers		216.7	226.5
Debt securities in issue	26	1,245.7	631.1
		2,035.9	1,468.8
Derivative financial instruments	15	29.2	45.7
Current tax liabilities		7.0	5.3
Other liabilities	27	6.9	6.8
Provisions for liabilities	19	6.1	7.1
Accruals and deferred income		17.5	18.8
Deferred tax liabilities	28	0.4	0.5
Retirement benefit obligations	11	8.9	15.3
Subscribed capital	29	66.5	69.3
Total liabilities		8,742.2	7,802.8
General reserve		519.3	476.0
Other reserves		1.1	2.4
Total equity and liabilities		9,262.6	8,281.2

The accounting policies and notes on pages 87 to 96 form part of these accounts. These accounts were approved by the Board on 6 February 2018.

Signed on behalf of the Board:

Laurence Philip Adams
Chairman

Steve Hughes
Chief Executive Officer

Tom Denman
Chief Financial Officer

Statement of financial position of the Society as at 31 December 2017

	Notes	2017 £m	2016 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		1,026.3	585.7
Loans and advances to credit institutions	13	61.4	62.1
Debt securities	14	124.9	389.6
		1,212.6	1,037.4
Derivative financial instruments	15	27.8	30.4
Loans and advances to customers:			
Loans fully secured on residential property		7,270.6	6,362.6
Other loans		281.7	307.2
	16	7,552.3	6,669.8
Investments in subsidiary undertakings	20	218.8	328.3
Intangible fixed assets	21	0.8	1.3
Property, plant and equipment	22	32.0	43.7
Non current assets classified as held-for-sale	23	4.2	-
Deferred tax assets	28	3.3	4.1
Other assets		1.5	1.4
Prepayments and accrued income		6.3	8.0
Total assets		**9,059.6**	**8,124.4**
Liabilities			
Shares	24	6,563.8	6,165.2
Deposits and debt securities:			
Amounts owed to credit institutions	25	1,398.8	1,148.8
Amounts owed to other customers		216.7	226.5
Debt securities in issue	26	313.6	15.6
		1,929.1	1,390.9
Derivative financial instruments	15	28.2	43.6
Current tax liabilities		5.3	4.3
Other liabilities	27	5.5	5.2
Provisions for liabilities	19	2.2	4.3
Accruals and deferred income		15.7	17.1
Deferred tax liabilities	28	0.4	0.5
Retirement benefit obligations	11	8.9	15.3
Subscribed capital	29	66.5	69.3
Total liabilities		8,625.6	7,715.7
General reserve		432.9	406.3
Other reserves		1.1	2.4
Total equity and liabilities		**9,059.6**	**8,124.4**

The accounting policies and notes on pages 87 to 96 form part of these accounts. These accounts were approved by the Board on 6 February 2018.

Signed on behalf of the Board:

C. P. Adams

Laurence Philip Adams
Chairman

Steve Hughes

Steve Hughes
Chief Executive Officer

TDenman

Tom Denman
Chief Financial Officer

Statement of changes in Members' interests for the year ended 31 December 2017

	2017			2016		
	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	476.0	2.4	478.4	447.4	1.6	449.0
Comprehensive income for the year	43.3	(1.3)	42.0	28.6	0.8	29.4
At 31 December	519.3	1.1	520.4	476.0	2.4	478.4
Society						
At 1 January	406.4	2.4	408.8	385.5	1.6	387.1
Comprehensive income for the year	26.5	(1.3)	25.2	20.9	0.8	21.7
At 31 December	432.9	1.1	434.0	406.4	2.4	408.8

Consolidated statement of cash flows for the year ended 31 December 2017

	2017 £m	2016 £m
Net cash inflow from operating activities (see below)	210.1	252.3
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(5.0)	(5.7)
Purchase of investment securities	(16.0)	(124.7)
Proceeds from sale and maturity of investment securities	278.8	173.4
Cash flows from financing activities		
Repayment of subordinated liabilities	–	(92.3)
Increase in cash and cash equivalents	467.9	203.0
Cash and cash equivalents at beginning of year	727.2	524.2
Cash and cash equivalents at end of year	**1,195.1**	**727.2**
Represented by:		
Cash and balances with the Bank of England	1,026.3	585.7
Loans and advances to credit institutions repayable on demand	168.8	141.5
	1,195.1	**727.2**
Net cash outflow from operating activities		
Profit before taxation	57.6	50.3
Adjusted for:		
Depreciation and amortisation	13.2	7.9
Charge on defined benefit scheme	0.3	0.1
Impairment release on loans and advances to customers	(10.0)	(2.7)
Change in fair values	11.1	(6.9)
Changes in net-operating assets		
Increase in loans and advances to customers	(806.8)	(513.8)
Decrease in other assets	0.1	1.1
Decrease/(increase) in prepayments and accrued income	2.1	(4.0)
Change in derivative financial instruments	(15.7)	5.3
Increase in shares	409.5	538.8
Increase in deposits and debt securities	568.8	179.7
Increase/(decrease) in other liabilities	0.1	(1.0)
(Decrease)/increase in provisions for liabilities	(0.9)	3.2
(Decrease)/increase in accruals and deferred income	(1.3)	7.1
Contributions paid into defined benefit scheme	(6.7)	(1.5)
Movement in subscribed capital	0.1	0.1
Taxation paid	(11.4)	(11.4)
	210.1	**252.3**

The group is required to maintain interest-free balances with the Bank of England which at 31 December 2017 amounted to £12.9m (2016: £11.9m).

Statement of cash flows of the Society for the year ended 31 December 2017

	2017 £m	2016 £m
Net cash inflow from operating activities (see below)	182.1	281.0
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(5.0)	(5.8)
Purchase of investment securities	(16.0)	(124.7)
Proceeds from sale and maturity of investment securities	278.8	173.4
Cash flows from financing activities		
Repayment of subordinated liabilities	–	(92.3)
Increase in cash and cash equivalents	439.9	231.6
Cash and cash equivalents at beginning of year	647.8	416.2
Cash and cash equivalents at end of year	1,087.7	647.8
Represented by:		
Cash and balances with the Bank of England	1,026.3	585.7
Loans and advances to credit institutions repayable on demand	61.4	62.1
	1,087.7	647.8
Net cash outflow from operating activities		
Profit before taxation	37.5	40.1
Adjusted for:		
Depreciation and amortisation	13.0	7.4
Charge on defned benefit scheme	0.3	0.1
Impairment release on loans and advances to customers	(4.6)	(0.6)
Change in fair values	11.1	(3.3)
Changes in net-operating assets		
Increase in loans and advances to customers	(904.3)	(629.1)
Decrease in loans to subsidiary companies	109.5	123.4
(Increase)/decrease in other assets	(0.1)	0.8
Decrease/(increase) in prepayments and accrued income	1.7	(4.3)
Change in derivative financial instruments	(12.7)	3.8
Increase in shares	409.5	538.8
Increase in deposits and debt securities	539.9	206.7
Increase/(decrease) in other liabilities	0.3	(1.6)
(Decrease)/increase in provisions for liabilities	(2.1)	1.6
(Decrease)/increase in accruals and deferred income	(1.4)	7.2
Contributions paid into defined benefit scheme	(6.7)	(1.5)
Movement in subscribed capital	0.1	0.1
Taxation paid	(8.9)	(8.8)
	182.1	281.0

Notes to the accounts for the year ended 31 December 2017

1. Accounting policies

Basis of preparation

The group and Society's financial statements for the year ended 31 December 2017 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 70, 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 an expected loss impairment model. Based on an analysis of the group's financial assets and financial liabilities as at 31 December 2017, the Directors of the Society have assessed the impact of IFRS 9 to the group's consolidated financial statements as follows:	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.	
	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 2017

Pronouncement	Nature of Change	Effective Date
IFRS 9 Financial Instruments (continued)	**Impairment** IFRS 9 outlines a three stage model for impairment based on changes in credit quality since initial recognition. Each stage represents a change in the credit risk of a financial instrument since origination. Credit Risk is measured using probability of default (PD), exposure at default (EAD) and loss given default (LGD). If a significant increase in credit risk (SICR) since initial recognition is identified, the financial instrument is moved from stage 1 to stage 2 but is not yet deemed to be credit impaired; financial instruments that are deemed to be credit impaired are moved to stage 3. Financial instruments in stage 1 have their expected credit loss (ECL) measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible within the next 12 months. Financial instruments in stages 2 or 3 have their ECL measured based on expected credit losses on a lifetime basis.	Accounting periods beginning on or after 1 January 2018
	Significant Increase in Credit Risk **Retail Financial Services and Secured Personal Lending** There are three main components to the staging criteria for the portfolio. In order to move from stage 1 to stage 2 a loan is required to meet at least one of the following criteria: 1. Forbearance activity; 2. PD grade deterioration over a predetermined threshold; and 3. 30 days past due. Loans will move from stage 2 to stage 3 when they are credit impaired. Loans are considered to be credit impaired if they are 90 days past due or the Society considers that the borrower is unlikely to pay its credit obligations in full.	
	Commercial Lending There are two main components to the Commercial Lending staging criteria. In order to move from stage 1 to stage 2 a loan is required to meet at least one of the following criteria: 1. Risk grade deterioration; and 2. 30 days past due. Forbearance is included within the Commercial Lending impairment model although does not automatically trigger a stage movement. Loans will move from stage 2 to stage 3 when they are credit impaired. Loans are considered to be credit impaired if they are 90 days past due or the borrower's risk grade has increased beyond a predetermined threshold.	

Notes to the accounts for the year ended 31 December 2017

1. Accounting policies

Basis of preparation

Pronouncement	Nature of Change	Effective Date
IFRS 9 Financial Instruments (continued)	**Expected Credit Loss Models** **Retail Financial Services and Secured Personal Lending** Expected credit losses are the discounted product of the Probability of Default (PD), Exposure at Default (EAD), and Loss Given Default (LGD), defined as follows: • PD is calculated via a behavioural scorecard approach. This is calculated using internal account level specific data including arrears history and external credit profile data provided by external credit reference agencies. • EAD is based on the amounts the group expects to be owed at the time of default. • LGD represents the group's expectation of the extent of loss on defaulted exposures. Material judgements included within the Retail Financial Services and Secured Personal Lending IFRS 9 model include PD, staging and possession given default. Material judgements will be reviewed on an ongoing basis as part of the IFRS 9 model governance process.	Accounting periods beginning on or after 1 January 2018
	Commercial Lending • Commercial Lending PDs are based on defined risk grading methodologies, which are based on a combination of qualitative and quantitative measures including forward looking factors. • EAD is based on the amounts the group expects to be owed at the time of default. • LGD represents the group's expectation of the extent of loss on defaulted exposures. Material judgements included within the Commercial Lending IFRS 9 model are PD and staging. Material judgements will be reviewed on an ongoing basis as part of the IFRS 9 model governance process.	
	Forward-looking information in the ECL models The assessment of SICR and the calculation of ECL both incorporate forward looking information. The group has performed historical analysis and identified the economic variables impacting credit risk and expected credit losses for each portfolio. Forecasts of these economic variables together with probability weightings are supplied by an external provider and reviewed by management. Five different economic scenarios have been selected taking account of a range of possible economic outcomes. Management will also add overlays to model outputs when considered reasonable and supportable. The five scenarios consist of a base case scenario, one upturn scenario and three downturn scenarios of varying severity.	

Estimated impact of IFRS 9

The estimated impacted of adopting IFRS 9 is as follows:

Financial Instrument	IAS 39 measurement basis	IFRS 9 measurement basis	IAS 39 carrying amount 31 December 2017 £m	IFRS 9 carrying amount 1 January 2018 £m
Loans and advances to customers				
Retail Financial Services	Amortised cost	Amortised cost	6,775.5	6,774.2
Secured Personal Lending	Amortised cost	Amortised cost	311.8	311.3
Commercial Lending	Amortised cost	Amortised cost	763.9	763.8
Total loans and advances to customers			**7,851.2**	**7,849.3**
Cash in hand and balances with Bank of England	Amortised cost	Amortised cost	1,026.3	1,025.8
Loans and advances to credit institutions	Amortised cost	Amortised cost	237.4	237.2
Debt securities	Available-for-sale	FVOCI	124.9	124.8
Derivative financial instruments	FVTPL	FVTPL	27.8	27.8

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

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

Pronouncement	Nature of Change	Effective Date
IFRS 15 Revenue from Contracts with Customers	IFRS 15 specifies how and when an entity will recognise revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures. The group will implement IFRS 15 using the cumulative effective method. The implementation will bring forward the recognition of revenues earned from third party commissions received.	Accounting Periods beginning on or after 1 January 2018
IFRS 16 Leases	IFRS 16 specifies how an entity will recognise, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases. 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 accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements.

Notes to the accounts for the year ended 31 December 2017

1. Accounting policies (continued)

Basis of preparation (continued)

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

Subsidiaries

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

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).

Investments in subsidiaries

Investments in subsidiaries are recorded in the Society's Statement of Financial Position at cost, less impairment for cost of shares, and amortised cost for loans to subsidiaries.

Securitisation transactions

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

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

Interest receivable and payable

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

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

Interest income on 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 commission and Other income

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

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

The group receives trail commission based on the performance of previous sales of insurance products. The commission is recognised when payment is received.

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

Notes to the accounts for the year ended 31 December 2017

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.

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.

Notes to the accounts for the year ended 31 December 2017

1. Accounting policies (continued)

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

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

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

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

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

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

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

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

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

Loans and advances to credit institutions

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

Derivative financial instruments and hedge accounting

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

Notes to the accounts for the year ended 31 December 2017

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.

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

Notes to the accounts for the year ended 31 December 2017

1. Accounting policies (continued)

Taxation (continued)

temporary differences. In contrast, deferred tax assets are only recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilised.

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

Investment properties

Investment properties comprise 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. Investment properties are depreciated using the same methodology as property, plant and equipment, please see opposite.

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.

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.

Notes to the accounts for the year ended 31 December 2017

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

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

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

Leases

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

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

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

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

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

Segmental reporting

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

Cash and cash equivalents

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

Provisions and contingent liabilities

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

Advertising and promotional costs

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

Sale and repurchase agreements

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

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

Non current assets held-for-sale

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

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

Notes to the accounts for the year ended 31 December 2017

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 to this, critical accounting estimates and assumptions are also made that could affect the reported amounts of assets and liabilities within the following financial year. Where the application of the group's accounting policy requires elements of both judgement and estimation, the group considers these assessments to be accounting estimates.

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

Key sources of estimation uncertainty

Key assumptions are made that could affect the reported amounts of assets and liabilities within the following financial year. The most significant areas where estimations have been 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. Accounting estimates are used to estimate future cash flows and to measure the potential loss.

Key estimates in the measurement of the incurred loss include 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 estimates impacting on the residential mortgage portfolios. Sensitivity analysis demonstrates that if HPI movements were to differ from current observations by 3%, the impact on impairment provisions would be £1.4m. The 3% sensitivity is considered to be a reasonable estimate of likely HPI variation over the next 12 months. The impact of a 3% change in the forced sale discounts, a key source of estimation uncertainty, would impact provisions by £1.8m.

The loan loss provision against the commercial lending portfolio is sensitive to a number of factors where management must apply estimation techniques 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 also the likely funds available on liquidation or bankruptcy, including the value of any guarantees.

These estimates are based on observed historical data and updated to reflect current and future conditions. 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 portfolio with the Nationwide and Hometrack indices being used in the Secured Personal Lending portfolio. External and internal valuations are used to estimate commercial security values and future cash flows.

Retirement benefit obligations

The group has to make significant estimations in relation to the 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 these assumptions would change the reported liability, service cost and expected return on pension plan assets.

Sensitivity analysis demonstrates that a 0.5% increase in the inflation assumption would 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 £4.8m. Sensitivities of 0.5% have been used to reflect a significant but reasonably likely market event that causes a one-off shock to the actuarial assumptions. The sensitivity analysis above may not be representative of the actual change in the scheme liabilities as it is unlikely that the change in assumptions would occur in isolation of one another. Some of the assumptions may be correlated.

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 an estimate of the expected lives of financial instruments and the anticipated level of early redemption charges.

Sensitivity analysis for both the retail portfolio and commercial lending portfolio has shown that 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 £0.4m/(£0.4m) respectively. The impact of a 10% change in the anticipated level of early repayment charges (ERC), within the retail portfolio, would result in an increase/(decrease) in the value of the loans in the statement of financial position by £0.4/(£0.4m) respectively. A 10% variance has been selected to illustrate the sensitivity as this is considered a plausible variation in prepayment rates over the period of the unwind of the ERC balance, based on expectations of customer behaviour in response to changes in external market factors, in particular interest rates.

Notes to the accounts for the year ended 31 December 2017

Customer and regulatory complaints

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

The group notes that the FCA has finalised its 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 Company has increased its regulatory provision balance accordingly to take account of those developments.

Further information can be found in note 19.

3. Business segments

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

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

	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

Notes to the accounts for the year ended 31 December 2017

3. Business segments (continued)

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

	Group	
	2017 £m	2016 £m
Total assets by business segment		
Retail financial services	8,169.1	7,086.6
Secured personal lending	312.4	405.2
Commercial lending	781.1	789.4
Total assets	9,262.6	8,281.2
Total liabilities and equity by business segment		
Retail financial services and Commercial lending	8,950.2	7,876.0
Secured personal lending	312.4	405.2
Total liabilities and equity	9,262.6	8,281.2

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	
	2017 £m	2016 £m	2017 £m	2016 £m
On loans fully secured on residential property	216.7	231.7	189.1	195.0
On other loans	12.2	12.3	12.2	12.3
On loans to subsidiaries	–	–	9.0	13.5
On debt securities	2.3	3.9	2.3	3.9
On other liquid assets	2.7	2.7	2.7	2.5
On derivative financial instruments	(19.7)	(21.5)	(19.7)	(21.5)
	214.2	229.1	195.6	205.7

5. Interest payable and similar charges

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
On shares held by individuals	78.5	91.1	78.5	91.1
On deposits and debt securities	14.2	17.2	17.0	19.5
On subscribed capital	4.2	4.2	4.2	4.2
On subordinated liabilities	–	0.8	–	0.8
On derivative financial instruments	(8.6)	(9.1)	(11.4)	(11.6)
	88.3	104.2	88.3	104.0

Notes to the accounts for the year ended 31 December 2017

6. Fees and commission receivable

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Insurance and related financial service products	2.6	4.4	2.6	4.4
Mortgage related fees	4.2	4.2	4.2	4.2
Other fees and commission	0.3	0.4	–	0.1
	7.1	9.0	6.8	8.7

7. Other fair value gains and losses

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Gains/(losses) on derivatives	15.4	(5.3)	12.5	(3.9)
(Losses)/gains on hedged items attributable to the hedged risk	(11.1)	6.9	(11.1)	6.9
	4.3	1.6	1.4	3.0

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Wages and salaries	39.8	38.7	37.5	35.2
Social security costs	3.9	3.8	3.8	3.5
Other pension costs	2.1	1.7	2.0	1.6
	45.8	44.2	43.3	40.3
Other administrative expenses	30.6	27.6	28.4	24.6
Nemo strategic review and restructuring costs	–	2.4	–	–
	76.4	74.2	71.7	64.9

	Group		Society	
	2017 £000	2016 £000	2017 £000	2016 £000
Other administrative expenses include:				
Auditor's remuneration				
For audit of the Society's Annual Accounts	312	178	312	178
For audit of the Society's subsidiaries	33	24	–	–
Total	345	202	312	178
For other services				
Tax advisory	–	59	–	59
Further assurance services	80	75	80	75
Total other services	80	134	80	134
Operating lease charges – motor vehicles	234	224	234	224
– land and buildings	1,259	1,251	1,057	951

Notes to the accounts for the year ended 31 December 2017

9. Employees

The average number employed including Executive Directors was:

	Full-time		Part-time	
	2017 Number	2016 Number	2017 Number	2016 Number
Society's Customer Support Centre and administration office	653	608	112	102
Society branch offices	191	186	125	122
Employed by the Society	844	794	237	224
Subsidiaries	43	66	5	8
Employed by the group	**887**	**860**	**242**	**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 68 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 £2.0m (2016: £1.9m).

11. Retirement benefit obligations

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

Defined contribution scheme

The group operates a defined contribution scheme, the Group Flexible Retirement Plan (GFRP). A defined contribution scheme is one into which the group and the employee pay contributions, without any obligation to pay further contributions. Staff employed after 1 January 2001 and those staff who were formerly members of the defined benefit scheme are eligible to join this scheme. The cost to the group and Society of employer's contributions (before salary sacrifice arrangements) to the scheme in 2017 was £1.8m (2016: £1.5m). There were no contributions outstanding or prepaid at the end of the year.

Defined benefit scheme

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

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

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

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

A further £6.7m was paid into the pension scheme from the Society during 2017. The agreed contributions to be paid by the Society in 2018 amount to £4.8m. The Society may, however, pay additional amounts at any time.

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

The Trustees have continued to act in accordance with the Statement of Investment Principles adopted on 6 December 2013 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 2017

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 (2016: £32.8m).

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

	At 31 December				
	2017 %	2016 %	2015 %	2014 %	2013 %
Rate of increase of pensions in payment	2.25	2.25	2.20	2.05	3.50
Discount rate	2.40	2.55	3.75	3.55	4.50
Inflation assumption (RPI)	3.20	3.25	3.15	3.05	3.50
Inflation assumption (CPI)	2.20	2.25	2.15	2.05	2.70

The assumptions on mortality are determined by the following tables:

	2017 %	2016 %
Retired and non-retired members	SAPS CMI2016 LTR 1.25% SF7.5	SAPS CMI2015 LTR 1.25%
The assumptions are illustrated by the following year of life expectancy at age 65:		
Retired members		
Males currently aged 65	22.3	22.4
Females currently aged 65	24.2	24.5
Non-retired members		
Males currently aged 45	23.7	24.1
Females currently aged 45	25.7	26.4

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

	At 31 December				
	2017 £m	2016 £m	2015 £m	2014 £m	2013 £m
Target return funds	29.0	27.4	27.1	26.5	25.0
Annuities	25.9	26.4	23.5	25.2	23.4
Bonds and cash	8.5	4.3	3.5	2.9	1.3
Total fair value of plan assets	63.4	58.1	54.1	54.6	49.7
Present value of funded obligations	(71.8)	(72.9)	(57.7)	(61.0)	(66.3)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net deficit recognised in the statement of financial position	**(8.9)**	**(15.3)**	**(4.1)**	**(6.9)**	**(17.1)**

The deficit has decreased primarily as a result of £6.7m contributions paid into the pension scheme by the Society in 2017.

The actual return on plan assets was £2.8m (2016: £4.6m).

Notes to the accounts for the year ended 31 December 2017

11. Retirement benefit obligations (continued)

Defined benefit scheme (continued)

The amounts recognised in the income statement are as follows:

	Group and Society	
	2017 £m	2016 £m
Analysis of the amounts recognised in the income statement		
Interest on pension scheme assets	(1.5)	(2.0)
Interest on pension scheme liabilities	1.8	2.1
Net interest expense	0.3	0.1
Total amount recognised in the income statement	**0.3**	**0.1**
Analysis of amount recognised in statement of other comprehensive income		
Gains on scheme assets in excess of interest	1.4	2.6
Experience (losses)/gains on liabilities	(0.4)	0.4
Gains/(losses) from changes to demographic assumptions	0.8	(0.1)
Losses from changes to financial assumptions	(1.8)	(15.5)
Total remeasurement	**-**	**(12.6)**
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(15.3)	(4.1)
Movement in year:		
Net interest expense	(0.3)	(0.1)
Remeasurements	-	(12.6)
Contributions paid and accrued	6.7	1.5
Deficit in scheme at end of year	**(8.9)**	**(15.3)**
Analysis of the movement in the fair value of pension scheme assets		
Fair value of assets at the beginning of the year	58.1	54.1
Interest on assets	1.5	2.0
Society contributions	6.7	1.5
Benefits paid	(4.3)	(2.1)
Return on plan assets less interest	1.9	(0.3)
Change in fair value of the annuity policy	(0.5)	2.8
Fair value of assets at the end of the year	**63.4**	**58.0**

Significant actuarial assumptions in the determination of the defined benefit obligation are the discount rate, inflation rate and life expectancy. The sensitivity analysis below represents the net impact on the scheme liabilities taking into account the change in the value of both the scheme's liabilities and the bulk annuity contract. No allowance has been made for any changes to the non-insured asset values. The weighted average duration of the liabilities is 18 years and the duration of insured pensioners is estimated to be around 10 years.

Notes to the accounts for the year ended 31 December 2017

Defined benefit scheme (continued)

	Group and Society	
	Increase 0.5% £m	Decrease 0.5% £m
Discount rate	(4.8)	5.4
Inflation	4.8	(4.3)
Life expectancy (+1 year/-1 year)	2.2	(2.2)

Sensitivities of 0.5% have been used to reflect a significant but reasonably likely market event that causes a one-off shock to the actuarial assumptions. The sensitivity analysis 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. Some of the assumptions may be correlated.

12. Taxation

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Current tax				
UK corporation tax charge for the year	13.5	11.6	10.2	9.2
Adjustments in respect of prior years	0.1	0.5	0.1	0.5
	13.6	12.1	10.3	9.7
Deferred tax				
Deferred tax charge/(credit) for year	0.4	(0.1)	0.4	-
Adjustments in respect of prior years	0.1	(0.8)	0.1	(0.9)
	0.5	(0.9)	0.5	(0.9)
Taxation on profit on ordinary activities	**14.1**	**11.2**	**10.8**	**8.8**

The statutory rate of corporation was reduced to 19.0% from 6 April 2017. The group was subject to corporation tax of 20.0% for the period 1 January to March 2017 and 19.0% for the period 1 April to 31 December 2017, resulting in an effective statutory rate of 19.3% for the year ending December 2017. The statutory rate of corporation tax will be reduced to 17.0% from April 2020.

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Profit before taxation	57.6	50.3	37.6	40.1
Profit multiplied by the standard rate of Corporation tax at 19.25% (2016: 20.00%)	11.1	10.0	7.2	8.0
Effects of				
Expenses not deductible for tax purposes	1.4	0.4	2.0	0.1
Adjustments to prior years	0.2	(0.3)	0.2	(0.4)
Impact of banking surcharge	1.4	1.1	1.4	1.1
Taxation on profit from ordinary activities	**14.1**	**11.2**	**10.8**	**8.8**

Notes to the accounts for the year ended 31 December 2017

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Current tax				
Relating to retirement benefit obligations	(0.5)	(0.4)	(0.5)	(0.4)
Revaluations of available-for-sale financial assets	(0.1)	(0.1)	(0.1)	(0.1)
	(0.6)	(0.5)	(0.6)	(0.5)
Deferred tax				
Relating to retirement benefit obligations	0.5	(2.2)	0.5	(2.2)
Revaluations of available-for-sale financial assets	(0.3)	0.3	(0.3)	0.3
	0.2	(1.9)	0.2	(1.9)
Total charged to other comprehensive income	**(0.4)**	**(2.4)**	**(0.4)**	**(2.4)**

13. Loans and advances to credit institutions

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Loans and advances to credit institutions	168.8	141.5	61.4	62.1

Included in the above amount for the group is £72.7m of collateral given under Credit Support Annex (CSA) agreements (2016: £50.5m).

14. Debt securities

	Group and Society	
	2017 £m	2016 £m
Issued by UK Government	85.9	338.5
Issued by Supranational entities	–	10.1
Issued by other borrowers and unlisted	39.0	41.0
	124.9	389.6

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

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

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

	Group and Society	
	2017 £m	2016 £m
At 1 January	389.6	437.8
Additions	16.0	124.7
Disposals and maturities	(278.1)	(172.8)
(Losses)/gains from changes in fair value	(1.9)	0.6
(Decrease) in accrued interest	(0.7)	(0.7)
At 31 December	124.9	389.6

Notes to the accounts for the year ended 31 December 2017

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Derivative assets:				
Interest rate swaps	3,635.0	2,278.3	27.0	25.4
Equity and RPI index linked interest rate swaps	16.4	32.3	2.6	5.0
Total recognised derivative assets	3,651.4	2,310.6	29.6	30.4
Derivative liabilities:				
Interest rate swaps	3,408.9	3,325.9	(29.2)	(45.7)
Total recognised derivative liabilities	3,408.9	3,325.9	(29.2)	(45.7)

	Society			
	Contract/notional amount		Fair value	
	2017 £m	2016 £m	2017 £m	2016 £m
Derivative assets:				
Interest rate swaps	3,490.3	2,278.3	25.2	25.4
Equity and RPI index linked interest rate swaps	16.4	32.3	2.6	5.0
Total recognised derivative assets	3,506.7	2,310.6	27.8	30.4
Derivative liabilities:				
Interest rate swaps	2,743.9	2,810.3	(28.2)	(43.6)
Total recognised derivative liabilities	2,743.9	2,810.3	(28.2)	(43.6)

16. Loans and advances to customers

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Fully secured on residential property	7,568.2	6,744.8	7,254.5	6,325.9
Fully secured on land	291.9	323.9	291.9	323.9
	7,860.1	7,068.7	7,546.4	6,649.8
Provision for impairment losses	(30.3)	(45.4)	(20.5)	(30.1)
Effective Interest Rate adjustments	21.4	11.2	13.5	10.7
Fair value adjustment for hedged risk	12.9	39.4	12.9	39.4
	7,864.1	7,073.9	7,552.3	6,669.8

Notes to the accounts for the year ended 31 December 2017

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 2017 the encumbrance ratio was 20.3% (31 December 2016: 19.3%). All other assets are defined as unencumbered.

An analysis of the group's encumbered and unencumbered on-balance sheet assets as at 31 December 2017 and 2016 is set out below.

	2017		2016	
	Encumbered	Unencumbered	Encumbered	Unencumbered
	£m	£m	£m	£m
Cash in hand and balances at the Bank of England	–	1,026.3	–	585.7
Loans and advances to credit institutions	158.0	10.8	129.9	11.6
Debt securities	–	124.9	–	389.6
Derivative financial instruments	–	29.6	–	30.4
Loans and advances to customers	1,719.2	6,144.9	1,470.1	5,603.8
Other assets	–	48.9	–	60.1
Total	1,877.2	7,385.4	1,600.0	6,681.2

Notes to the accounts for the year ended 31 December 2017

18. Provision for impairment losses

	Specific £m	Collective £m	Total £m
2017			
Group			
At 1 January 2017	14.8	30.6	45.4
Amounts written off during the year	(5.1)	-	(5.1)
Charge/(release) for loan impairment	0.9	(10.9)	(10.0)
At 31 December 2017	**10.6**	**19.7**	**30.3**
Society			
At 1 January 2017	11.3	18.8	30.1
Amounts written off during the year	(5.0)	-	(5.0)
Charge/(release) for loan impairment	1.4	(6.0)	(4.6)
At 31 December 2017	**7.7**	**12.8**	**20.5**

	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**

Notes to the accounts for the year ended 31 December 2017

19. Provisions for liabilities

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
At 1 January	7.1	3.8	4.3	2.7
Additions/(Release)	0.5	6.5	(1.0)	3.4
Utilisation	(1.5)	(3.2)	(1.1)	(1.8)
At 31 December	6.1	7.1	2.2	4.3

Included in provisions is the Financial Services Compensation Scheme (FSCS) levy of £0.5m (2016: £1.4m) which is the expected interest charge for scheme year April 2017 to March 2018.

At 31 December 2017, the group held a provision of £3.8m (2016: £2.7m) in relation to customer redress issues, including Payment Protection Insurance ("PPI"). The FCA has finalised 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), and a further provision of £1.5m has been made during the period in relation to previous sales of PPI. The provision considers sales of PPI via direct channels as well as via brokers, some of whom are no longer trading, as well as recent customer behaviour and reopening previously closed complaints.

Other provisions of £1.8m (2016: £3.0m) 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	
	2017 £m	2016 £m
Shares in subsidiary undertakings	0.1	0.1
Loans to subsidiary undertakings	218.7	328.2
	218.8	328.3

	Subsidiary undertakings	
	Shares £m	Loans £m
Movement in investments in subsidiary undertakings:		
At 1 January 2017	0.1	328.2
Loan repayment	–	(109.5)
At 31 December 2017	0.1	218.7

Notes to the accounts for the year ended 31 December 2017

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
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.2 Plc, Friary No.3 Plc and Friary No.4 Plc into the group accounts. These companies are not wholly owned by the Society but the Society retains substantially all of the risk and reward of the assets, and 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.

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 2017

20. Investments in subsidiary undertakings (continued)

The Society also holds 100% of the ordinary share capital of the following subsidiary undertakings. With the exception of Nemo Personal Finance Limited none of the subsidiary businesses listed below carried out business during the year. All subsidiary businesses were incorporated in the United Kingdom and with the exception of Loan Link Limited, whose registered addresses is 2 Sovereign Quay, Havannah Street, Cardiff, CF10 5SF, all other companies are at the registered address of Principality Buildings, Queen Street, Cardiff, CF10 1UA.

Brokerpoint Limited
Energy Assess Wales Limited
Home Information Pack Wales Limited
Loan Link 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
Principalty (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
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 2017	8.5	8.5	8.5	8.5
Additions	–	–	–	–
At 31 December 2017	8.5	8.5	8.5	8.5
Amortisation:				
At 1 January 2017	7.2	7.2	7.2	7.2
Charge for the year	0.5	0.5	0.5	0.5
At 31 December 2017	7.7	7.7	7.7	7.7
Net book value:				
At 31 December 2017	0.8	0.8	0.8	0.8
At 31 December 2016	1.3	1.3	1.3	1.3

	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

Notes to the accounts for the year ended 31 December 2017

22. Property, plant and equipment

	Land and buildings		Equipment, fixtures, fittings and vehicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2017	67.7	66.5	30.8	23.5	98.5	90.0
Additions	1.8	1.8	3.2	3.2	5.0	5.0
Disposals	(2.0)	(2.0)	(1.1)	(1.2)	(3.1)	(3.2)
Reclassified as held-for-sale	(5.8)	(5.8)	–	–	(5.8)	(5.8)
At 31 December 2017	**61.7**	**60.5**	**32.9**	**25.5**	**94.6**	**86.0**
Depreciation:						
At 1 January 2017	32.5	32.0	21.5	14.3	54.0	46.3
Charge for the year	1.9	1.9	3.9	3.7	5.8	5.6
Impairment in the year	5.8	5.8	–	–	5.8	5.8
Disposals	(1.0)	(1.0)	(1.1)	(1.1)	(2.1)	(2.1)
Reclassified as held-for-sale	(1.6)	(1.6)	–	–	(1.6)	(1.6)
At 31 December 2017	**37.6**	**37.1**	**24.3**	**16.9**	**61.9**	**54.0**
Net book value:						
At 31 December 2017	**24.1**	**23.4**	**8.6**	**8.6**	**32.7**	**32.0**
At 31 December 2016	35.2	34.5	9.3	9.2	44.5	43.7

	Land and buildings		Equipment, fixtures, fittings and 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

The impairment charge in the year of £5.8m relates to the group's head office building, Principality House. This impairment reduces the carrying value of the property to the level of the valuation provided by independent surveyors, as the value in use of the property is not considered to exceed the valuation amount. Additionally, there was a loss of £1.1m from the disposal of property, plant and equipment. Included within land and buildings additions is £1.7m (2016: £2.3m) on account of assets in the course of construction. The value of assets subject to operating leases where the group acts as lessor is £22.3m (2016: £29.2m).

Principality employ an independent third party to complete all valuations. The appointment of the valuer is completed through a thorough tender process, including assessment of the relevant qualifications of the valuer, to ensure competence and independence.

Notes to the accounts for the year ended 31 December 2017

22. Property, plant and equipment (continued)

	2017		2016	
	Group £m	Society £m	Group £m	Society £m
Land and buildings:				
Freehold	21.2	20.5	32.3	31.6
Long leasehold	0.2	0.2	0.2	0.2
Short leasehold	2.7	2.7	2.7	2.7
	24.1	23.4	35.2	34.5
Occupied by the Society and subsidiary undertakings	13.6	13.6	18.5	18.5

23. Non current assets held-for-sale

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Non current assets held-for-sale	4.2	-	4.2	-

The Society holds £4.2m (2016: £nil) of property as non current assets held-for-sale. The sale process for these assets is expected to conclude in 2018.

24. Shares

	Group and Society	
	2017 £m	2016 £m
Held by individuals	6,559.4	6,149.6
Other shares	3.9	4.2
Fair value adjustment for hedged risk	0.5	11.4
	6,563.8	6,165.2

25. Amounts owed to credit institutions

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Amounts owed to credit institutions	573.5	611.2	1,398.8	1,148.8

Included in the above amount is £6.3m of collateral held under Credit Support Annex (CSA) agreements (2016: £5.8m).

26. Debt securities in issue

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Certificates of deposit	13.5	15.6	13.5	15.6
Senior unsecured debt	299.2	-	299.2	-
Residential mortgage backed securities	932.1	615.5	-	-
Fair value adjustment for hedged risk	0.9	-	0.9	-
	1,245.7	631.1	313.6	15.6

Notes to the accounts for the year ended 31 December 2017

27. Other liabilities

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Other taxation and social security	1.0	0.9	1.0	0.9
Other creditors	5.9	5.9	4.5	4.3
	6.9	6.8	5.5	5.2

28. Deferred tax

The movement in net deferred tax is as follows:

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
At 1 January	3.8	1.1	3.6	0.8
Income statement (charge)/credit	(0.5)	0.9	(0.5)	0.9
Statement of other comprehensive income charge	(0.2)	1.9	(0.2)	1.9
At 31 December	3.1	3.9	2.9	3.6

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

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Deferred tax liabilities:				
Revaluations for available-for-sale financial assets	(0.1)	(0.5)	(0.1)	(0.5)
Other	(0.3)	-	(0.3)	-
	(0.4)	(0.5)	(0.4)	(0.5)
Deferred tax assets:				
Retirement benefit obligation	2.4	3.1	2.4	3.1
Accelerated tax depreciation	1.0	0.8	0.8	0.6
Other	0.1	0.5	0.1	0.4
	3.5	4.4	3.3	4.1

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 statement of other comprehensive income includes a deferred tax loss of £0.5m (2016: £2.2m gain) arising from the actuarial loss on retirement benefit obligations. The charge reflected in the income statement is not material.

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

Notes to the accounts for the year ended 31 December 2017

29. Subscribed capital

	Group and Society	
	2017 £m	2016 £m
7.00% Permanent Interest Bearing Shares	60.0	60.0
Unamortised issue costs	(0.2)	(0.3)
Fair value adjustment for hedged risk	6.7	9.6
	66.5	69.3

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 2017, the group holds a provision of £3.8m (2016: £2.7m), 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.

In August 2016 the Financial Conduct Authority (FCA) issued a further Consultation Paper (CP16/20), which confirmed the original proposal for a two year deadline for PPI claims (ending June 2019). In March 2017, the FCA issued a Policy Statement (PS17/3) which confirmed a deadline for PPI claims of August 2019.

CP16/20 also consulted on rules and guidance on the handling of PPI complaints in light of the Supreme Court's decision in Plevin v Paragon Personal Finance Limited ('Plevin'). PS17/3 confirms that both up-front commission arrangements and profit share arrangements should be considered in the calculation of total commission for Plevin complaints.

The group increased its PPI provision during the period to reflect:

- the impact on current claim volumes of the proposed extension to the time bar;
- an updated assessment of the current claim rate; and
- the impact on the expected cost of redress from new rules proposed in the FCA paper regarding Plevin.

Although a significant degree of uncertainty remains with regard to the ultimate cost of settling PPI complaints, in particular the volume of complaints arising from customers ahead of the confirmed deadline, the provision balance represents Management's best estimate at the reporting date of that cost. The PPI provision will continue to be monitored as trends in complaint volumes and levels of redress develop.

Notes to the accounts for the year ended 31 December 2017

30. Financial commitments and contingent liabilities (continued)

c) Commitments under non-cancellable operating leases:

	2017		2016	
	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	1.6	0.2	1.5	0.2
Due between two and five years	3.9	0.1	4.4	0.2
Due after five years	3.0	–	3.2	–
	8.5	0.3	9.1	0.4
Society commitments in respect of operating lease rentals:				
Due within one year	1.0	0.2	1.0	0.2
Due between two and five years	3.0	0.1	3.0	0.2
Due after five years	3.0	–	3.2	–
	7.1	0.3	7.2	0.4

d) Income receivable under non-cancellable operating leases:

Property rental income earned during the year was £1.1m (2016: £1.3m).

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

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Receivable within one year	1.0	1.0	1.0	1.0
Receivable between two and five years	3.9	3.7	3.9	3.7
Receivable after five years	12.4	8.0	12.4	8.0
	17.3	12.7	17.3	12.7

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Capital expenditure contracted for but not provided for	1.6	1.2	1.6	1.2

f) Loan commitments:

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
Loan commitments contracted but not paid	96.8	90.5	96.8	90.5

Notes to the accounts for the year ended 31 December 2017

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 2017	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Group assets					
Cash in hand and balances with Bank of England	1,026.3	-	-	-	1,026.3
Loans and advances to credit institutions	-	168.8	-	-	168.8
Debt securities	-	-	124.9	-	124.9
Derivative financial instruments	-	-	-	29.6	29.6
Loans and advances to customers	-	7,864.1	-	-	7,864.1
Total financial assets	1,026.3	8,032.9	124.9	29.6	9,213.7
Total non-financial assets					48.9
Total group assets					9,262.6
Group liabilities					
Shares	6,563.8	-	-	-	6,563.8
Amounts owed to credit institutions	554.6	-	-	18.9	573.5
Amounts owed to other customers	216.7	-	-	-	216.7
Debt securities in issue	1,245.7	-	-	-	1,245.7
Derivative financial instruments	-	-	-	29.2	29.2
Subscribed capital	66.5	-	-	-	66.5
Total financial liabilities	**8,647.3**	**-**	**-**	**48.1**	**8,695.4**
Total non-financial liabilities					46.8
General reserve and other reserves					520.4
Total group reserves and liabilities					9,262.6

Notes to the accounts for the year ended 31 December 2017

Categories of financial instruments (continued)

Society As at 31 December 2017	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Society assets					
Cash in hand and balances with Bank of England	1,026.3	-	-	-	1,026.3
Loans and advances to credit institutions	-	61.4	-	-	61.4
Debt securities	-	-	124.9	-	124.9
Derivative financial instruments	-	-	-	27.8	27.8
Loans and advances to customers	-	7,552.3	-	-	7,552.3
Loans to and investments in subsidiaries	0.1	218.7	-	-	218.8
Total financial assets	1,026.4	7,832.4	124.9	27.8	9,011.5
Total non-financial assets					48.1
Total Society assets					9,059.6
Society liabilities					
Shares	6,563.8	-	-	-	6,563.8
Amounts owed to credit institutions	1,379.9	-	-	18.9	1,398.8
Amounts owed to other customers	216.7	-	-	-	216.7
Debt securities in issue	313.6	-	-	-	313.6
Derivative financial instruments	-	-	-	28.2	28.2
Subscribed capital	66.5	-	-	-	66.5
Total financial liabilities	8,540.5	-	-	47.1	8,587.6
Total non-financial liabilities					38.0
General reserve and other reserves					434.0
Total Society reserves and liabilities					9,059.6

Notes to the accounts for the year ended 31 December 2017

31. Financial instruments (continued)

Categories of financial instruments (continued)

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 2017

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 2017

31. Financial instruments (continued)

Carrying and fair values (continued)

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	2017		2016	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Group assets					
Cash in hand and balances with Bank of England	i.	1,026.3	1,026.3	585.7	585.7
Loans and advances to credit institutions	ii.	168.8	168.8	141.5	141.5
Debt securities	iii.	124.9	124.9	389.6	389.6
Derivative financial instruments	iv.	29.6	29.6	30.4	30.4
Loans and advances to customers	v.	7,864.1	7,898.1	7,073.9	7,127.8
		9,213.7	9,247.7	8,221.1	8,275.0
Group liabilities					
Shares	vii.	6,563.8	6,574.8	6,165.2	6,215.9
Amounts owed to credit institutions	viii.	573.5	573.5	611.2	611.2
Amounts owed to other customers	viii.	216.7	216.7	226.5	226.5
Debt securities in issue	ix.	1,245.7	1,241.6	631.1	627.3
Derivative financial instruments	iv.	29.2	29.2	45.7	45.7
Subscribed capital	ix.	66.5	64.7	69.3	59.8
		8,695.4	8,700.5	7,749.0	7,786.4

	Note	2017		2016	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Society assets					
Cash in hand and balances with Bank of England	i.	1,026.3	1,026.3	585.7	585.7
Loans and advances to credit institutions	ii.	61.4	61.4	62.1	62.1
Debt securities	iii.	124.9	124.9	389.6	389.6
Derivative financial instruments	iv.	27.8	27.8	30.4	30.4
Loans and advances to customers	v.	7,552.3	7,584.4	6,669.8	6,720.6
Loans and advances to subsidiaries	vi.	218.8	218.8	328.3	328.3
		9,011.5	9,043.6	8,065.9	8,116.8
Society liabilities					
Shares	vii.	6,563.8	6,574.8	6,165.2	6,215.9
Amounts owed to credit institutions	viii.	1,398.8	1,398.8	1,148.8	1,148.8
Amounts owed to other customers	viii.	216.7	216.7	226.5	226.5
Debt securities in issue	ix.	313.6	313.6	15.6	15.6
Derivative financial instruments	iv.	28.2	28.2	43.6	43.6
Subscribed capital	ix.	66.5	64.7	69.3	59.8
		8,587.6	8,596.8	7,669.0	7,710.2

Notes to the accounts for the year ended 31 December 2017

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following methods and assumptions have been applied in determining fair value:

i) The carrying amount of cash in hand and balances with the Bank of England are assumed to equate to fair value. Balances are held at amortised cost, and would be considered as a Level 1 item within the hierarchy for fair value

ii) The carrying amount of loans and advances to credit institutions with a maturity of under 12 months is assumed to equate to their fair value. Balances are classified as loans and receivables, and would be considered as a Level 2 item within the hierarchy for fair value disclosures.

iii) Debt securities classified as available-for-sale are measured at fair value by reference to market prices, with balances considered as a Level 1 item within the hierarchy for fair value disclosures.

iv) The fair value of interest rate swaps is calculated by utilising discounted cash flow valuation models. Balances are held as fair value through profit and loss, and a breakdown of the fair value hierarchies can be seen on page 123.

v) The fair value of loans and advances to customers represents the discounted amount of estimated future cash flows expected to be received after taking account of expected loss provisions, expected levels of early repayment and discounting at current market rates. Balances are classified as loans and receivables, and would be considered as a Level 3 item within the hierarchy for fair value disclosures.

vi) The fair value of loans and advances to subsidiaries at a variable rate is considered to be to their carrying amounts with the use of transfer pricing mechanisms. Balances would be considered as a Level 3 item within the hierarchy for fair value disclosures.

vii) The fair value of customer accounts represents the discounted amount of estimated future cash flows expected to be paid, with reference to market-observable interest rates.

viii) 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. Balances are held at amortised cost, and would be considered as a Level 2 item within the hierarchy for fair value.

ix) The fair values of debt securities in issue and subscribed capital are obtained from market prices. Balances are held at amortised cost, and would be considered as a Level 1 item within the hierarchy for fair value.

	Group			
	2017 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	29.6	-	26.7	2.8
Available-for-sale financial assets:				
Debt securities	124.9	124.9	-	-
Total	154.5	124.9	26.7	2.8
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	18.9	-	18.9	-
Derivative financial instruments	29.2	-	26.4	2.8
Total	48.1	-	45.3	2.8

	Society			
	2017 £m	Level 1 £m	Level 2 £m	Level 3 £m
Financial assets at fair value through profit or loss:				
Derivative financial instruments	27.8	-	26.7	1.1
Available-for-sale financial assets:				
Debt securities	124.9	124.9	-	-
Total	152.7	124.9	26.7	1.1
Financial liabilities at fair value through profit or loss:				
Amounts owed to credit institutions	18.9	-	18.9	-
Derivative financial instruments	28.2	-	26.4	1.8
Total	47.1	-	45.3	1.8

Notes to the accounts for the year ended 31 December 2017

31. Financial instruments (continued)

Carrying and fair values (continued)

	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	–

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

Hierarchy for fair value disclosures

Level	Description
1.	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
2.	Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices).
3.	Inputs for the asset or liability that are not based 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 2017

32. Credit risk

The credit risk to which the group is exposed is described in the Risk Management Report on pages 46 to 57. 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	
	2017 £m	2016 £m	2017 £m	2016 £m
In respect of loans and advances to customers:				
Secured by a first charge on residential property	7,254.5	6,325.9	7,254.5	6,325.9
Secured by a first charge on land	291.9	323.9	291.9	323.9
Secured by a second charge on residential property	313.7	418.9	-	-
	7,860.1	7,068.7	7,546.4	6,649.8
Provision for impairment losses	(30.3)	(45.4)	(20.5)	(30.1)
Effective Interest Rate adjustments	21.4	11.2	13.5	10.7
Fair value adjustments	12.9	39.4	12.9	39.4
	7,864.1	7,073.9	7,552.3	6,669.8

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Retail financial services	6,775.5	5,858.3	6,775.5	5,858.3
Commercial lending	763.9	772.1	763.9	772.1
Secured personal lending	311.8	404.1	-	-
Fair value adjustments	12.9	39.4	12.9	39.4
	7,864.1	7,073.9	7,552.3	6,669.8

Notes to the accounts for the year ended 31 December 2017

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	
	2017 %	2016 %	2017 %	2016 %
In Wales	32.4	31.5	29.8	28.8
Outside Wales	67.6	68.5	70.2	71.2
	100.0	100.0	100.0	100.0

The group holds a high quality buy-to-let portfolio of £1,696.6m (2016: £1,494.3m). At the end of the year, 74% of buy-to-let mortgages were on interest only products, 25% repayable by capital and interest repayments and 1% a combination of interest only and capital and interest.

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property. The average index linked LTV in respect of the group's loans secured on residential property including mortgages under offer is estimated to be 57.0% (2016: 56.8%). Index-linked LTV banding is shown below:

	Group		Society	
	2017 %	2016 %	2017 %	2016 %
Less than 70%	71.1	72.2	71.2	72.7
More than 70% but less than 80%	13.4	13.5	13.3	13.3
More than 80% but less than 90%	10.2	8.7	10.4	8.6
More than 90% but less than 100%	3.6	3.6	3.5	3.5
More than 100%	1.7	2.0	1.6	1.9
	100.0	100.0	100.0	100.0

Notes to the accounts for the year ended 31 December 2017

Performance

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than three months is 0.53% (2016: 0.63%) which compares favourably with the industry average of 0.86% (CML arrears and possession data at 30 September 2017). Residential lending fully secured by a first charge which were six months or more in arrears had arrears balances of £0.8m (31 December 2016: £0.9m) with 179 (31 December 2016: 184) cases.

The percentage of secured personal loans currently in arrears of two months or more by number is 4.63% (2016: 5.88%), which by value is 5.66% (2016: 6.69%).

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

	Group			
	2017		2016	
	£m	%	£m	%
Current	6,997.5	98.8	6,152.1	98.2
Past due up to 3 months	50.3	0.7	60.9	1.0
Past due 3 months up to 6 months	21.1	0.3	22.8	0.4
Past due 6 months up to 12 months	10.5	0.1	15.5	0.2
Past due over 12 months	7.2	0.1	10.0	0.2
Possessions	0.8	-	1.1	-
	7,087.4	100.0	6,262.4	100.0

	Society			
	2017		2016	
	£m	%	£m	%
Current	6,709.1	99.0	5,781.1	98.7
Past due up to 3 months	35.5	0.5	43.5	0.7
Past due 3 months up to 6 months	17.3	0.3	16.2	0.3
Past due 6 months up to 12 months	8.3	0.1	11.4	0.2
Past due over 12 months	4.5	0.1	5.2	0.1
Possessions	0.8	-	0.9	-
	6,775.5	100.0	5,858.3	100.0

Collateral values are updated at the date of each statement of financial position based on the best information publicly available. Land Registry data is used in the Retail Financial Services sector with Nationwide and Hometrack indices being used in the Secured Personal Lending business. Both indices take account of the geographical location of the collateral.

Based on indexed valuations the total collateral held against lending secured against residential property is estimated to be £17,224.4m (2016: £15,735.6m).

Notes to the accounts for the year ended 31 December 2017

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. £2.5m (2016: £1.7m) 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 the previous page.

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:

	2017 £m	2016 £m
Retail financial services	5.5	5.6
Secured personal loans	9.8	15.3
	15.3	20.9

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. 53 properties were taken into possession during 2017 (2016: 48) with balances of £3.2m (2016: £3.0m).

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

2017	Revised payment schedule £m	Transfer to interest-only £m	Term extensions £m	Other £m	Total £m
Current	14.9	13.6	0.4	2.1	31.0
Past due up to 3 months	10.4	0.3	-	1.1	11.8
Past due 3 months up to 6 months	4.3	0.2	-	0.4	4.9
Past due 6 months up to 12 months	2.2	-	-	0.8	3.0
Past due over 12 months	0.7	0.1	-	2.1	2.9
	32.5	14.2	0.4	6.5	53.6

Notes to the accounts for the year ended 31 December 2017

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

The underlying performance of previous forbearance activities is reflected in the provisioning methodology and is not individually or collectively material. In addition to the specific provisions held against individual accounts, a collective provision of £0.7m (2016: £0.6m) 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 page 50.

Risk Concentrations

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

	Group and Society			
	2017		2016	
	£m	%	£m	%
Loans to Registered Social Landlords secured on residential property	153.8	19.7	150.3	18.9
Other loans secured on residential property	342.0	43.7	331.3	41.4
Loans secured on commercial property	286.2	36.6	317.6	39.7
	782.0	100.0	799.2	100.0

Notes to the accounts for the year ended 31 December 2017

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			
	2017		2016	
	£m	%	£m	%
Office	96.4	33.7	96.9	30.5
Retail	104.7	36.6	114.5	36.0
Industrial	50.3	17.6	60.3	19.0
Leisure	11.8	4.1	21.2	6.7
Land	2.6	0.9	2.8	0.9
Other	20.4	7.1	21.9	6.9
	286.2	100.0	317.6	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			
	2017		2016	
Region	£m	%	£m	%
Wales	379.2	48.5	401.4	50.2
Greater London	228.8	29.3	214.6	26.9
South East/East of England	46.6	6.0	49.1	6.1
Midlands	28.7	3.7	31.1	3.9
South West/South of England	38.6	4.9	38.0	4.8
North West/North of England	30.8	3.9	37.6	4.7
Mixed/other	29.3	3.7	27.4	3.4
	782.0	100.0	799.2	100.0

The average loan to value (LTV) in respect of the group's commercial loans is estimated to be 56.8% (2016: 62.0%). 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.

£17.7m of exposures have an LTV of greater than 100% (2016: £33.3m). Of these, £15.9m are already classified as impaired and a further £1.1m are on the watch-list, leaving £0.7m 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 £29.6m (2016: £29.8m) or 3.8% (2016: 3.7%) of gross balances.

Notes to the accounts for the year ended 31 December 2017

Performance

The commercial lending risk procedure for loans and advances to customers is described in the Risk Management Report on page 50.

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			
	2017		2016	
	£m	%	£m	%
Exposures not classified as higher risk	753.1	96.3	757.0	94.7
Watch-list	11.8	1.5	14.5	1.8
Impaired or past due up to 3 months	17.1	2.2	27.7	3.5
	782.0	100.0	799.2	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			
	2017		2016	
	£m	%	£m	%
Unimpaired				
Current	764.9	97.8	771.4	96.5
Past due up to 3 months	-	-	-	-
Impaired				
Past due 3 to 6 months	-	-	-	-
Past due 6 to 12 months	-	-	-	-
Past due over 12 months	-	-	-	-
Defaulted but not past due	17.1	2.2	26.4	3.3
Law of Property Act (LPA) Receivers appointed	-	-	1.4	0.2
	782.0	100.0	799.2	100.0

There are no commercial cases (2016: one) three months or more in arrears.

Notes to the accounts for the year ended 31 December 2017

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 £1,546m (2016: £1,520m). 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.

Provisions are held against impaired loans as follows:

	Group and Society	
	2017 £m	2016 £m
Collective provisions	9.0	14.8
Specific provisions	6.0	9.7
Total provisions	15.0	24.5

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 2017, one (2016: five) accounts with balances totaling £1.9m (2016: £1.4m) in value were granted forbearance concessions. The total exposure in forbearance at December 2017 stands at balances of £28.3m and 21 accounts (2016: £25.0m, 25 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 Management Report on page 51.

The classes of financial instruments to which the group is most exposed to Treasury credit risk are loans and advances to credit institutions, debt securities and financial derivatives. For financial assets recognised in the statement of financial position, the exposure to credit risk equals their carrying amount. For loan commitments and guarantees, the exposure to credit risk is the full amount committed. The following table shows the group's estimated maximum exposure to credit risk without taking into account any collateral held or other credit enhancements.

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
UK government securities	85.9	338.5	85.9	338.5
Supranational securities	-	10.1	-	10.1
UK financial institutions	237.4	212.9	128.2	133.5
	323.3	561.5	214.1	482.1

Notes to the accounts for the year ended 31 December 2017

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 £6.3m (2016: £5.8m) is held over derivative financial instruments.

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

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
AAA to AA-	248.2	518.7	173.7	439.3
A+ to A-	60.3	29.9	27.4	29.9
BBB+ to BBB-	14.8	12.9	13.0	12.9
Unrated	-	-	-	-
	323.3	561.5	214.1	482.1

The geographical distribution of these exposures is as follows:

	Group		Society	
	2017 £m	2016 £m	2017 £m	2016 £m
UK	323.3	551.4	214.1	472.0
Multilateral Development Banks	-	10.1	-	10.1
	323.3	561.5	214.1	482.1

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

Notes to the accounts for the year ended 31 December 2017

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.

2017	Undefined maturity £m	Less than 3 months £m	Between 3 months and 1 year £m	Between 1 year and 5 years £m	More than 5 years £m	Total £m
Group						
Non-derivative liabilities						
Shares	–	3,926.7	759.9	1,831.2	–	6,517.8
Amounts owed to credit institutions	6.3	40.2	17.7	506.4	–	570.6
Other customers	–	88.3	127.9	–	–	216.2
Debt securities in issue	–	47.2	153.1	743.8	298.4	1,242.5
Subscribed capital	–	–	–	60.0	–	60.0
	6.3	4,102.4	1,058.6	3,141.4	298.4	8,607.1
Society						
Non-derivative liabilities						
Shares	–	3,926.7	759.9	1,831.2	–	6,517.8
Amounts owed to credit institutions	6.3	56.1	129.1	1,204.4	–	1,395.9
Other customers	–	88.3	127.9	–	–	216.2
Debt securities in issue	–	0.5	13.0	–	298.4	311.9
Subscribed capital	–	–	–	60.0	–	60.0
	6.3	4,071.6	1,029.9	3,095.6	298.4	8,501.8
Group						
Derivative liabilities						
Interest rate swaps	–	0.1	1.9	15.0	12.2	29.2
	–	0.1	1.9	15.0	12.2	29.2
Society						
Derivative liabilities						
Interest rate swaps	–	0.1	1.9	14.0	12.2	28.2
	–	0.1	1.9	14.0	12.2	28.2

Notes to the accounts for the year ended 31 December 2017

33. Liquidity risk (continued)

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
Subordinated liabilities	-	-	-	-	-	-
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
Subordinated liabilities	-	-	-	-	-	-
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**

Further information on the Society's approach to managing capital risk is described within the Risk Management Report on pages 46 to 57.

34. Market risk

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

Interest rate risk

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

Notes to the accounts for the year ended 31 December 2017

34. Market risk (continued)

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. In line with regulatory requirement, the group monitors, amongst other scenarios, the current net notional value of assets and liabilities for a 2% parallel shift upwards. If there was a 2% parallel upward shift in interest rates the favourable impact on reserves would be £5.8m (2016: £1.9m adverse impact on reserves).

Currency risk

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

35. Related party transactions

The remuneration of the Directors (including Non-Executive Directors), who are the key management personnel of the group, is set out in the Report of the Remuneration Committee on pages 62 to 68.

Loans to and shares held by Directors

There was an aggregate of £0.2m (2016: £0.6m) outstanding at the end of the financial year in respect of secured advances made prior to or during the year to Directors.

In so far as it is required under Section 68(1) and Section 68(3) of the Building Societies Act 1986, details of such loans are maintained in a register kept at Principality Buildings, Queen Street, Cardiff, and a statement containing requisite particulars will be available for inspection by Members at the same address for the period of 15 days prior to the Annual General Meeting to be held on 27 April 2018.

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 (2016: £0.1m).

Directors' transactions

There were no other transactions with Directors during the year.

	Interest paid to Society £m	Fees paid to Society £m
Year ended 31 December 2017		
Nemo Personal Finance Limited	9.0	0.6
	9.0	0.6
Year ended 31 December 2016		
Nemo Personal Finance Limited	13.5	1.0
	13.5	1.0

At the year-end the following balances were outstanding:

	Loans owed to Society 2017 £m	Loans owed to Society 2016 £m
Nemo Personal Finance Limited	218.8	328.2
	218.8	328.2

FINANCIAL STATEMENTS

Annual business statement for the year ended 31 December 2017

1. Statutory percentages

	At 31 December 2017	At 31 December 2016	Statutory limit
	%	%	%
The lending limit	4.2	5.1	25.0
The funding limit	23.7	19.3	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

	2017 %	2016 %
As a percentage of shares and borrowings:		
Gross capital	6.8	7.2
Free capital	6.7	7.0
Liquid assets	15.4	14.6
As a percentage of mean total assets:		
Profit for the year as a percentage of mean total assets	0.50	0.49
Management expenses as a percentage of mean total assets	1.02	1.04

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 32 to 36.

Details of Directors' service contracts are included in the Report of the Remuneration Committee on page 68.

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 share capital in, or debentures of, any connected undertaking of the Society.

Subsidiary company

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.
Brand Consideration	Brand Consideration measures whether a respondent would actively consider Principality as a potential provider when approaching a new purchase.
Buffer eligible liquid assets	Includes high quality debt securities issued by a government or central bank, securities issued by a designated multilateral development bank or reserves in the form of sight deposits with a central bank in an European Economic Area (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.
Euro Medium Term Note (EMTN)	Medium term flexible debt instrument.
Expected Loss (EL)	A regulatory capital calculation to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.
Exposure	The maximum loss that a financial institution might suffer if a borrower or counterparty fails to meet its obligations to the group.
Exposure At Default (EAD)	A regulatory capital parameter used to estimate the amount outstanding at the time of default.
Financial Conduct Authority (FCA)	The statutory body responsible for conduct of business regulation and supervision of UK authorised firms from 1 April 2013. The FCA also has responsibility for protecting consumers and promoting healthy competition.
Financial Services Compensation Scheme (FSCS)	A protection fund for depositors of failed institutions. This is funded by the financial services industry and each firm, including the Society, is obliged to pay an annual levy.
Forbearance strategies	Strategies to assist borrowers in financial difficulty, such as extending loan terms, temporarily converting loans to an interest-only basis and agreeing a temporary reduction in payments. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.
Funding limit	The proportion of shares and borrowings not in the form of customer accounts held by individuals.
Individual Liquidity Adequacy Assessment Process (ILAAP)	The group’s internal assessment of the levels of liquidity that need to be held by the Society to meet its regulatory liquidity requirements.

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

Glossary (continued)

Net Interest Margin (NIM)	This ratio calculates the net interest income as a percentage of mean total assets.
Net Stable Funding Ratio (NSFR)	A liquidity ratio, currently proposed under Basel III, to calculate the proportion of long-term assets that are funded by stable, long-term funding sources (customer deposits and long-term wholesale funding).
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
Overnight Indexed Swap rate (OIS)	A rate reflecting the overnight interest typically earned or paid in respect of collateral exchanged. OIS is used in valuing collateralised interest rate derivatives.
Permanent Interest-Bearing Shares (PIBS)	Unsecured, sterling denominated Additional Common Equity Tier 1 capital instruments repayable at the option of the Society.
Plevin	In November 2014, the Supreme Court ruled in Plevin v Paragon Personal Finance Ltd (Plevin) that a failure to disclose a commission payment on a Payment Protection Insurance (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 (reverse repo).
Residential Mortgage Backed Securities (RMBS)	A category of asset backed security that represents interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).
Retail loans	Loans to individuals rather than institutions, including residential mortgage lending.
Risk appetite	The articulation of the level of risk that the group is willing to take (or not take) in order to safeguard the interests of the Society's Members whilst achieving business objectives.

Risk-Weighted Assets (RWA)	A regulatory measure that adjusts the value of assets to reflect their level of risk when calculating capital requirements.
Securitisation	A process by which a group of assets, usually loans, is aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) which then issues securities backed by the assets. The group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.
Senior unsecured debt funding	Bonds issued by corporate bodies and financial institutions, which are not secured by any collateral and are not subordinated to any other liabilities of the Society.
Shares	Money deposited by Members in a retail savings account with the Society and held as a liability in the statement of financial position.
Shares and borrowings	The total of shares, deposits from banks, other deposits, amounts due to customers and debt securities in issue.
Solvency ratio	A component of regulatory capital measuring of the group's total regulatory capital as a proportion of the group's risk weighted assets.
Special Purpose Entities (SPEs)	Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The group uses an SPE set up under securitisation programme. Where the group has control of these entities or retains the risks and rewards relating to them they are consolidated within the group's results. This term is used interchangeably with 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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