

PRINCIPALITY BUILDING SOCIETY

Annual Report and Accounts for the year ended 31 December 2008

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This brochure is available in large print, braille and audio tape.

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Chairman's

statement

2008 Headlines

In a year of unprecedented conditions in the financial markets, I am pleased to report that your Society has delivered a robust operating performance in 2008. Our Group of businesses has continued to weather the financial storm. We remain profitable, the balance sheet is strong, recruitment of new members is at an all-time high and we have delivered significant benefits to our members. We believe the Principality brand and franchise has been strengthened during these testing times.

“We remain profitable, the balance sheet is strong, recruitment of new members is at an all-time high and we have delivered significant benefits to our members.”

Last year I commented upon the collapse of the interbank lending market following the US sub-prime crisis. The aftershock continued throughout the year as global news of bank failures and government intervention dominated the headlines. In the UK, we saw the nationalisation of Bradford and Bingley, the troubled mortgage bank, part nationalisation of RBS and the merger of HBOS, Britain's largest mortgage lender, with Lloyds TSB. Throughout the world, governments have been actively

intervening through deposit guarantees and injections of capital into financial institutions.

The strains in financial markets have severely curtailed the availability of credit, depressed house prices and contributed to a rapid deterioration in economic conditions. The financial downturn coupled with the worsening economic outlook has placed more pressure on borrowers, with 13 per cent of households reporting that they had found it difficult to meet their housing costs, up from 9 per cent in 2007, the highest figure recorded since the Bank of England started its survey in 1995.

The considerable slowdown in housing market transactions posed serious challenges and we have responded promptly to changed market conditions, taking decisive and sometimes difficult measures across the Group to contain our costs. Falling house prices have inevitably resulted in a marked increase in provisions for mortgage losses as we continue to ensure these are maintained at a prudent level across the Group. Funding costs have risen and we have also been faced with an exceptional item in the form of a levy to the Financial Services Compensation Scheme towards the costs of rescuing failed financial institutions. These factors have each contributed to the reduction in our pre-tax profit for the year when compared to 2007.

Although we have been able to secure what we need by way of wholesale funds our dependence on this source is limited. As a precautionary measure,

we have launched a covered bond programme which will allow us to further diversify our funding. As ever we have continued to look to traditional building society savers as our principal means of raising deposits. The low interest rate environment during the latter part of the year has presented us with a difficult challenge in balancing the interests of both savers and borrowers. In performing this balancing act, we will continue to act in the interests of our members as a whole.

Board and Management

The only change to the composition of the Board in 2008 was as a result of Margaret Foster's retirement as a non-executive director at the Annual General Meeting. We are very grateful for Margaret's valuable contribution throughout her nine years on the Board and we wish her well for the future. I am delighted to report that Jo Kenrick has been appointed to the Board with effect from 1 January 2009. She brings a strong background in marketing and customer service, gained across a range of well-known retail and consumer businesses including Mars, Pepsico and Asda - becoming Marketing Director at Asda subsidiary George Clothing. This was followed by a period on the main Board of the national house builder Wilcon. She then became Director of Marketing Communications at Camelot following which she was appointed Marketing and Customer Proposition Director for B&Q. We look forward to her participation in the Board's deliberations.

On behalf of the Board, I would like to thank all staff in the Principality Group for their dedication, team work and contribution throughout 2008. In an extremely testing year, they have risen to the many challenges with commitment, energy and enthusiasm which is greatly appreciated.

2009 Outlook

Looking forward, we do not underestimate the pressures we can expect to face in 2009. The restricted availability of credit looks set to continue and economic conditions are not forecast to improve in the short term. We may see more borrowers facing difficulties, with fewer options open to them if there are further reductions in property values. However, with a strong capital position and realistic impairment provisions, we are well placed to deal with these challenges. We will continue to attract retail savings as our main source of funding and to look for further efficiencies in our operations. These priorities will ensure that we continue to provide our members with the

security, fairness and success they look for in a mutual building society.

It is the Board's responsibility to keep the Society's mutual status under review. Having considered the question once again, the Board concluded unanimously that the Society should continue to be run as a mutual for the benefit of current and future members.



David B. Williams
Chairman
24 February 2009

“On behalf of the Board, I would like to thank all staff in the Principality Group for their dedication, team work and contribution throughout 2008. In an extremely testing year, they have risen to the many challenges with commitment, energy and enthusiasm which is greatly appreciated.”



Principality staff, Canton branch.



Chief Executive's review

In my review last year I predicted that the Society faced an uncertain time ahead. That certainly proved to be true but few people could have anticipated the pace, depth and ferocity of the problems that arose in the financial markets and wider economy during 2008. The meltdown of global financial services leaves a huge legacy and as a result we are likely to see major structural change in the marketplace in the years ahead. Remediation will be drawn out and difficult to deliver. The path to recovery is uncharted and difficult to tread.

2008 – Keeping our members' money safe

Our members are entitled to take for granted the simple fact that we can keep their money safe. That has been our key objective and we have achieved that aim.

It has been a year of consolidation. We are in a strong position to cope with the uncertainties ahead. The Group has underlying capital of £479.8m, strong liquidity and a healthy set of key financial ratios.

These are the key features of the business performance in 2008:

- A record £822.1m retail savings raised with 76,260 new savers joining the Society
- A strong liquidity ratio of 23.98 % at the year end
- An increase in general reserves to £283.5m
- An increase in Group assets by £546.2m to £6,398.7m
- Group pre-tax profit of £9.3m, after charging a Financial Services Compensation Scheme levy of £5.2m

Anticipating the slowdown, we took early decisions to curtail lending growth, especially in the Nemo business. We also trimmed back growth plans for traditional society mortgage lending and scaled back our plans for the commercial lending business. At the same time, we drove in record volumes of retail savings. In a two-pronged approach we were able to provide safety and security for our members as we deliberately reduced our reliance on wholesale funds. Some 95% of loans and advances were funded by retail savings and we were able to pass on enhanced returns to our savers, allowing them, rather than wholesale providers, to benefit from market premiums for funds.

Our diversified business model helps us maintain a healthy net interest margin, allowing us to fund an attractively priced range of products for our savers whilst still maintaining reasonable profitability, even in a difficult market.

2008 – The challenges

Contradictory demands to build up capital, hold record levels of liquidity, pay savers the best rate possible and provide adequate lines of finance for borrowers posed some real challenges. Finding a way to keep all our stakeholders happy has been a difficult juggling act. We have achieved a good balance. We have invested our reserves safely and we have not been hit by losses from exposures to defaulting UK and overseas banks.

Our underlying operating profit of £16.0m was reduced to £9.3m after the levy for the Financial Services Compensation Scheme (FSCS) of £5.2m and one-off costs of £1.5m of launching

our covered bond programme. Further costs of the FSCS are likely to arise in future years. These costs have been partially offset by a fair value gain of £3.2m on financial instruments on our balance sheet.

This is a solid set of results, despite taking into account the unusually high cost of funding and the impact of falling house prices on provisions.

The core Society business has performed well with 76,260 new members bringing record levels of retail savings to us. With ten savers to every one borrower, we recognise fully the need to try and protect returns to our members in a very low interest rate environment which looks likely to sustain itself for the next twelve months at least.

“We are in a strong position to cope with the uncertainties ahead”

The commercial loan book performed well and arrears are low against sector benchmarks. We suffered losses in both Nemo, our secured loans business and in Peter Alan, our estate agency. Early decisive action was taken with some 99 job losses through redundancy programmes and natural staff turnover. We closed Moneypilot, our on-line broking business, as demand for and availability of finance rapidly contracted in a shrinking market. Our surveyors' business too, went through a redundancy programme but delivered a profit in a falling housing market with much lower transaction levels.

The Nemo business has been hardest hit by falling house prices and rising default. Balance sheet provisions of £26m are calculated based on arrears levels and the rapid fall in house price indices. Arrears are higher than traditional first charge lending but are within industry norms for this type of business. Clearly this business has a higher propensity for risk but pricing of loans reflects that risk and supports the overall strong Group net interest margin and profitability. This is likely to be of significant benefit in 2009 as funding costs fall and margins further improve.

Provisions for losses have risen across all of our businesses as the economic downturn escalates. We expect losses and write-offs to continue rising. We have taken a prudent view of risk and carry in excess of £38m of provisions to cover impairment losses across the Group.

During the year the Society's credit ratings fell as did others' across the sector. Our ability to source the required level of wholesale funds has not been significantly affected and the requisite levels have been received from both existing and new counterparties.

2008 – Business as usual

Our commitment to the communities in which we operate remains undiminished as evidenced by sustained levels of community support.

Our sponsorship policies are designed to aid sporting, arts and cultural initiatives with a pan Wales profile, thereby spreading our support fairly across the local communities within which we operate. During 2008 we announced a further three-year sponsorship term with the Welsh Rugby Union for the Principality Premiership, demonstrating our assistance for sport at grass roots level in Wales.

We continue to support Welsh culture and traditions through our longstanding sponsorships of the National Eisteddfod of Wales and the Urdd Eisteddfod. 2008 marked our 28th consecutive year of support for the National Eisteddfod.

Our five-year sponsorship of Oriel 1 gallery at the National Museum of Wales St. Fagans led to Principality winning the Arts & Business Cymru Award in the category The Arts, Business & the Welsh Language.



Kate Murray from Principality Building Society and colleagues join Nerys Sales, Corporate Fundraising Manager at NSPCC Cymru/Wales, to put a Full Stop to child cruelty.

As well as our major corporate sponsorships, we also invested in a wide range of community projects and initiatives during 2008. Examples of branch sponsorships undertaken are many and varied and include Penarth Summer Festival, Swansea's Young Welsh Musical Theatre Singer of the Year competition, Denbigh's Winter Wonderland, Cowbridge Food Festival, Splott Operatic Society and a Welsh language children's football summer school in Llandudno.

Our chosen charity for 2008 was NSPCC Cymru, a charity that aims to protect children from cruelty and to support vulnerable families across Wales. Throughout the year staff supported the charity through a range of fundraising initiatives including dress down days, raffles, Christmas card competitions and a very special three peaks challenge. Together with money raised through our AGM, we contributed over £40k.

2008 - Thanks to all concerned

I am very grateful for the support of a loyal team. The year has been one of tough choices and sadly we reduced the number of roles by 209 across the Group, some 21% of overall Group staffing through a programme of redundancy and natural staff turnover. However, the team remains in good heart and its commitment is recognised, valued and appreciated.

My thanks also go to the Member Forum who provided very valuable support during their term in office. We are recruiting a new group of members

to continue the important process of member feedback and will hold our first meeting early in 2009.

2009 – Looking ahead

These are the most testing of times. Our approach to the challenges presented has been pro-active and prudent. Our performance has been robust. We have a sound balance sheet, strong capital and high levels of liquidity. We have received our certificate of eligibility for the Government Credit Guarantee Scheme.

As we look into 2009 we can expect more challenges. Market disruption will continue for some time yet as politicians and regulatory authorities work with the sector to free up interbank lending. Once 'cash' gets back into the system confidence should return but this is likely to be a slow process.

It is also right to expect further consolidation in a sector where substantial overcapacity exists. New mutual models are emerging and the mutual proposition now more than ever before will resonate more strongly with savers and borrowers alike. This plays to our strengths and we continue to face the future with confidence.

Peter L. Griffiths
Chief Executive
24 February 2009

Business review

for the year ended 31 December 2008

This section reviews the current position and performance of the Group, described in terms of a number of Key Performance Indicators used within the business.

The business objectives and activities of the Society and its subsidiaries are described in the Directors' Report on pages 14 to 17. The Group's strategy is described by the Chairman and Chief Executive on pages 2 to 5.

Financial position at the year-end

At 31 December 2008:

- Group assets increased by £546.2m to £6,398.7m.
- The pre-tax profit for the Group was £9.3m, and the net profit after tax was £5.7m, equivalent to 0.09% of mean assets employed.
- Liquid assets held in the form of Government stocks, short-term deposits and cash totalled £1,390.0m, equivalent to 23.98% of shares and borrowings.
- Mortgage assets increased by 6.55% to £4,884.3m.
- Retail deposits increased by 21.61% to £4,626.4m.
- Shares and borrowings increased by 8.76% to £5,812.4m.
- Proportion of loans and advances to customers funded by retail savings increased to 95%.
- The Group gross capital ratio was 8.00% of total share and deposit liabilities whilst the free capital ratio was 7.94% of those liabilities.

Significant events occurring during the year

These are the events considered to have had an important effect on the Group during the year:

- Achievement of record savings balance growth of £822.1m, through the attraction of 76,260 new savers to the Society, thus decreasing the Group's reliance on wholesale funding.
- Asset growth of 9.33%, taking the Group past the £6bn asset milestone.

- Changes to Fitch IBCA and Moody's credit ratings of the Society did not result in notable difficulty in obtaining wholesale funding.
- Difficult trading conditions in the housing market resulted in a loss in Peter Alan, the Society's estate agency subsidiary, and the closure of three of its branches.
- Continued house price deflation and the current economic climate have resulted in Nemo, the Society's secured lending subsidiary, recording a loss principally as a result of increased provisions against loan losses.
- The decision was taken to cease the operations of Moneypilot, a subsidiary of the Society which provided remote mortgage and financial advice via the internet.
- The Group qualified for an eligibility certificate that enabled entry into the Government Credit Guarantee Scheme.
- Principality received a 4 star award under the mortgages category in the Financial Adviser Service Awards.
- Principality won the Arts & Business Cymru Award in the category The Arts, Business & the Welsh Language for our substantial five-year sponsorship of Oriel 1 gallery at the National Museum of Wales, St. Fagans.

Capital and profit

Capital comprises the Group's general reserve, permanent interest bearing shares and subordinated debt. This capital is held to support the development of the business, to protect members' deposits and provide a buffer against unexpected losses. During 2008 total capital has increased by 5.67% to £479.8m.

The gross capital ratio and free capital ratio are explained in the Annual Business Statement on page 65.

Since 1 January 2008 the Group has managed its capital in accordance with the EU Capital Requirements Directive (Basel II), as required by the Financial Services Authority. This supersedes the requirements of the Capital Accord (Basel I). The solvency ratio compares the Group's total capital with the Group's risk weighted assets at the end of the year. The solvency ratio of 15.95% at the end of 2008 is well in excess of the minimum established by the Society's regulator and supports the Group's strategic objectives. The measurement of risk weighted assets differs significantly under Basel II, and therefore the solvency ratio for 2008 is not directly comparable with prior years. The main change is that retail mortgages are weighted at 35% under Basel II (50% Basel I). On a Basel I basis, the solvency ratio is 12.94%.

During the year the Group has continued to perform stress tests regularly on its capital base, and these tests have consistently demonstrated a capital surplus even allowing for extreme stress scenarios. The Group has set up sufficient provisions during the year against the risk of losses on its loans and advances to customers and is well placed to face the challenging economic conditions which will persist into 2009.

Net interest income is earned on a combination of retail mortgage and savings products, commercial products, liquid assets and borrowings, and through the investment of reserves. At 1.38% the Group's net interest margin continues to benefit from the higher margins earned in the commercial lending and secured personal loan businesses. Although market rates have been impacted by a lack of liquidity, the resulting interest rate environment has been beneficial to the Society, with margin benefiting from the higher than average differential between LIBOR and Bank Base Rate, as the Group is a net receiver of LIBOR.

Key Performance Indicators

The following indicators illustrate the Principality Group's performance during 2008 compared to the preceding four years:

| Year ended 31 December | 2008 | 2007 | 2006 | 2005 | 2004 |
|--|---------|---------|---------|---------|---------|
| Capital and Profit | | | | | |
| Gross capital ratio | 8.00% | 8.53% | 9.99% | 7.31% | 7.19% |
| Free capital ratio | 7.94% | 8.07% | 9.10% | 6.35% | 6.34% |
| Solvency ratio (2008: Basel II) | 15.95% | 13.33% | 15.58% | 12.60% | 13.24% |
| General reserve | £283.5m | £277.3m | £257.8m | £236.5m | £211.1m |
| Profit before tax | £9.3m | £30.6m | £29.0m | £22.6m | £18.9m |
| Profit after tax as a % of mean total assets | 0.09% | 0.38% | 0.44% | 0.37% | 0.34% |
| Profit after tax as a % of mean total assets (excluding FSCS levy) | 0.15% | 0.38% | 0.44% | 0.37% | 0.34% |
| Net interest income as % of mean total assets | 1.38% | 1.28% | 1.37% | 1.26% | 1.30% |
| Other income as % of net operating income | 20.18% | 34.45% | 35.25% | 30.85% | 24.40% |
| Operating expenses as % of mean total assets | 1.04% | 1.27% | 1.38% | 1.23% | 1.22% |

| | | | | | |
|---|-----------|-----------|-----------|-----------|-----------|
| Assets | | | | | |
| Total assets | £6,398.7m | £5,852.5m | £4,830.2m | £4,384.3m | £4,055.7m |
| Growth | 9.33% | 21.17% | 10.17% | 8.10% | 13.35% |
| Loans and advances to customers | £4,884.3m | £4,584.0m | £3,887.9m | £3,522.2m | £3,250.6m |
| Gross lending in the year | £1,125.9m | £1,602.3m | £1,313.8m | £965.6m | £1,117.4m |
| Liquid assets | £1,390.0m | £1,196.7m | £875.6m | £803.6m | £761.4m |
| Liquid assets as % of shares and borrowings | 23.98% | 22.39% | 20.12% | 19.89% | 20.30% |

| | | | | | |
|----------------|-----------|-----------|-----------|-----------|-----------|
| Funding | | | | | |
| Shares | £4,626.4m | £3,804.3m | £3,406.1m | £3,225.0m | £3,012.0m |
| Borrowings | £1,186.0m | £1,540.0m | £946.3m | £815.0m | £738.8m |
| Funding limit | 20.60% | 29.03% | 22.05% | 20.58% | 20.07% |

| | | | | | |
|-----------------------------------|-----|-------|-------|-----|-----|
| Employees | | | | | |
| Average number of people employed | 997 | 1,206 | 1,004 | 903 | 791 |

| | | | | | |
|----------------------------------|----|----|----|----|----|
| Other measures | | | | | |
| Number of branches | 50 | 50 | 50 | 51 | 51 |
| Number of estate agency branches | 23 | 26 | 25 | 25 | 25 |

Other income as a percentage of total income gives an indication of the relative value of our non-interest income streams compared with net interest income. The Group's non-interest income includes insurance income, estate agency income and income generated from a number of other complementary activities which together generated 20.18% of total income. The reduction in this ratio year on year is as a result of the impact that the downturn in the economy has had on estate agency income and lending related insurance income.

The ratio of management expenses as a percentage of total mean assets is one indication of how efficiently the Society is managing its assets. At 1.04%, the Principality Group ratio is higher than many of its peers. The main reason for this is that the Group's activities are now more diverse than most building societies. The reduction in this ratio in 2008 reflects how the Society has exercised strong cost management across the Group to counter the cyclical downturn in income.

The Group's profit after tax position for the year to 31 December 2008 is lower than the previous year, primarily due to increased provisions and a reduction in other income. The very difficult trading conditions in the year have resulted in the Society's secured lending subsidiary Nemo Personal Finance making a provision for impaired loans of £28.2m and this has had a significant detrimental effect on profit. The drop in other income reflects the slowdown in the mortgage market, affecting the Group's lending, surveying and estate agency activities. This is illustrated in the ratio of other income as a percentage of net operating income, which has fallen from 34.45% in 2007 to 20.18%.

The ratio of profit after tax to mean total assets is used by the Board to

compare the Group's financial performance with that of other organisations of different sizes. In 2008 this figure stands at 0.09% (0.15% excluding the Financial Services Compensation Scheme levy).

Funding/liabilities

Shares represent members' savings account balances within the Society. Record growth in 2008 was underpinned by strong take-up of fixed rate bonds and ISAs. Our fixed rate ISA products were consistently amongst the best available and as a result our market share of ISAs in Wales at October 2008 was 15.84%. Members' balances increased by a record £822.1m in the year and now cover 95% of all mortgage balances.

Borrowings represent funds from wholesale (money market) sources, administered by the Group's treasury function. At 20.60% of all shares, deposits and loans, Principality's borrowings remain at or below the average of its peer group and represent a relatively low dependence on financial markets. Despite the continued dislocation of the wholesale funding markets the Group has continued to diversify its funding sources and regularly reviews its list of approved counterparties. Balancing the growth of borrowings and savings will continue to be a key focus and the Board is committed to maintaining a prudent position.

The Group matches its maturity profile of liquid asset maturities with the maturity profile of liabilities to ensure a cash flow surplus. As at 31 December 2008 the maturity profile excluding interest was as described in the table below.

During the year, the Group received an eligibility certificate for the Government Credit Guarantee Scheme and since the year end the Group has issued a covered bond programme. These will enable the Group to further diversify its funding sources

Assets

Total assets have grown by £2,347.2m over the past four years, including £546.2m growth in 2008. This represents an average growth rate of 12.10% over the four years and 9.33% in 2008. During 2008 turbulence in the financial markets affected many lenders and started to restrict the availability of credit to consumers. The Board's primary concern remains the sustainability of the business so that it can deliver value to members well into the future. With this in mind the Board will continue to prudently apply controls to the Group's lending reflecting the changing business environment. As a result, growth in mortgage assets in 2008 fell to 6.55% (2007: 17.91%).

Liquid assets give protection against the risk of sudden, unexpected outflows of funds and they have been increased by £193.3m in 2008 to 23.98% of shares and borrowings. The Board believes this increased level of liquidity offers an appropriate level of protection given the current turbulence in the financial markets.

The Society's liquidity is held in the form of investments with other financial institutions. The majority of the Society's liquidity is invested for short periods to cover contractual maturities and normal day-to-day cash requirements. Liquid assets can be turned readily into cash should the need arise, and the percentage of these exposures that are rated between A and AAA under Fitch IBCA credit ratings for 2008 is 96.0% (2007: 91.9%). The Group had no exposure to Lehmans or the Icelandic banks throughout the year.

W. Guy Thomas
Group Finance Director
24 February 2009

Profile of liquid asset maturities

| | On Demand £m | Up to 1 month £m | 1-2 months £m | 2-3 months £m | 3-6 months £m | 6-9 months £m | 9-12 months £m | More than a year £m |
|-------------------------------------|-----------------|---------------------|------------------|------------------|------------------|------------------|-------------------|------------------------|
| Wholesale funding | - | (260.7) | (171.1) | (130.0) | (139.6) | (63.2) | (267.5) | (119.8) |
| Cash & loans to credit institutions | 103.2 | 105.0 | - | - | - | - | - | - |
| Debt securities | - | 275.0 | 250.0 | 110.0 | 50.0 | 85.0 | 42.0 | 337.8 |
| Total maturities | 103.2 | 119.3 | 78.9 | (20.0) | (89.6) | 21.8 | (225.5) | 218.0 |
| Cumulative cash inflows/(outflows) | 103.2 | 222.5 | 301.4 | 281.4 | 191.8 | 213.6 | (11.9) | 206.1 |

Risk management

report

Principal risks and uncertainties

The management of the business and the execution of the Group's strategy are subject to a number of risks, the principal elements being credit risk, market risk, liquidity risk and operational risk. The Group aims to manage appropriately all the risks that arise from its activities and believes that its risk management philosophy should be based on an awareness of actual and potential risk exposures, the quantification of the probable impact of such exposures and the development and implementation of measures that manage such exposures within agreed limits.

There is a formal structure for managing risks across the Group which includes detailed risk management policies which document the approach to the management of risk. These policies, including associated limits, are owned and reviewed at least annually by functional risk committees which report to the Executive Committee and the Board.

Risk governance is provided by a structure consisting of six key risk management committees. Each committee includes appropriate representation from the Executive Committee, divisional managers and Credit Risk specialists:

- Building Society Management Board, which has responsibility for retail credit risk.
- Commercial Lending Asset Management Committee, which has responsibility for commercial credit risk.
- Nemo Board, which has responsibility for secured personal lending credit risk.

- Asset and Liability Committee, which has responsibility for market and liquidity risk.
- Commercial Lending Credit Committee, which has responsibility for sanctioning commercial loan applications which fall within the criteria defined by the Board.
- Group Risk Committee, which has responsibility for ensuring a Group-wide co-ordinated approach across all risks.

Primary responsibility for managing risk and ensuring controls are in place lies with the business units themselves with risk analysis being provided by specialists within the business units. The role of these functional specialists is to maintain and review policies, establish limits which are consistent with the Group's risk appetite, monitor and report on compliance of those limits and generally to provide an oversight role in relation to the management of risk.

Group Internal Audit provides independent assurance regarding the activities of the business units and the specialist units within the business. Oversight of the risk management framework and control systems is provided by the Audit Committee on behalf of the Board. The Audit Committee and Board receive risk reports at each of their meetings and the Board has intensified its programme of risk review with quarterly reviews of major strategic risks.

Credit risk

Credit risk is the potential risk that a customer or counterparty will fail to meet their financial obligations to the Group as they become due. Credit risk arises primarily from loans to retail customers, loans to commercial customers and from the liquid and investment assets held by Group

Treasury in order to meet liquidity requirements and for general business purposes.

The controlled management of credit risk is critical to the success of the Group's lending and investment portfolios. The quality of individual lending decisions, the subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the business, will have a direct impact on the achievement of the financial objectives of the Group.

Each business area, residential first and second charge lending, commercial lending and treasury, has its own individual Credit Risk Policy Statement setting out its risk appetite and including such matters as policy scope, structures and responsibilities, definitions of risk and risk measurement and monitoring. In addition, each business area has its own detailed Procedures Manual setting out operating rules and standards.

Day-to-day management of credit risk is undertaken by specialist teams working in each business area in compliance with policies approved by the Board. Such functions undertaken include credit sanctioning, portfolio management and management of higher risk and defaulted accounts.

During 2008, driven by the changing economic climate, the Group became more selective in its approach to credit risk and repositioned the business accordingly. In a period of falling house prices, lending criteria were tightened and lending volumes deliberately reduced, especially in the Group's secured personal loans business.

The Group's forecasts and plans have taken account of the risk of further decreases in house prices plus deterioration in the economic environment and have been prepared and stressed accordingly.

Market risk

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

Group Treasury is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's treasury policies. Oversight is provided by the Asset and Liability Committee (ALCO). ALCO approves the market risk policy and receives regular reports on all aspects of market risk, including interest rate risk and foreign currency risk. Reporting lines and terms of reference are set out clearly by the Board which also receives monthly reports from the Group Finance Director covering significant issues dealt with by ALCO.

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

Interest rate risk

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

The Group is exposed to interest rate risk, principally arising from the fixed rate mortgage and savings products that it offers. The various interest rate features and maturities on these products, and the use of wholesale funds to support these products, create interest rate risk exposures due to the imperfect matching of interest

rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities.

Another significant form of interest rate risk arises from the imperfect correlation between re-pricing of interest rates on different assets and liabilities, often referred to as basis risk. The basis risk on the Group's balance sheet arises from administered liabilities which are priced relative to base rate, but are invested in money market assets earning a LIBOR return.

Interest rate risk is managed on a continual basis, within limits set by the Board, using appropriate financial instruments including derivatives. The gain of £3.2m relating to fair value adjustments on derivatives and hedge accounting represents the net fair value adjustments on derivative instruments that are matching risk exposures on an economic basis. Some income statement volatility arises on these items due to accounting ineffectiveness of designated hedges or because hedge accounting has not been adopted or is not achievable. The credit is primarily due to timing differences in cash flows and interest rate reset dates between the derivative instrument and the hedged assets and liabilities. The impact can be volatile, especially so in current market conditions, but will trend to zero over time.

A specific team has been set up to consider the Group's options and strategies in the current low interest rate environment.

Use of derivatives

Derivatives are only used to limit the extent to which the Group will be affected by changes in interest rates, foreign exchange rates or other

indices which affect fair values or cash flows. Derivatives are therefore used exclusively to hedge risk exposures.

The principal derivatives used by the Group are interest rate exchange contracts, commonly known as interest rate swaps, interest rate options and interest rate caps. The table below describes the principal activities undertaken by the Group, the related risks associated with those activities and the types of derivatives which are typically used to manage such risks.

Currency risk

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

Currency risk is managed through the use of derivatives, primarily in the form of cross currency swaps.

Liquidity risk

Liquidity risk is the risk that the Group is not able to meet its financial obligations as they fall due, or can do so only at excessive cost.

The objective of the Group's liquidity policy is therefore to maintain sufficient liquid assets to cover cash flow imbalances and fluctuations in funding, to maintain full public confidence in the Group and to ensure that all financial obligations are met. In response to the turbulence in financial markets, this has been a key focus during 2008.

Interest Rate Risk Management

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

The Group uses derivatives in accordance with 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.

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

ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing thereon. The policy is to maintain sufficient liquid resources to cover day-to-day fluctuations in funding as well as more severe, and less likely, demands. The Board applies prudent policies to ensure the interests of members and depositors are protected and that public confidence in the Society is maintained.

The Group also complies with regulatory guidelines which govern the scope and nature of the Group's holdings of liquid assets. In the current climate, liquid asset maturities are matched with the maturity profile of the Group's liabilities to ensure that financial obligations are covered as they fall due. The Group continues to monitor its cash flows on a daily basis and has developed further its stress tests to ensure that contingency plans are sufficient to meet any unexpected events.

Since the year end, the Society has issued a covered bond programme, which will enable the Society to further diversify its funding sources as the need arises.

Operational risk

Operational risk is the risk of a loss arising from inadequate or failed internal processes or systems, human error or external events. For the purposes of managing operational risk, the Group divides it into a number of discrete areas of risk which include, for example, process management, systems failure and fraud risk.

The Group's operational risk management framework sets out the strategy for identifying, assessing and managing operational risk, with senior management having responsibility for understanding how it impacts on their business areas and for putting in place the appropriate controls such as business continuity management, disaster recovery and insurance.

The framework is regularly reviewed and updated to confirm that the risks being managed remain relevant and appropriate to the business.

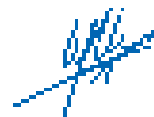
Capital management

New capital adequacy rules came into force in the UK from 1 January 2008, following the implementation of Basel II and the EU Capital Requirements Directive as set out in the Financial Services Authority (FSA) handbook BIPRU (Prudential Sourcebook for Banks, Building Societies and Investment Firms). From 1 January 2008, the Group adopted the Basel II Pillar 1 (Minimum Capital) standardised approach to credit risk and operational risk; it also became subject to Pillar 2 (Supervisory Review and Evaluation Process) and Pillar 3 (Disclosure) from that date. The Group has applied to the FSA for permission to use an Internal Ratings Based (IRB) approach to retail credit risk and capital management. This will allow the Group to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.

The Group conducts an Internal Capital Adequacy Assessment Process (ICAAP) at least annually. This is used to assess the Group's capital adequacy and determine the levels of capital required to support the current and future risks in the business. The outcome of the ICAAP is presented in a document covering all material risks to determine the capital requirement

over a five-year horizon and includes stress scenarios which are intended to meet regulatory requirements. The ICAAP is presented to the Board for approval with the most recent review being completed in January 2009. The ICAAP is used by the FSA to determine and set the Group's Individual Capital Guidance (ICG). The Group manages its capital above the ICG at all times.

Under Basel II Pillar 3, the Group is required to publish further information about its exposures and its risk management procedures and policies. It is anticipated that the Pillar 3 report, which was first published on the Society's website (www.principality.co.uk) in December 2008, will be updated in April 2009.



W. Guy Thomas
Group Finance Director
24 February 2009

Board of Directors

at 31 December 2008



David B. Williams (age 68)
Chairman

Became non-executive Chairman in 2006 having been appointed a non-executive director on 1 November 2000. He is Chairman of the Nominations Committee and a member of the Remuneration and Commercial Lending Credit Committees.



Eurfyl ap Gwilym BSc PhD (age 64)
Deputy Chairman

Appointed a non-executive director on 9 June 2000. He is a director of Nemo Personal Finance Limited and Loan Link Limited, a member of the Nominations Committee and Chairman of the Trustees of the Principality Building Society Pension and Assurance Scheme.

Other Directorships:

Director of NCC Group plc, Pure Wafer plc.



Peter L. Griffiths ACIB (age 50)
Chief Executive

Joined the Principality in December 2001 and became Chief Executive in March 2002. He was appointed a director on 2 January 2002. He is Chairman of: Peter Alan Limited, Nemo Personal Finance Limited, Loan Link Limited and Principality Mortgage and Insurance Services Limited (T/A Money pilot). He is a director of all the Society's subsidiary undertakings which have not carried on

business throughout the year. These can be seen listed in Note 22 on page 46. He is Chairman of the Commercial Lending Asset Management Committee and Building Society Management Board. He is a member of the Asset and Liability, Commercial Lending Credit and Group Risk Committees.



W. Guy Thomas
BSc (Hons) ACA FCT C.Dir (age 53)
Group Finance Director

Joined the Society as Finance Director on 1 November 2003. He is Chairman of Friary One Limited and a director of Peter Alan Limited, Nemo Personal Finance Limited, Loan Link Limited, and Principality Mortgage and Insurance Services Limited

(T/A Money pilot). He is also Chairman of the Asset and Liability and Group Risk Committees and a member of the Commercial Lending Asset Management and Commercial Lending Credit Committees.



Haydn Warman LLB (age 58)
Director and Secretary

Joined the Principality as Assistant General Manager in 1985, appointed Secretary in 1994. He was appointed a director on 1 October 2002. He is a director of Nemo Personal Finance Limited, Loan Link Limited, Principality Mortgage and Insurance Services

(T/A Money pilot). He is also a member of the Asset and Liability and Group Risk Committees.

Other Directorships and Appointments:

Governor of the University of Glamorgan



Christopher A. Jones BA (age 45)

Non-Executive Director

Appointed a non-executive director on 1 April 2006. He is a company director. He is Chairman of the Remuneration Committee and a member of the Nominations Committee.

Other Directorships and Appointments:

Director of Dŵr Cymru CYF, Glas Cymru CYF, Glas Cymru (Securities) CYF, Dŵr Cymru (Financing) Limited, Welsh Water Utilities Finance PLC, Dŵr Cymru (Holdings) Limited and the Institute of Welsh Affairs. He is also a member of the Council of Prince's Trust Cymru.



Gordon MacLean BA FCA (age 54)

Non-Executive Director

Appointed a non-executive director on 1 April 2006. He is a company director. He is Chairman of the Audit Committee and a member of the Nominations Committee.

Other Directorships and Appointments:

9 Highcliffe Road Management Ltd.



Langley Davies BSc (Hons) ACA (age 49)

Non-Executive Director

Appointed a non-executive director on 1 May 2007. He is a director of Nemo Personal Finance Limited and Loan Link Limited and a member of the Audit and Commercial Lending Credit Committees.

Other Directorships and Appointments:

Executive Director of Raglan Consultancy Limited, KL&S Limited and Vansdirect.co.uk Limited and partner in Ruperra Properties LLP and Hensol Properties LLP.



Keith Brooks (age 60)

Non-Executive Director

Appointed a non-executive director on 1 May 2007. He is a member of the Audit, Commercial Lending Credit and Remuneration Committees.

Other Directorships and Appointments:

Chairman of Vista Retail Support Group Limited and Vansdirect.co.uk Limited. Director of KL&S Limited and a partner in Airport Investments and Enterprises.



Graeme Yorston FCIB MBA (age 51)

Chief Operating Officer

Joined the Society as Chief Operating Officer on 3 July 2006 and was appointed a director on 19 October 2007.

He is a member of the Building Society Management Board and Asset and Liability & Group Risk Committees.

Directors' report

for the year ended 31 December 2008

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 2008.

Directors

The names of the directors at the date of this report, together with brief biographical details, are listed on pages 12 and 13.

On 18 April 2008 Margaret Foster retired from the Board. At the Annual General Meeting to be held on 24 April 2009 Peter Griffiths, Christopher Jones and Gordon MacLean will retire by rotation under Rule 26(1). All three are eligible and willing to continue serving on the Board and there have been no other nominations.

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

Business objectives and activities of the Society and its subsidiaries

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

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

- estate agency and property services; and
- the provision of secured personal loans.

The directors consider that no activities carried out during 2008 were outside the powers of the Society.

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

New activities

- ATMs have been installed as a pilot in 9 branches providing members and non-members with free cash withdrawals;
- A customer management system is being rolled-out, having been piloted in 10 branches, to improve the customer experience in branch by providing staff with a single view of a member's product holdings and account history. The system will prompt staff to offer details of other products and services which may be of interest to that particular member; and

- Travel insurance was added to the products available for members and non-members to purchase online.

Profits and capital

Profit before tax was £9.3m (2007: £30.6m). The profit after tax transferred to the general reserve was £5.7m (2007: £20.5m).

Total Group general reserves at 31 December 2008 were £283.5m (2007: £277.3m).

Gross capital at 31 December 2008 was £479.8m (2007: £455.3m), including £125.9m of subordinated debt and £68.9m of permanent interest bearing shares (PIBS).

The ratio of gross capital as a percentage of shares and borrowings at 31 December 2008 was 8.00% (2007: 8.53%) and the free capital ratio was 7.94% (2007: 8.07%). The Annual Business Statement on page 65 contains an explanation of these ratios.

Important events since the year-end

On 22 January 2009, the Society entered into a €3bn covered bond programme. The first issue of £700m was made on 27 January 2009. The Board considers there have been no other events since the year-end that have had a significant

effect on the Society's position or that of any of its subsidiaries.

Mortgage arrears

At 31 December 2008 there were 298 mortgage accounts across the Group on which payments were 12 or more months in arrears. Within these accounts the total amount of principal outstanding was £12.0m and the total amount of arrears was £2.1m, for which provision has been made where appropriate.

Material differences between market and book value of land/buildings

The Board considers that the overall market value of the Group's freehold and leasehold properties is in excess of the book value.

Charitable donations

During the year the Group made charitable donations of £45k (2007: £62k). No contributions were made for political purposes.

Supplier payment policy

It is the Society's policy to discharge suppliers' invoices for the complete provision of goods and services (unless there is an express provision

for stage payments) in full conformity with the conditions of the purchase and within the agreed payment terms. It is intended that this policy be continued in 2009.

At 31 December 2008 the total amount owed to suppliers was equivalent to 14 days' credit (2007: 15 days).

Environmental policy

The Society has continued its investment in environmental projects and remains committed to working with environmentally conscious partners. These are some of the initiatives undertaken during 2008:

- Investment in a new building management system to control the heating and ventilation plant within Principality House. This will result in a significant reduction in energy usage.
- Replacement of all water and heating pumps in Principality House with energy efficient models.
- Piloting a new building management system within three of our branches. If the pilot proves successful, the system will be rolled out across all branches during 2009. This will control lighting and heating automatically.

- Fitting timers to high energy consumption equipment to ensure that out of normal office hours equipment such as vending machines and photocopiers are powered down.
- Investment in software which will automatically turn off IT equipment such as computers, monitors and laptops overnight. This has already been rolled out to over 70% of Society computers and the remainder will be covered during the early part of 2009.
- A research project was undertaken during 2008 to investigate the use of photocopiers and paper. The results of this project are anticipated to produce a significant reduction in the usage of paper in 2009.

The combined effect of all of these initiatives will be a significant reduction in our energy consumption and generate annualised savings of £50k per annum.



Steffan Rhodri, star of sitcom, Gavin and Stacey, presents Pat Ashman, Events and Sponsorship Manager, with the prestigious Arts, Business and the Welsh Language Award.

Employees

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

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

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

Auditors

At the Annual General Meeting on 18 April 2008 the members passed a resolution that Deloitte & Touche LLP be appointed as auditors for the ensuing year. On 1 December 2008, Deloitte & Touche LLP changed its name to Deloitte LLP.

Responsibilities of the directors

The following statement, which should be read in conjunction with the statement of the auditors' responsibilities on page 24, 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 Directors' Report. The directors are required by the

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

- select appropriate accounting policies and apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the Annual Accounts; 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 by the Financial Services Authority under the Financial Services and Markets Act 2000.

The directors have general responsibility for safeguarding the

assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are also responsible for the integrity of the Society's website www.principality.co.uk. The work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

Information published on the internet is accessible in many countries with different legal requirements relating to the preparation and dissemination of financial statements. Information in these financial statements is provided under the legislation of the United Kingdom.

Going concern

The Chairman's statement and Chief Executive's review on pages 2 to 5, together with the Business Review on pages 6 to 8, set out a review of the business for the year and the Society's future plans. In addition note 40 to the financial statements on pages 55 to 64 gives detail of the Group's financial instruments and hedging activities; and its exposures to credit, liquidity and market risk. The principal risks and uncertainties faced by the Society and the Group, financial risk management objectives and policies, and the way in which the Group uses financial derivatives, are summarised in the Risk management report on pages 9 to 11 and in note 40 on pages 55 to 64.

As presented in the Consolidated Balance Sheet and the table on page 8, the Group meets its funding requirements mainly from retail sources supplemented from wholesale sources. The current economic conditions create some uncertainty over the availability of wholesale funding in the foreseeable future. The Group's forecasts and projections include scenario testing as carried out in accordance with the Internal Capital Adequacy Assessment

Process (ICAAP), which is a process required by our regulator to demonstrate appropriate levels of capital under stressed conditions. This takes account of reasonably possible changes in trading performance, and shows that the Group will be able to operate within the sources of funding currently available to it. In addition to these sources, additional contingency funding plans are in place, in particular the covered bond programme referred to in note 42.

The Group monitors its liquidity levels so as to ensure that an appropriate level of resources is maintained to meet the requirements of the business. These are assessed under a number of stressed scenarios reflecting the directors' views of different risks that might arise under the current economic conditions. The assets held for liquidity purposes are assessed and reviewed for counterparty risks, and the directors consider that the Group is not exposed to losses on those assets

that would affect the decision to adopt the basis of going concern. The directors consider that the overall level of capital, including Tier 1 capital of £340.3m (11.7% as a percent of risk-weighted assets) and a solvency ratio of 15.95% is adequate. Having considered the plans and forecasts for the Group the directors believe that there are no material uncertainties that lead to significant doubt on the Group's ability to continue in business for our members as a mutual building society for the foreseeable future. Accordingly, the financial statements continue to be prepared on a going concern basis.

The future

Market disruption will continue for some time as politicians and regulatory authorities work with financial institutions to restore inter-bank lending. We can also expect further consolidation in a sector where substantial excess capacity exists. The mutual proposition will resonate more strongly with savers and borrowers alike now more than

ever before. This plays to our strengths and we continue to face the future with confidence.

On behalf of the Board of Directors.



David B. Williams
Chairman
24 February 2009



Rosalind Stevens, Manager at Principality Bridgend branch (Centre) with Class Teacher and pupils from Mynydd Cynffig Infants School.

Corporate governance

report

The Society has continued to comply with the Combined Code on Corporate Governance in so far as its provisions are relevant to building societies.

The Board

The Board focuses on strategic issues, control of the business, review of operational and management performance, oversight of subsidiary companies and maintaining a system of effective corporate governance. The Board Controls and Procedures Manual sets out matters reserved to the Board and those which are delegated to management. This is reviewed annually by the Board.

The Board operates through its regular monthly meetings and three committees – Audit, Remuneration and Nominations.

Board committees

Audit Committee

The Audit Committee is chaired by Gordon MacLean. The other members during the year were Margaret Foster, Langley Davies and Keith Brooks.

Representatives of the Society's executive, internal audit department and its external auditors, Deloitte LLP, and the Heads of Group Risk and of Group Compliance attend the Committee's meetings. The Committee had private meetings with each of the external auditors, the Head of Group Audit and the Head of Group Compliance once during the year, and the Chairman of the Committee had regular private meetings with the Society Secretary, the Head of Group Audit, the Head of Group Risk and the Head of Group Compliance.

The Committee has written terms of reference which are reviewed annually. The Committee's responsibilities include:

- Review of the Group's processes for the identification, assessment, monitoring and control of business risks including market, credit and operational risks. The Committee receives reports from the Head of Group Risk;
- Assisting the Board in discharging its responsibility for satisfying itself that systems of control fully reflect the risk profile of the various businesses operated by the Group and that the adequacy and effectiveness of the systems of control including internal financial controls for the Group are regularly reviewed;

Board and Committee membership and attendance record

| | Board | Audit | Remuneration |
|---|-------|-------|--------------|
| David Williams | 13/13 | - | 4/4 |
| Eurfyl ap Gwilym | 12/13 | - | - |
| Keith Brooks | 13/13 | 3/3 | 3/3 |
| Langley Davies | 13/13 | 5/5 | - |
| Margaret Foster [retired 18 April 2008] | 4/4 | 2/2 | 1/1 |
| Peter Griffiths | 13/13 | - | - |
| Christopher Jones | 13/13 | - | 4/4 |
| Gordon MacLean | 13/13 | 5/5 | - |
| Guy Thomas | 13/13 | - | - |
| Haydn Warman | 13/13 | - | - |
| Graeme Yorston | 12/13 | - | - |

The Nominations Committee meets as and when required to consider and recommend new appointments to the Board.

- Assessment of internal systems of control within the framework established under the Financial Services and Markets Act 2000;
- Monitoring the relationship between internal and external auditors;
- Review of internal and external audit functions;
- Consideration of accounting policies;
- Review of statutory, regulatory and prudential requirements generally;
- Consideration of the Annual Report and Accounts before they are reviewed by the Board;
- Consideration of reports from the Head of Group Audit, the Head of Group Compliance and the Money Laundering Reporting Officer; and
- Reporting on its activities to the Board.

Remuneration Committee

This Committee is chaired by Christopher Jones. The other members during the year were Margaret Foster, David Williams and Keith Brooks. The Committee has written terms of reference which are reviewed annually. It considers remuneration policy and the Board delegates to this non-executive committee decisions on executives' remuneration and compensation packages. Fees payable to the Chairman and other non-executive directors are determined by the Board on recommendations from the executive directors. Details of directors' remuneration are set out on page 22. The Committee reports on its activities to the Board.

Nominations Committee

The Nominations Committee is chaired by David Williams. It comprises all the non-executive directors. It has written terms of reference which are reviewed annually. The Committee is responsible for succession planning and acts as a nomination committee for all new Board appointments. The terms upon which directors are appointed are available from the Society Secretary on request. The Committee reports on its activities to the Board. Copies of the Terms of Reference for each Board Committee are available on request from the Society Secretary.

They can also be found on the Society's website – www.principalty.co.uk.

Board balance and independence

At the end of 2008 the Board comprised a non-executive Chairman and Deputy Chairman, four other non-executive directors and four executive directors. Each of the non-executive directors, including the Chairman, is considered by the Board to be independent in judgement and free of any relationships likely to affect his or her judgement.

The Board has appointed the Deputy Chairman as senior independent director.

The Chairman and Chief Executive

The Chairman leads the Board and is not involved in the day-to-day management of the Society. The Chairman's role profile has been approved by the Board. The Chairman does not hold any other directorships.

The Chief Executive's responsibilities are set out in a role profile approved by the Board.

Board appointments

The Nominations Committee makes recommendations for appointments to the Board. The Committee comprises only non-executive directors and is chaired by the Society Chairman.

Non-executive candidates are sought in various ways, including through press advertisements and with the assistance of external search consultants. Candidates must meet the Financial Services Authority's fitness and propriety standards. In addition, the Society's Rules require that new directors must stand for election at the Annual General Meeting in the year following the year in which they are appointed and must subsequently stand for re-election at least every three years after being first elected. A copy of the letter of appointment for a non-executive director can be obtained on request from the Society Secretary.

Information and training

The Board has full and timely access to all relevant information to enable it to discharge its duties effectively. The Chairman is responsible for ensuring that all directors are properly briefed on issues arising at Board meetings.

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

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

Performance evaluation

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

During 2008 the Board undertook an evaluation of the performance of the Chairman and will undertake an evaluation of its own performance early in 2009. The Audit and Remuneration Committees each undertook a review of their own effectiveness.

Communication with members and the Annual General Meeting

The Society is committed to maintaining good communications with members. During the year two meetings were held by the Members' Forum with Society directors. It is intended that the Forum will continue to meet periodically to provide another means for members' opinions about the Society to be canvassed by directors.



Heather Richards, Customer Adviser at Pwllheli Principality branch, welcomes visitors to Principality at the Royal Welsh Showground in Builth Wells.

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

Internal control

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

- Regular operational and financial reviews of performance against budgets and forecasts by management and the Board;
- Regular reviews by management and the Audit Committee of the scope and results of internal audit work across the Group. The scope of the work covers all key activities of the

Group and concentrates on higher risk areas;

- Reviews by the Audit Committee of the scope of the work of the external auditors and any significant issues arising;
- Reviews by the Audit Committee and the Board of accounting policies and delegated authority levels;
- Consideration by the Board of the major risks facing the Group and procedures to manage them.

There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Group. This process has been in place throughout the year. The Audit Committee receives four reports each year on the status of those risks. The Committee reports on this to the Board which in addition carries out regular exercises to validate management's conclusions on the major strategic risks facing the Group.

During the year the Board also commissioned a review of the risk management process. The process currently consists of:

- Formal identification by management across the Group through a self-assessment process of the key risks to achieving their business objectives and the controls in place to manage them. The

likelihood and potential impact of each risk is evaluated;

- Independent review by internal audit as to the existence and effectiveness of the risk management activities; and
- Regular review by the Board of perceived strategic risks.

Auditor independence

The appointment of external auditors is coordinated through the Audit Committee which recommends any appointment or re-appointment to the Board. This is normally undertaken through a process of competitive tendering every five years.

Policies are in place to control the amount and nature of any non-audit work performed by the external audit firm. 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.

David B. Williams
Chairman
24 February 2009

Report of the *Remuneration Committee*

The Board is committed to best practice in its Remuneration Policy for directors. The Society applies the principles in the Combined Code on Corporate Governance relating to directors' remuneration.

The Remuneration Committee is chaired by Christopher Jones. During the year Margaret Foster resigned as a director and her place on the Committee was taken by Keith Brooks. The Committee now comprises Christopher Jones, David Williams and Keith Brooks. All members of the Committee are independent of management. The Committee met on four occasions during the year.

The role of the Remuneration Committee is to approve, implement and keep under review the remuneration policy and specifically to:

- Approve the terms of the annual pay review for Group management and staff;
- Determine and agree with the Board the framework or broad policy for the remuneration of the Society's executive directors;
- Approve the salaries, bonus payments, incentive scheme payments and pension arrangements for executive directors and the managing directors of the subsidiary companies; and
- Approve service contracts for executive directors.

Full terms of reference for the Committee can be found on the Society's website.

In 2008 advisers to the Committee were Hewitt New Bridge Street Consultants who provided benchmarking on executive remuneration packages and advice on

the structuring of incentivisation arrangements. These consultants have no other connection with the Society.

Non-executive directors' remuneration policy

Fees for non-executive directors including the Chairman are set by the Board on recommendations from the executive directors by reference to benchmark information from a comparator group comprising large building societies. Details of non-executive directors' remuneration are set out on page 22.

There are no bonus schemes or incentive schemes for any non-executive director including the Chairman. Similarly, non-executive directors have no pension scheme entitlements.

Non-executive directors' fees include payments for attendance at committee and subsidiary company meetings where appropriate.

Executive directors' remuneration policy

The Society's overall policy is designed to ensure that executive directors' remuneration reflects performance and enables the Society to attract, retain and motivate executives to deliver improving business performance for the benefit of members. The objective is to pay executive directors market median salaries with the opportunity to achieve top quartile awards for outstanding performance.

The remuneration of executive directors consists of basic salary, annual bonus, group performance bonus, pension benefits and benefits in kind (details of which are set out on pages 22 and 23). Awards under bonus schemes are non-pensionable.

The salaries of the executive directors are reviewed annually based on periodic independent advice and take into account data for a comparator group of large building societies to ensure they are in line with the sector.

Annual bonus

The annual bonus is based on the achievement of a number of performance targets related to financial, customer, people and process measures, together with personal objectives.

Three executive directors, Peter Griffiths, Guy Thomas and Graeme Yorston, are eligible for annual bonuses which, if on-target performance were achieved, would deliver an award of 24% of basic salary. The maximum bonus achievable under the annual bonus scheme is 40%.

Under the terms of the annual bonus scheme, an award of 16% would have been payable in respect of performance during 2008. However, in view of the exceptional economic environment, the executive directors have agreed with the Committee that for 2008 the annual bonus award due would be reduced by 50% i.e. to 8%.

Group Performance Bonus (2008)

The Group Performance Bonus (GPB) is designed to incentivise executive directors to achieve increased returns by the Group, in particular through the growth of profitable new business within the Group. The GPB is based on a comparison of the Group's annual performance (in terms of the post-tax return on mean assets) with that of a comparator group consisting of the top 17 building societies' results for the same year.

For matching the average performance of the comparator group a bonus of 35% of basic salary for Peter Griffiths, Guy Thomas, Haydn Warman and Graeme Yorston would be payable. For exceeding the average performance, additional bonus can be earned at a rate of an additional 2% of basic salary for every one basis point out-performance of the average performance for the comparator group, up to a maximum of an additional 25%. Similarly, the percentage bonus earned will be reduced for under-performance against the comparator average.

In respect of the GPB earned during 2008, an award of 35% would have been payable. However in view of the exceptional economic environment, the executive directors have agreed with the Committee that the award made under the scheme will also be reduced by 50% i.e. to 17½%.

The GPB earned will be paid in three equal instalments over three years so long as the executive is still in the employment of the Society. Because the latest annual performance results of the comparator group of companies will not be known until later in 2009, an

amount equal to payout for average performance relative to the comparator group has been accrued for in these accounts, with an adjustment (either positive or negative) to be made once the results for the comparator group have been published.

In 2007, the performance resulted in a total bonus payment of 53% for Peter Griffiths, Guy Thomas, Graeme Yorston and 51⅓% for Haydn Warman. The extra award of 18% in relation to this has been included in the table below under Group Performance Bonus for 2007.

Directors' remuneration in respect of the year to 31 December 2008

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

| | Salary & fees £000 | Benefits £000 | Annual bonus £000 | Group performance bonus £000 | Sub-total £000 | Increase in accrued pension £000 | Total £000 |
|-------------------------------------|-----------------------|------------------|----------------------|---------------------------------|-------------------|-------------------------------------|---------------|
| Executive 2008 | | | | | | | |
| Peter Griffiths | 288 | 13 | 23 | 51 | 375 | 5 | 380 |
| Haydn Warman | 148 | 9 | - | 26 | 183 | 3 | 186 |
| Guy Thomas | 181 | 13 | 15 | 32 | 241 | 3 | 244 |
| Graeme Yorston | 186 | 27 | 14 | 30 | 257 | - | 257 |
| Executive remuneration total | 803 | 62 | 52 | 139 | 1,056 | 11 | 1,067 |
| Executive 2007 | | | | | | | |
| Peter Griffiths | 277 | 13 | 61 | 147 | 498 | 5 | 503 |
| Haydn Warman | 143 | 8 | - | 73 | 224 | 4 | 228 |
| Guy Thomas | 175 | 11 | 39 | 93 | 318 | 4 | 322 |
| Tracy Morshead (to 30/06/07) | 92 | 8 | 14 | 23 | 137 | - | 137 |
| Graeme Yorston (from 19/10/07) | 42 | 3 | 9 | 22 | 76 | - | 76 |
| Executive remuneration total | 729 | 43 | 123 | 358 | 1,253 | 13 | 1,266 |
| | | | | | | Salary & Fees | |
| | | | | | | 2008 | 2007 |
| | | | | | | £000 | £000 |
| Non-Executive | | | | | | | |
| David Williams | | | | | | 64 | 62 |
| Margaret Foster (to 18/04/08) | | | | | | 10 | 30 |
| Eurfyl ap Gwilym | | | | | | 48 | 39 |
| Christopher Rowlands (to 31/01/07) | | | | | | - | 3 |
| Christopher Jones | | | | | | 30 | 28 |
| Gordon MacLean | | | | | | 43 | 41 |
| Langley Davies (to 1/05/07) | | | | | | 44 | 23 |
| Keith Brooks (to 1/05/07) | | | | | | 30 | 17 |
| Sub-total | | | | | | 269 | 243 |
| Executive remuneration total | | | | | | 1,067 | 1,266 |
| Total | | | | | | 1,336 | 1,509 |

1. The 2007 GPB includes an additional £114,000 earned by executive directors in relation to the final outcome of the Scheme, payable over 3 years.
2. The 2008 GPB is based on an assumption of average performance relative to the comparator group and will be adjusted upwards or downwards to reflect actual performance once the other 2008 results are known.
3. The figures under benefits include cars, fuel, medical insurance and, in the case of Graeme Yorston, personal pension.

Executive directors' service contracts

The following directors have service contracts in relation to their executive duties which provide for a twelve-month notice period or termination payment:

| | Date of contract |
|-----------------|------------------|
| Peter Griffiths | 14/11/06 |
| Haydn Warman | 14/11/06 |
| Guy Thomas | 14/11/06 |
| Graeme Yorston | 31/12/07 |

Executive directors' pension arrangements

As at 31 December 2008 executive directors listed below were members of the Society's contributory Pension Scheme. The Scheme is a career average scheme whereby members earn a pension of 1/60th of their salary each year, index linked to the Retail Prices Index, up to retirement age. The Scheme provides dependants' pensions and a lump sum of four times basic salary in the event of death in service.

Information on the executive directors' defined benefit pension arrangements is set out below:

| | Accrued pension entitlement at 31/12/08 £000 pa | Increase in accrued pension during the year £000 | Transfer value of accrued pension at 31/12/07 £000 | Transfer value of accrued pension at 31/12/08 £000 | Directors' contributions during the year £000 | Increase in transfer value over the year, net of directors' contributions £000 |
|-----------------|--|---|---|---|--|---|
| Executive | | | | | | |
| Peter Griffiths | 12 | 5 | 76 | 137 | 19 | 42 |
| Haydn Warman | 54 | 3 | 828 | 946 | 10 | 108 |
| Guy Thomas | 13 | 3 | 122 | 172 | 12 | 38 |

2009 remuneration policy

Annual bonus

The annual bonus plan provides the opportunity to set challenging performance targets. The measures to be used will be profit before tax, other income, cost asset ratio, staff turnover, a basket of treating customers fairly measures and personal objectives. The maximum annual bonus that could be earned will be 40% with a bonus of 24% for on-target performance.

Group Performance Bonus

Under this scheme it will be possible for executive directors to earn a bonus of up to 60% of salary which is payable over the following three years. The measure for this scheme is the Group's performance relative to a comparator group of the 17 largest building societies in terms of post tax return on mean assets. For a performance which is the same as the average of the top 17 societies, a bonus of 35% will be awarded.

Conclusion

The Board recommends the Report of the Remuneration Committee to the members for approval at the Annual General Meeting.



Christopher A. Jones
Chairman
24 February 2009

Independent

Auditors' report

to the members of Principality Building Society

We have audited the Group and Society Annual Accounts of Principality Building Society for the year ended 31 December 2008 which comprise the Consolidated and Society Income Statements, the Consolidated and Society Statement of Total Recognised Income and Expense, the Consolidated and Society Balance Sheets and the Consolidated and Society Cash Flow Statements and the related notes. These Annual Accounts have been prepared under the accounting policies set out therein.

We have examined the Annual Business Statement (other than the details of directors and officers upon which we are not required to report) and the Directors' 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 auditors' 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.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report including the Directors' Report, the Annual Business Statement, and the Annual Accounts in accordance with applicable law and International

Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Annual Accounts in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). We are also responsible for examining the Annual Business Statement (other than the details of directors and officers) and for reading the information in the Directors' Report and assessing whether it is consistent with the accounting records and the Annual Accounts.

We report to you our opinion as to whether the Annual Accounts give a true and fair view and whether the Annual Accounts are properly prepared in accordance with the Building Societies Act 1986, regulations made under it and, as regards the Group Annual Accounts Article 4 of the IAS Regulation. In addition, we report to you our opinion as to whether certain information in the Annual Business Statement gives a true representation of the matters in respect of which it is given, whether the information in the Directors' Report is consistent with the accounting records and the Annual Accounts and whether the Annual Business Statement and the Directors' Report have each been prepared in accordance with the applicable requirements of the Building Societies Act 1986 and regulations made under it. The information given in the Directors' Report includes that specific information given in the

Chairman's Statement and Chief Executive's Review that is cross referred from the Business Review section of the Directors' Report.

We also report to you if, in our opinion, the Society has not kept proper accounting records or if we have not received all the information and explanations that we require for our audit.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited Annual Accounts. The other information comprises only the Chairman's Statement, Chief Executive's Review, Business Review, Risk Management Report, Corporate Governance Report and the Directors' Remuneration Report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Annual Accounts, Annual Business Statement and Directors' Report. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Annual Accounts and the Annual Business Statement. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Annual Accounts, and of whether the

accounting policies are appropriate to the Group's and Society's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Annual Accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Annual Accounts.

Opinion

In our opinion:

- a) the Annual Accounts give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of affairs of the Group and of the Society as at 31 December 2008 and of the income and expenditure of the Group and of the Society for the year then ended;
- b) 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;
- c) the information given in the Directors' Report is consistent with the accounting records and the Annual Accounts; and
- d) the Annual Accounts, the Annual Business Statement and the Directors' Report have each been prepared in accordance with the applicable requirements of the Building Societies Act 1986, regulations made under it and, as regards the Group Annual Accounts, Article 4 of the IAS Regulation.



Deloitte LLP
Chartered Accountants
and Registered Auditors
Cardiff, United Kingdom
24 February 2009

Consolidated income and expenditure statement

for the year ended 31 December 2008

| | Notes | 2008 £m | 2007 £m |
|--|-----------|------------|-------------|
| Interest receivable and similar income | 4 | 388.6 | 327.4 |
| Interest payable and similar charges | 5 | (304.0) | (258.8) |
| Net interest income | | 84.6 | 68.6 |
| Fees and commission receivable | 6 | 24.5 | 41.6 |
| Fees and commission payable | 7 | (2.8) | (6.3) |
| Net fee and commission income | | 21.7 | 35.3 |
| Other operating income | | 0.6 | 1.1 |
| Other fair value gains/(losses) | 8 | 3.2 | (0.3) |
| Net operating income | | 110.1 | 104.7 |
| Administrative expenses | 10 | (57.8) | (62.0) |
| Depreciation and amortisation | 24 & 25 | (6.1) | (5.6) |
| Operating expenses | | (63.9) | (67.6) |
| Impairment provision for losses on loans and advances | 21a | (31.7) | (6.5) |
| Financial Services Compensation Scheme levy | 21b | (5.2) | - |
| Operating profit and profit before taxation | | 9.3 | 30.6 |
| Taxation expense | 14 | (3.6) | (10.1) |
| Profit for the year | | 5.7 | 20.5 |
| Consolidated statement of total recognised income and expense | | | |
| Profit for the year | | 5.7 | 20.5 |
| Actuarial gain/(loss) on retirement benefit obligations | 13 | 0.7 | (1.5) |
| Movement in deferred tax relating to retirement benefit obligations | 34 | (0.2) | 0.5 |
| Total recognised income for the year | 37 | 6.2 | 19.5 |

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

The accounting policies and notes on pages 32 to 64 form part of these accounts.

Income and expenditure statement of the Society

for the year ended 31 December 2008

| | Notes | 2008 £m | 2007 £m |
|---|---------|-------------|-------------|
| Interest receivable and similar income | 4 | 368.4 | 319.2 |
| Interest payable and similar charges | 5 | (304.0) | (258.9) |
| Net interest income | | 64.4 | 60.3 |
| Dividend income | 9 | - | 1.5 |
| Fees and commission receivable | 6 | 9.2 | 9.9 |
| Fees and commission payable | 7 | (0.5) | (0.8) |
| Net fee and commission income | | 8.7 | 9.1 |
| Other operating income | | 0.8 | 1.6 |
| Other fair value gains/(losses) | 8 | 3.2 | (0.3) |
| Net operating income | | 77.1 | 72.2 |
| Administrative expenses | 10 | (40.5) | (38.5) |
| Depreciation and amortisation | 24 & 25 | (4.6) | (4.2) |
| Operating expenses | | (45.1) | (42.7) |
| Impairment provision for losses on loans and advances | 21a | (3.5) | (1.7) |
| Financial Services Compensation Scheme levy | 21b | (5.2) | - |
| Operating profit and profit before taxation | | 23.3 | 27.8 |
| Taxation expense | 14 | (5.0) | (8.1) |
| Profit for the year | | 18.3 | 19.7 |

| Statement of total recognised income and expense | | | |
|---|-----------|-------------|-------------|
| Profit for the year | | 18.3 | 19.7 |
| Actuarial gain/(loss) on retirement benefit obligations | 13 | 0.7 | (1.5) |
| Movement in deferred tax relating to retirement benefit obligations | 34 | (0.2) | 0.5 |
| Total recognised income for the year | 37 | 18.8 | 18.7 |

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

The accounting policies and notes on pages 32 to 64 form part of these accounts.

Consolidated balance sheet

at 31 December 2008

| | Notes | 2008 £m | 2007 £m |
|--|-------|----------------|----------------|
| Assets | | | |
| Liquid assets: | | | |
| Cash in hand and balances with the Bank of England | | 6.1 | 6.3 |
| Loans and advances to credit institutions | 15 | 203.6 | 149.0 |
| Debt securities | 16 | 1,180.3 | 1,041.4 |
| | | 1,390.0 | 1,196.7 |
| Derivative financial instruments | 17 | 40.9 | 10.8 |
| Loans and advances to customers: | | | |
| Loans fully secured on residential property | 18 | 4,209.0 | 3,982.0 |
| Other loans fully secured on land | 19 | 588.5 | 531.0 |
| Other loans | 18 | 86.8 | 71.0 |
| | 20 | 4,884.3 | 4,584.0 |
| Investment in joint venture | 23 | 1.9 | 1.3 |
| Intangible fixed assets | 24 | 3.3 | 4.0 |
| Property, plant and equipment | 25 | 38.4 | 39.8 |
| Deferred tax assets | 34 | 1.0 | 2.1 |
| Other assets | 26 | 4.7 | 5.5 |
| Prepayments and accrued income | 27 | 34.2 | 8.3 |
| Total assets | | 6,398.7 | 5,852.5 |
| Liabilities | | | |
| Shares | 28 | 4,626.4 | 3,804.3 |
| Deposits and debt securities: | | | |
| Amounts owed to credit institutions | 29 | 68.2 | 41.0 |
| Amounts owed to other customers | 30 | 733.9 | 1,063.9 |
| Debt securities in issue | 31 | 383.9 | 435.1 |
| | | 1,186.0 | 1,540.0 |
| Derivative financial instruments | 17 | 70.5 | 9.9 |
| Current tax liabilities | | 3.6 | 4.0 |
| Other liabilities | 32 | 7.3 | 12.3 |
| Provision for liabilities and charges | 21b | 6.8 | 2.0 |
| Accruals and deferred income | 33 | 14.4 | 20.0 |
| Deferred tax liabilities | 34 | 2.6 | 2.8 |
| Retirement benefit obligations | 13 | 1.3 | 1.9 |
| Subordinated liabilities | 35 | 125.9 | 120.9 |
| Subscribed capital | 36 | 68.9 | 57.6 |
| Total liabilities | | 6,113.7 | 5,575.7 |
| General reserve | 37 | 283.5 | 277.3 |
| Other reserves | 38 | 1.5 | (0.5) |
| Total equity and liabilities | | 6,398.7 | 5,852.5 |

The accounting policies and notes on pages 32 to 64 form part of these accounts.

These accounts were approved by the Board on 24 February 2009.

Signed on behalf of the Board:

David B. Williams Chairman

Peter L. Griffiths Chief Executive

W. Guy Thomas Group Finance Director

Balance sheet of the Society

at 31 December 2008

| | Notes | 2008 £m | 2007 £m |
|--|-------|----------------|----------------|
| Assets | | | |
| Liquid assets: | | | |
| Cash in hand and balances with the Bank of England | | 6.1 | 6.3 |
| Loans and advances to credit institutions | 15 | 202.2 | 146.2 |
| Debt securities | 16 | 1,180.3 | 1,041.4 |
| | | 1,388.6 | 1,193.9 |
| Derivative financial instruments | 17 | 40.9 | 10.8 |
| Loans and advances to customers: | | | |
| Loans fully secured on residential property | 18 | 3,586.7 | 3,367.9 |
| Other loans fully secured on land | 19 | 588.5 | 531.0 |
| | 20 | 4,175.2 | 3,898.9 |
| Investments in subsidiary undertakings | 22 | 716.7 | 670.1 |
| Investment in joint venture | 23 | 1.9 | 1.3 |
| Intangible fixed assets | 24 | 2.5 | 2.6 |
| Property, plant and equipment | 25 | 33.6 | 34.5 |
| Deferred tax assets | 34 | 1.0 | 2.1 |
| Other assets | 26 | 1.8 | 3.9 |
| Prepayments and accrued income | 27 | 33.6 | 7.9 |
| Total assets | | 6,395.8 | 5,826.0 |
| Liabilities | | | |
| Shares | 28 | 4,626.4 | 3,804.3 |
| Deposits and debt securities: | | | |
| Amounts owed to credit institutions | 29 | 65.4 | 31.1 |
| Amounts owed to other customers | 30 | 733.9 | 1,064.1 |
| Debt securities in issue | 31 | 383.9 | 435.1 |
| | | 1,183.2 | 1,530.3 |
| Derivative financial instruments | 17 | 70.5 | 9.9 |
| Current tax liabilities | | 3.6 | 3.3 |
| Other liabilities | 32 | 6.0 | 8.8 |
| Provision for liabilities and charges | 21b | 6.3 | 2.0 |
| Accruals and deferred income | 33 | 12.8 | 16.4 |
| Deferred tax liabilities | 34 | 2.3 | 2.8 |
| Retirement benefit obligations | 13 | 1.3 | 1.9 |
| Subordinated liabilities | 35 | 125.9 | 120.9 |
| Subscribed capital | 36 | 68.9 | 57.6 |
| Total liabilities | | 6,107.2 | 5,558.2 |
| General reserve | 37 | 287.1 | 268.3 |
| Other reserves | 38 | 1.5 | (0.5) |
| Total equity and liabilities | | 6,395.8 | 5,826.0 |

The accounting policies and notes on pages 32 to 64 form part of these accounts.

These accounts were approved by the Board on 24 February 2009.

Signed on behalf of the Board:

David B. Williams Chairman

Peter L. Griffiths Chief Executive

W. Guy Thomas Group Finance Director

Consolidated cash flow statement

for the year ended 31 December 2008

| | 2008 £m | 2007 £m |
|---|--------------|-------------|
| Net cash inflow from operating activities (see below) | 175.4 | 331.7 |
| Cash flows from investing activities | | |
| Purchase of intangible assets and property, plant and equipment | (5.4) | (11.2) |
| Proceeds from sale of intangible assets and property, plant and equipment | 0.4 | 0.1 |
| Purchase of investment securities | (4,298.2) | (2,288.7) |
| Proceeds from sale and maturity of investment securities | 4,162.2 | 1,991.9 |
| Purchase of shares in joint venture | (0.6) | - |
| Increase in cash and cash equivalents | 33.8 | 23.8 |
| Cash and cash equivalents at beginning of year | 70.9 | 47.1 |
| Cash and cash equivalents at end of year | 104.7 | 70.9 |

| | | |
|--|--------------|--------------|
| Represented by: | | |
| Cash and balances with the Bank of England | 6.1 | 6.3 |
| Loans and advances to credit institutions repayable on demand | 98.6 | 64.6 |
| | 104.7 | 70.9 |
| Net cash inflow from operating activities | | |
| Profit before taxation | 9.3 | 30.6 |
| Adjusted for: | | |
| Depreciation and amortisation | 6.1 | 5.6 |
| Loss on sale of property, plant and equipment | 1.0 | 0.3 |
| Increase in impairment losses on loans and advances to customers | 18.8 | 5.4 |
| Change in fair values | (38.9) | (9.2) |
| Other non-cash movements | 6.8 | 0.1 |
| Changes in net operating assets | | |
| (Increase)/decrease in loans and advances to credit institutions | (27.2) | 6.0 |
| (Increase) in loans and advances to customers | (249.8) | (692.9) |
| Decrease/(increase) in other assets | 2.2 | (2.1) |
| (Increase)/decrease in prepayments and accrued income | (25.9) | 0.9 |
| Increase in derivative financial instruments | 30.4 | 5.9 |
| Increase in shares | 809.2 | 397.8 |
| (Decrease)/increase in deposits and debt securities | (355.3) | 586.3 |
| (Decrease)/increase in other liabilities | (6.7) | 3.6 |
| Increase/(decrease) in accruals and deferred income | 0.6 | (0.1) |
| (Decrease) in retirement benefit obligations | - | (0.1) |
| Taxation | (5.2) | (6.4) |
| | 175.4 | 331.7 |

The Group is required to maintain interest free balances with the Bank of England which at 31 December 2008 amounted to £4.3m (2007: £4.8m).

Cash flow statement of the Society

for the year ended 31 December 2008

| | 2008 £m | 2007 £m |
|---|--------------|-------------|
| Net cash inflow from operating activities (see below) | 168.7 | 331.8 |
| Cash flows from investing activities | | |
| Purchase of intangible assets and property, plant and equipment | (3.9) | (8.7) |
| Proceeds from sale of intangible assets and property, plant and equipment | 0.4 | - |
| Purchase of investment securities | (4,298.2) | (2,288.7) |
| Proceeds from sale and maturity of investment securities | 4,162.2 | 1,991.9 |
| Purchase of shares in joint venture | (0.6) | - |
| Dividends received from subsidiary companies | - | 1.5 |
| Increase in cash and cash equivalents | 28.6 | 27.8 |
| Cash and cash equivalents at beginning of year | 74.6 | 46.8 |
| Cash and cash equivalents at end of year | 103.2 | 74.6 |

| | | |
|--|--------------|--------------|
| Represented by: | | |
| Cash and balances with the Bank of England | 6.1 | 6.3 |
| Loans and advances to credit institutions repayable on demand | 97.1 | 68.3 |
| | 103.2 | 74.6 |
| Net cash inflow from operating activities | | |
| Profit before taxation | 23.3 | 27.8 |
| Adjusted for: | | |
| Depreciation and amortisation | 4.6 | 4.2 |
| Loss on sale of property, plant and equipment | - | 0.3 |
| Increase in impairment losses on loans and advances to customers | 3.0 | 1.5 |
| Change in fair values | (38.9) | (9.2) |
| Other non-cash movements | 0.2 | (1.3) |
| Changes in net operating assets | | |
| (Increase)/decrease in loans and advances to credit institutions | (27.2) | 6.0 |
| (Increase) in loans and advances to customers | (210.1) | (424.8) |
| (Increase) in loans to subsidiary companies | (46.6) | (256.5) |
| Decrease/(increase) in other assets | 2.1 | (1.4) |
| (Increase)/decrease in prepayments and accrued income | (25.9) | 0.9 |
| Increase in derivative financial instruments | 30.4 | 5.9 |
| Increase in shares | 809.2 | 397.8 |
| (Decrease)/increase in deposits and debt securities | (348.5) | 581.2 |
| (Decrease)/increase in other liabilities | (4.8) | 5.3 |
| Increase/(decrease) in accruals and deferred income | 2.8 | (0.1) |
| (Decrease) in retirement benefit obligations | - | (0.1) |
| Taxation | (4.9) | (5.7) |
| | 168.7 | 331.8 |

Notes to the accounts

for the year ended 31 December 2008

1. Accounting policies

a) Basis of preparation

The Group's financial statements for the year ended 31 December 2008 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 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 16, under the heading, 'Going concern'.

At the date of authorisation of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue but not yet effective:

- IFRS 8 Operating segments
- Amendments to IAS 1 presentation of financial statements
- Amendments to IAS 27 consolidated and separate financial statements
- Amendment to IAS 39 financial instruments: recognition and measurement: eligible hedged items
- Amendment to IAS 39 reclassification of financial assets: effective date and transition
- Revised IFRS 3 business combinations
- Revised IFRS 1 first time adoption of IFRS
- IFRIC 17 distributions of non-cash asset to owners

In addition the following standards and interpretations which have not been applied in these financial statements were in issue but not effective but which have no impact on the Group:

- IFRIC 12 service concession arrangements
- IFRIC 15 agreements for the construction of real estate
- IFRIC 16 hedges of a net investment in a foreign operation

The directors anticipate that the adoption of these standards and interpretations in future periods 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.

b) Accounting convention

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

c) Basis of consolidation

The financial information of the Group incorporates the assets, liabilities and results of the Society, its share of interests in joint ventures and its subsidiary undertakings from the date of acquisition. The acquisition method of accounting is used to account for the purchase of subsidiaries.

d) Interest receivable and payable

Interest receivable and payable for loans and advances to customers and customer accounts are recognised in the income and expenditure 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 carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the product (for example prepayment options) but does not consider future credit losses. The calculation includes all amounts received or paid by the Group that are an integral part of the overall return and the direct incremental transaction costs related to the acquisition or issue of a product.

Interest income on available-for-sale investments, derivatives and other financial assets accounted at fair value through the income and expenditure statement 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.

e) Fees and commissions

Loan origination fees are reflected in the calculation of the effective interest rate on the loan. Other fees and commissions are recognised on an accruals basis when the service has been provided.

Notes to the accounts

1. Accounting policies (continued)

f) Measurement of financial assets and liabilities

Financial assets and liabilities are classified as:

i) Loans and receivables

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

iv) Financial assets at fair value accounted through income and expenditure 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 and expenditure statement. Subsequent measurement is at fair value with changes in value reflected in the income and expenditure statement.

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

vi) Financial liabilities

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.

g) Impairment losses on loans and advances to customers

The Group assesses at each balance sheet date 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 or the debt being restructured to reduce the burden on the borrower.

The Group first assesses whether objective evidence of impairment exists either individually for assets that are separately significant or individual, or collectively for assets that are not separately significant. If there is no objective evidence of impairment for an individually assessed asset it is included in a group of assets with similar credit risk characteristics and 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 assets carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions have been deducted from the appropriate asset values in the balance sheet.

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 and expenditure 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 and expenditure 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.

Notes to the accounts

1. Accounting policies (continued)

h) Derivative financial instruments and hedge accounting

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

The Group's derivative activities are entered into for the purpose of matching or eliminating risk from potential movements in interest and foreign exchange rates inherent in the Group's assets, liabilities and positions. All derivative transactions are for economic hedging purposes.

i) Derivative financial instruments

Derivatives are initially measured at fair value and are subsequently remeasured to fair value at each reporting date with movements recorded in the income and expenditure statement. Fair values are obtained from quoted prices prevailing in active markets and valuation techniques, including discounted cash flow models, as appropriate. All derivatives are classified as assets where their fair value is positive and liabilities where their fair value is negative. Where there is the legal ability and intention to settle net, then the derivative is classified as a net asset or liability, as appropriate.

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 and expenditure 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 and expenditure 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 and expenditure 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.

i) Foreign currency translation

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

j) Intangible assets

i) Goodwill

Goodwill arising on the acquisition of subsidiary companies and joint ventures, which is represented by the excess of fair value of the purchase consideration over the fair value of the assets acquired, is capitalised and shown as an asset in the balance sheet. It is reviewed for impairment annually. Any impairment is recognised immediately in the income and expenditure statement.

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

ii) Computer software

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

Notes to the accounts

1. Accounting policies (continued)

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 3 to 5 years. The amortisation periods used are reviewed annually.

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

k) Taxation

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

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

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

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

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

l) Property, plant and equipment

Freehold and long leasehold properties comprise mainly branches and office buildings.

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

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

Depreciation 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 each balance sheet date. Where the cost of freehold land can be identified separately from buildings, the land value is not depreciated. Fixed assets are subject to impairment testing, if deemed appropriate.

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

m) 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 pays fixed contributions, without any further obligation to pay further contributions. Payments into the defined contribution scheme are charged to the income and expenditure statement as they become payable in accordance with the rules of the 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. Pension scheme assets are measured using closing market values. Pension scheme liabilities are measured using the projected unit method and discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability.

Notes to the accounts

1. Accounting policies (continued)

m) Pension costs (continued)

The increase in the present value of the liabilities of the defined benefit scheme expected to arise from employee service in the period is charged to the income and expenditure statement. The expected return on the scheme's assets and the increase during the period in the present value of the scheme's liabilities, arising from the passage of time, are included in other operating income.

Actuarial gains and losses are recognised in full in the statement of total recognised income and expense.

n) Leases

Leases entered into by the Group are operating leases.

(i) As lessee

Operating lease payments are charged to the income and expenditure 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 and expenditure statement on a straight-line basis over the life of the lease.

o) 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.

p) Segmental reporting

The Group's primary reporting format is by business segment. A business segment is a component of the Group, the activities of which are subject to risks and returns that are different from those of other business segments.

q) 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.

r) 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.

No contingent liabilities have been recognised. Further detail on financial commitments is described in Note 39 on page 54.

s) Government grants

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

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

2. Judgements in applying accounting policies and critical accounting estimates

The Group has to make judgements in applying its accounting policies which affect the amounts recognised in the financial statements. In addition, estimates and assumptions are made that could affect the reported amounts of assets and liabilities within the following financial year. The most significant areas where judgements and estimates are made are as follows:

Impairment provision on loans and advances

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

Key assumptions included in the measurement of the incurred loss include data regarding the probability of any account going into default, the probability of defaulted accounts progressing to possession and the eventual loss incurred in the event of forced sale or write-off. These assumptions are based on observed historical data and updated as management considers appropriate to reflect current and future conditions. The accuracy of the impairment provision would therefore be affected by unexpected changes in the above assumptions.

Retirement benefit obligations

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

Notes to the accounts

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

Retirement benefit obligations (continued)

The impact of a 0.1% increase in the inflation assumptions would be to increase the carrying value of the pension obligations by approximately £0.6m. The impact of a 0.1% increase in the discount rate would be to reduce the value of pensions obligations by approximately £0.6m. Further details on the assumptions used in valuing retirement benefit obligations can be found in note 13.

Other provisions for liabilities and charges

The Group establishes provisions for the estimated cost of making redress payments to customers in respect of past product sales or other administrative processes, in those cases where the original processes are found to have been deficient. The ultimate cost is inherently uncertain and, in determining the level of provisions required, it is necessary for management to exercise significant judgement. The principal assumptions underlying the provisions relate to the number of cases requiring redress and the estimated average cost of redress per case; these will be affected by external factors beyond the control of management, such as regulatory actions.

The Group has to make judgements in relation to the Financial Services Compensation Scheme levy which are described in note 39 on page 54.

Effective interest rates (EIR)

The Group uses the EIR method to recognise income for certain financial instruments held at amortised cost. To calculate the appropriate EIR, the Group makes assumptions of the expected lives of financial instruments and the anticipated level of early redemption charges. The most critical assumption is the anticipated level of early redemption penalty charges.

The impact of a 10% increase in the anticipated level of early redemption would result in an increase in the value of the loans on the balance sheet of £0.7m. The impact of a 10% decrease in the anticipated level of early redemption would result in a decrease in the value of the loans on the balance sheet of £1.4m.

Taxation

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

3. Business segments

The Group operates four main business segments, retail financial services, secured personal lending, estate agency and commercial lending. Transactions between the business segments are on normal commercial terms and conditions.

| | Group | |
|---|----------------|----------------|
| | 2008 £m | 2007 £m |
| Result by business segment | | |
| Net operating income before fair value gains and losses | | |
| Retail financial services | 68.9 | 61.5 |
| Secured personal lending | 25.5 | 22.6 |
| Estate agency | 6.2 | 11.7 |
| Commercial lending | 6.3 | 9.2 |
| | 106.9 | 105.0 |
| Administrative expenses | (57.8) | (62.0) |
| Depreciation and amortisation | (6.1) | (5.6) |
| Impairment losses on loans and advances | (31.7) | (6.5) |
| Financial Services Compensation Scheme levy | (5.2) | - |
| Fair value gains/(losses) | 3.2 | (0.3) |
| Profit before taxation | 9.3 | 30.6 |
| Total assets by business segments | | |
| Retail financial services | 4,723.3 | 4,281.5 |
| Secured personal lending | 714.4 | 688.9 |
| Commercial lending | 956.8 | 874.5 |
| Estate agency | 4.2 | 7.6 |
| Total assets | 6,398.7 | 5,852.5 |

The allocation of liabilities to business segments is not appropriate. Net proceeds of funding will be used by the Group for the general purposes of its business.

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

Intra-group recharges have been adjusted to reflect an increase in the cost of funds across the Group.

Money pilot is included within retail financial services as the directors consider that it does not represent a separate segment.

Notes to the accounts

4. Interest receivable and similar income

| | Group | | Society | |
|--|--------------|--------------|--------------|--------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| On loans fully secured on residential property | 269.6 | 229.2 | 206.7 | 187.5 |
| On other loans fully secured on land | 37.1 | 34.8 | 37.1 | 34.7 |
| On other loans to subsidiaries | - | - | 42.7 | 33.6 |
| On debt securities | 68.4 | 50.4 | 68.4 | 50.4 |
| Profit on realisation of investments | 0.2 | 1.3 | 0.2 | 1.3 |
| On other liquid assets | 5.4 | 6.2 | 5.4 | 6.2 |
| On derivative financial instruments | 7.9 | 5.5 | 7.9 | 5.5 |
| | 388.6 | 327.4 | 368.4 | 319.2 |

5. Interest payable and similar charges

| | Group | | Society | |
|---|--------------|--------------|--------------|--------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| On shares held by individuals | 202.5 | 172.5 | 202.5 | 172.5 |
| On other shares | 0.3 | 0.4 | 0.3 | 0.4 |
| On deposits and debt securities | 89.4 | 73.0 | 89.4 | 73.1 |
| On subscribed capital | 4.5 | 4.3 | 4.5 | 4.3 |
| On subordinated liabilities | 6.5 | 6.4 | 6.5 | 6.4 |
| On derivative financial instruments | 0.8 | 2.2 | 0.8 | 2.2 |
| | 304.0 | 258.8 | 304.0 | 258.9 |
| Interest to subsidiary undertakings included in interest expense and similar charges: | | | | |
| On deposits and debt securities | | | - | 0.1 |

6. Fees and commission receivable

| | Group | | Society | |
|--|-------------|-------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Insurance and related financial service products | 11.8 | 23.3 | 4.1 | 3.3 |
| Estate agency | 5.2 | 9.9 | - | - |
| Mortgage related fees | 5.2 | 5.5 | 3.6 | 4.3 |
| Other fees and commission | 2.3 | 2.9 | 1.5 | 2.3 |
| | 24.5 | 41.6 | 9.2 | 9.9 |

Notes to the accounts

7. Fees and commission payable

| | Group | | Society | |
|---------------------------|------------|------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Mortgage related fees | 2.5 | 5.2 | 0.2 | 0.5 |
| Other fees and commission | - | 0.7 | - | - |
| Bank charges | 0.3 | 0.4 | 0.3 | 0.3 |
| | 2.8 | 6.3 | 0.5 | 0.8 |

8. Other fair value gains and losses

| | Group and Society | |
|---|-------------------|--------------|
| | 2008 £m | 2007 £m |
| Losses on derivatives | (22.5) | (5.9) |
| Gains on hedged items attributable to the hedged risk | 25.7 | 5.6 |
| | 3.2 | (0.3) |

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

9. Dividend income

Dividend income relates to dividends received from subsidiary undertakings.

10. Administrative expenses

| | Group | | Society | |
|-------------------------------|-------------|-------------|-------------|-------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Wages and salaries | 30.0 | 31.5 | 19.9 | 19.6 |
| Social security costs | 3.1 | 3.1 | 2.0 | 1.9 |
| Other pension costs | 1.3 | 1.4 | 1.1 | 1.3 |
| | 34.4 | 36.0 | 23.0 | 22.8 |
| Other administrative expenses | 23.4 | 26.0 | 17.5 | 15.7 |
| | 57.8 | 62.0 | 40.5 | 38.5 |

| Other administrative expenses include: | £000 | £000 | £000 | £000 |
|--|-------|-------|------|------|
| Auditors' remuneration: | | | | |
| For audit of the Society's Annual Accounts | 93 | 94 | 93 | 94 |
| For other services: | | | | |
| For audit of the Society's subsidiaries | 20 | 19 | - | - |
| Tax advisory | 42 | - | 38 | - |
| Further assurance services | 75 | 60 | 45 | 60 |
| Regulatory | 54 | 176 | 49 | 176 |
| Operating lease charges - motor vehicles | 379 | 415 | 321 | 366 |
| - land and buildings | 1,817 | 1,595 | 641 | 730 |

Notes to the accounts

11. Employees

The average number employed, including executive directors was:

| | Full-time | | Part-time | |
|---|-------------|--------------|-------------|-------------|
| | 2008 Number | 2007 Number | 2008 Number | 2007 Number |
| Society's Customer Support Centre and administration office | 390 | 494 | 58 | 46 |
| Society branch offices | 182 | 170 | 78 | 75 |
| Employed by the Society | 572 | 664 | 136 | 121 |
| Subsidiaries | 242 | 353 | 47 | 68 |
| Employed by the Group | 814 | 1,017 | 183 | 189 |

12. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on pages 22 and 23 in accordance with Schedule 5, paragraphs 4 and 5 to the Building Societies (Accounts and Related Provisions) Regulations 1998. Total directors' emoluments for the year were £1.3m (2007: £1.5m).

In addition, pensions amounting to £22k (2007: £30k) were paid to former directors.

13. Retirement benefit obligations

The Group 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 further obligation to pay further contributions. Staff employed after 1 January 2001 are eligible to join this scheme. The cost to the Group and Society of employer's contributions to the scheme in 2008 was £219k (2007: £231k). There were no contributions outstanding or prepaid at the end of the year.

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. 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 2007, at which date there was a surplus of £0.1m. This valuation was approved by the Trustees on 22 December 2008.

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

The Trustees have continued to act in accordance with the Statement of Investment Principles adopted on 1 November 2007 as required by s.35 of the Pensions Act 1995. The Scheme assets are currently invested in the Targeted Return Fund managed by UBS Global Assets Management, the Target Return Fund with BlackRock Investment Management (UK) Limited and the UK Aggregate Bond Pension Fund with Royal London Asset Management. In addition the Trustees may hold cash from time to time.

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

Updated calculations prepared by the scheme actuary on the IAS 19 basis at 31 December 2008, including the unfunded liability referred to above, revealed a deficit amounting to £1.3m (2007: £1.9m).

Notes to the accounts

13. Retirement benefit obligations (continued)

The major assumptions used by the actuary were:

| | At 31 December | | | | |
|--|----------------|-----------|-----------|-----------|-----------|
| | 2008 % | 2007 % | 2006 % | 2005 % | 2004 % |
| Rate of increase in pensionable salaries | 2.70 | 3.20 | 2.75 | 2.60 | 4.10 |
| Rate of increase of pensions in payment and deferred pensions | 2.70 | 3.20 | 2.75 | 2.60 | 2.60 |
| Discount rate | 6.25 | 5.70 | 5.10 | 4.70 | 5.30 |
| Inflation assumption | 2.70 | 3.20 | 2.75 | 2.60 | 2.60 |
| The long-term rates of return expected on investments in the schemes were: | 6.50 | 6.50 | 6.00 | 6.00 | 6.20 |

The table used to forecast the mortality rates was P[M/F] A92 medium short year of birth.

The retirement benefit obligation relating to the Scheme recognised in the balance sheet is made up as follows:

| | At 31 December | | | | |
|--|----------------|--------------|--------------|--------------|---------------|
| | 2008 £m | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
| Target return funds | 17.8 | 21.5 | - | - | - |
| Debt securities | 17.7 | 17.6 | - | - | - |
| Equities | - | - | 19.1 | 17.6 | 14.2 |
| Bonds and cash | - | - | 18.3 | 17.5 | 9.8 |
| Total fair value of plan assets | 35.5 | 39.1 | 37.4 | 35.1 | 24.0 |
| Present value of funded obligations | (36.3) | (40.5) | (37.4) | (36.7) | (35.1) |
| Present value of unfunded obligations | (0.5) | (0.5) | (0.6) | (0.6) | (1.1) |
| Net deficit recognised in the balance sheet | (1.3) | (1.9) | (0.6) | (2.2) | (12.2) |

The amounts recognised in the income and expenditure statement are as follows:

| | Group and Society | |
|---|-------------------|--------------|
| | 2008 £m | 2007 £m |
| Analysis of pension costs (included in administrative expenses) | | |
| Current service cost | (1.1) | (1.1) |
| | (1.1) | (1.1) |
| Analysis of finance credit (included in other operating income) | | |
| Expected return on pension scheme assets | 2.5 | 2.2 |
| Interest on pension scheme liabilities | (2.4) | (1.9) |
| Net credit to other financial income | 0.1 | 0.3 |
| Analysis of amount recognised in statement of total recognised income and expense | | |
| Actuarial gain/(loss) | 0.7 | (1.5) |
| Analysis of the movement in the balance sheet deficit | | |
| Deficit in schemes at beginning of year | (1.9) | (0.6) |
| Movement in year: | | |
| Current service cost | (1.1) | (1.1) |
| Other finance credit | 0.1 | 0.3 |
| Actuarial gain/(loss) | 0.7 | (1.5) |
| Contributions paid | 0.9 | 1.0 |
| Deficit in schemes at end of year | (1.3) | (1.9) |

Notes to the accounts

13. Retirement benefit obligations (continued)

| Details of experience gains and losses | Group and Society | | | | |
|--|-------------------|---------|---------|-------|---------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Difference between the expected and actual return on scheme assets: | | | | | |
| (Loss)/gain amount | (£6.2m) | (£0.7m) | (£0.1m) | £3.3m | £0.4m |
| Percentage of scheme assets | 17.5% | 1.8% | 0.1% | 9.3% | 1.7% |
| Experience gains and losses on scheme liabilities: | | | | | |
| (Loss)/gain amount | (£6.9m) | (£0.8m) | - | £2.3m | - |
| Percentage of the present value of scheme liabilities | 18.8% | 1.9% | - | 6.2% | - |
| Total amount recognised in statement of total recognised income and expense: | | | | | |
| Gain/(loss) amount | £0.7m | (£1.5m) | £1.6m | £5.0m | (£1.4m) |
| Percentage of the present value of scheme liabilities | 1.8% | 3.7% | 4.1% | 13.6% | 3.9% |

The actual loss on plan assets was £3.6m (2007: £1.6m return).

14. Taxation

During the year, the statutory rate of corporation tax was reduced to 28% from 1 April 2008. The Group is subject to corporation tax at a rate of 30% for the period 1 January to 31 March 2008, and 28% for the period 1 April to 31 December 2008, resulting in an effective rate of corporation tax of 28.5% for the full year.

| | Group | | Society | |
|--|------------|-------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Current tax | | | | |
| UK corporation tax charge for the year | 4.3 | 9.6 | 4.3 | 7.6 |
| Adjustments in respect of prior periods | (1.5) | (0.1) | 0.2 | (0.1) |
| | 2.8 | 9.5 | 4.5 | 7.5 |
| Deferred tax | | | | |
| Deferred tax charge/(credit) for year | 0.6 | (0.1) | 0.5 | (0.1) |
| Adjustments in respect of prior periods | 0.2 | 0.7 | - | 0.7 |
| | 0.8 | 0.6 | 0.5 | 0.6 |
| Taxation on profit on ordinary activities | 3.6 | 10.1 | 5.0 | 8.1 |

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.

| | | | | |
|--|------------|-------------|------------|------------|
| Profit before taxation | 9.3 | 30.6 | 23.3 | 27.8 |
| Profit multiplied by the standard rate of corporation tax in the UK at 28.5% (2007: 30.0%) | 2.6 | 9.2 | 6.6 | 8.3 |
| Effects of: | | | | |
| Group relief received for nil consideration | - | - | (2.8) | - |
| Depreciation in excess of capital allowances | 0.3 | - | 0.2 | - |
| Expenses not deductible for tax purposes | 0.2 | 0.3 | 0.1 | (0.8) |
| Adjustments to prior years | (1.3) | 0.6 | 0.1 | 0.6 |
| Write-off of connected party loan | - | - | 0.7 | - |
| Tax losses carried back | 1.7 | - | - | - |
| Other | 0.1 | - | 0.1 | - |
| Total taxation for the year | 3.6 | 10.1 | 5.0 | 8.1 |

Notes to the accounts

15. Loans and advances to credit institutions

| | Group | | Society | |
|--|--------------|--------------|--------------|--------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Repayable from the date of the balance sheet in the ordinary course of business: | | | | |
| Accrued interest | - | 0.2 | - | 0.2 |
| On demand | 98.5 | 71.1 | 97.1 | 68.3 |
| Less than three months | 105.1 | 77.7 | 105.1 | 77.7 |
| | 203.6 | 149.0 | 202.2 | 146.2 |

16. Debt securities

| | Group and Society | |
|--|-------------------|----------------|
| | 2008 £m | 2007 £m |
| Issued by UK government | 251.7 | - |
| Issued by other borrowers and unlisted | 928.6 | 1,041.4 |
| | 1,180.3 | 1,041.4 |

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

The debt securities set out above are repayable from the date of the balance sheet in the ordinary course of business as follows:

| | Group and Society | |
|-----------------------------------|-------------------|----------------|
| | 2008 £m | 2007 £m |
| Accrued interest | 14.3 | 17.5 |
| Less than three months | 615.8 | 500.3 |
| Between three months and one year | 198.6 | 260.1 |
| Between one year and five years | 351.6 | 263.5 |
| | 1,180.3 | 1,041.4 |

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

| | Group and Society |
|----------------------------------|-------------------|
| | £m |
| At 1 January 2008 | 1,041.4 |
| Additions | 4,298.2 |
| Disposals and maturities | (4,159.0) |
| Gains from changes in fair value | 2.8 |
| Decrease in accrued interest | (3.1) |
| At 31 December 2008 | 1,180.3 |

The Society engages in gilt stock lending controlled through the Central Gilt Office of the Bank of England.

Notes to the accounts

17. Derivative financial instruments

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

| | Group and Society | | | |
|--|------------------------------|----------------|---------------|--------------|
| | Contract/ notional amount | | Fair value | |
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Derivative assets held for hedging purposes and designated fair value hedges: | | | | |
| Interest rate swaps | 1,399.3 | 1,135.5 | 32.7 | 7.8 |
| Cross currency interest rate swaps | 57.3 | 44.0 | 16.2 | 3.0 |
| Credit Support Annex (CSA) deposits | (8.0) | - | (8.0) | - |
| Total recognised derivative assets | 1,448.6 | 1,179.5 | 40.9 | 10.8 |
| Derivative liabilities held for hedging purposes and designated fair value hedges: | | | | |
| Interest rate swaps | 1,626.9 | 993.5 | (70.5) | (9.9) |
| Total recognised derivative liabilities | 1,626.9 | 993.5 | (70.5) | (9.9) |

The current replacement credit for derivatives held was £29.6m (2007: cost of £0.9m).

Contract/notional amount indicates the amount outstanding at the balance sheet date and does not represent amounts at risk.

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. £8.0m had been received during the year (2007: £nil).

18. Loans fully secured on residential property

| | Group | | Society | |
|---------------------------------------|----------------|----------------|----------------|----------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Gross balances | 4,216.0 | 4,022.1 | 3,525.9 | 3,371.0 |
| Provision for impairment losses | (38.3) | (19.4) | (12.3) | (9.3) |
| Unamortised loan origination fees | 43.1 | 44.5 | (1.9) | 0.4 |
| Fair value adjustment for hedged risk | 75.0 | 5.8 | 75.0 | 5.8 |
| | 4,295.8 | 4,053.0 | 3,586.7 | 3,367.9 |

Within the Group totals above there was £86.8m partially secured against residential property (2007: £71.0m).

19. Other loans fully secured on land

| | Group and Society | |
|-------------|-------------------|------------|
| | 2008 £m | 2007 £m |
| Other loans | 588.5 | 531.0 |

Notes to the accounts

20. Loans and advances to customers

| | Group | | Society | |
|--|------------|------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Maturity analysis of loans and advances to customers from the date of the balance sheet: | | | | |
| Repayable on demand | 41.7 | 79.7 | 41.7 | 79.4 |
| Less than three months | 104.3 | 58.9 | 104.3 | 52.6 |
| Between three months and one year | 225.1 | 222.2 | 225.1 | 202.4 |
| Between one year and five years | 932.7 | 932.5 | 910.0 | 805.0 |
| More than five years | 3,500.7 | 3,259.8 | 2,833.3 | 2,762.6 |
| | 4,804.5 | 4,553.1 | 4,114.4 | 3,902.0 |
| Provision for impairment losses | (38.3) | (19.4) | (12.3) | (9.3) |
| Unamortised loan origination fees | 43.1 | 44.5 | (1.9) | 0.4 |
| Fair value adjustment for hedged risk | 75.0 | 5.8 | 75.0 | 5.8 |
| | 4,884.3 | 4,584.0 | 4,175.2 | 3,898.9 |

21a. Provision for impairment losses

| | Loans fully secured on residential property | Loans fully secured on residential property |
|-------------------------------------|---|---|
| | 2008 £m | 2007 £m |
| Group | | |
| At 1 January | 19.4 | 13.2 |
| Amounts written off during the year | (12.8) | (0.3) |
| Provision for loan impairment | 31.7 | 6.5 |
| At 31 December | 38.3 | 19.4 |
| Society | | |
| At 1 January | 9.3 | 7.9 |
| Amounts written off during the year | (0.5) | (0.3) |
| Provision for loan impairment | 3.5 | 1.7 |
| At 31 December | 12.3 | 9.3 |

2007 has been restated due to changes in the categorisation of commercial asset classes during 2008.

21b. Provisions for liabilities and charges

| | Group | | Society | |
|------------------------|------------|------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| At 1 January | 2.0 | 2.1 | 2.0 | 2.1 |
| Additions | 5.2 | - | 5.2 | - |
| (Release) for the year | (0.4) | (0.1) | (0.9) | (0.1) |
| At 31 December | 6.8 | 2.0 | 6.3 | 2.0 |

Included in provisions is the Financial Services Compensation Scheme levy of £5.2m which is based on the Group's share of protected deposits and represents 18 months' charge of the levy to March 2010. The contingent aspect of the Financial Services Compensation Scheme levy is described in note 39 on page 54.

Notes to the accounts

22. Investments in subsidiary undertakings

| | Society | |
|------------------------------------|--------------|--------------|
| | 2008 £m | 2007 £m |
| Shares in subsidiary undertakings: | | |
| At cost | 4.5 | 4.5 |
| Amounts written off investments | (3.0) | (3.0) |
| | 1.5 | 1.5 |
| Loans to subsidiary undertakings | 715.2 | 668.6 |
| | 716.7 | 670.1 |

| | Subsidiary undertakings | |
|---|-------------------------|--------------|
| | Shares £m | Loans £m |
| Movement in investments in subsidiary undertakings: | | |
| At 1 January 2008 | 1.5 | 668.6 |
| Increase | - | 46.6 |
| At 31 December 2008 | 1.5 | 715.2 |

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

The Society has the following subsidiary undertakings which operated in the United Kingdom during the year and are included in the Group accounts:

| | Place of registration | Principal activity | Class of shares held | Interest of Society | Direct or indirect |
|---|-----------------------|---|-------------------------|---------------------|--------------------|
| Peter Alan Limited | England and Wales | Estate agency and financial services | Ordinary and preference | 100% | Direct |
| Nemo Personal Finance Limited | England and Wales | Secured personal lending | Ordinary | 100% | Direct |
| Loan Link Limited | England and Wales | Loan broking | Ordinary | 100% | Indirect |
| Principality Mortgage and Insurance Services Limited (T/A Moneypilot) | England and Wales | Provision of advisory and administration services | Ordinary | 100% | Direct |

On 11 September 2008, the decision was taken to cease the operations of Moneypilot. The costs of terminating the business included in the income and expenditure statement were immaterial. An inter-company loan of £2.4m between the Society and Moneypilot was written off during the year.

The Society also holds 100% of the ordinary share capital of the following subsidiary undertakings which have not carried on business during the year:

| | | |
|---------------------------------------|---|--|
| Brokerpoint Limited | Principality Direct Limited | Principality Mortgage Corporation Limited |
| Home Information Pack Wales Limited | Principality Estate Agency Limited | Principality Personal Loans Limited |
| Nemo Loans Limited | Principality Financial Management Limited | Principality Property Sales Limited |
| Nemo Financial Limited | Principality Homes Limited | Principality Property Services Limited |
| Nemo Financial Services Limited | Principality (IFA Services) Limited | Principality Surveyors Home Condition Report Limited |
| Nemo Secured Loans Limited | Principality Independent Financial Advisers Limited | Principality Syndicated Loans Limited |
| Nemo Insurance Services Limited | Principality Life Assurance Services Limited | The Principality Home Information Pack Limited |
| Principality Limited | Principality (Life and Pensions) Limited | |
| Principality Asset Management Limited | | |
| Principality Bank Limited | | |

Notes to the accounts

23. Investment in joint venture

The aggregate movement in investment in joint ventures is as follows:

| | Group and Society £m |
|----------------------------------|-------------------------|
| At 1 January 2008 | 1.3 |
| Additions | 0.6 |
| Share of profit of joint venture | - |
| At 31 December 2008 | 1.9 |

24. Intangible assets

| 2008 | Goodwill | | Computer software | | Total | |
|----------------------------|-------------|---------------|-------------------|---------------|-------------|---------------|
| | Group £m | Society £m | Group £m | Society £m | Group £m | Society £m |
| Cost: | | | | | | |
| At 1 January 2008 | 0.7 | - | 4.9 | 3.6 | 5.6 | 3.6 |
| Additions | - | - | 0.7 | 0.7 | 0.7 | 0.7 |
| Disposals | - | - | (0.9) | - | (0.9) | - |
| At 31 December 2008 | 0.7 | - | 4.7 | 4.3 | 5.4 | 4.3 |
| Amortisation: | | | | | | |
| At 1 January 2008 | - | - | 1.6 | 1.0 | 1.6 | 1.0 |
| Charge for the year | - | - | 0.9 | 0.8 | 0.9 | 0.8 |
| Disposals | - | - | (0.4) | - | (0.4) | - |
| At 31 December 2008 | - | - | 2.1 | 1.8 | 2.1 | 1.8 |
| Net carrying amount: | | | | | | |
| At 31 December 2008 | 0.7 | - | 2.6 | 2.5 | 3.3 | 2.5 |
| At 31 December 2007 | 0.7 | - | 3.3 | 2.6 | 4.0 | 2.6 |

| 2007 | Goodwill | | Computer software | | Total | |
|----------------------------|-------------|---------------|-------------------|---------------|-------------|---------------|
| | Group £m | Society £m | Group £m | Society £m | Group £m | Society £m |
| Cost: | | | | | | |
| At 1 January 2007 | 0.7 | - | 3.5 | 2.5 | 4.2 | 2.5 |
| Additions | - | - | 1.4 | 1.1 | 1.4 | 1.1 |
| At 31 December 2007 | 0.7 | - | 4.9 | 3.6 | 5.6 | 3.6 |
| Amortisation: | | | | | | |
| At 1 January 2007 | - | - | 0.7 | 0.4 | 0.7 | 0.4 |
| Charge for the year | - | - | 0.9 | 0.6 | 0.9 | 0.6 |
| At 31 December 2007 | - | - | 1.6 | 1.0 | 1.6 | 1.0 |
| Net carrying amount: | | | | | | |
| At 31 December 2007 | 0.7 | - | 3.3 | 2.6 | 4.0 | 2.6 |
| At 31 December 2006 | 0.7 | - | 2.8 | 2.1 | 3.5 | 2.1 |

The goodwill arises following the acquisition of 100% of the ordinary share capital of Loan Link Limited on 1 December 2004.

In accordance with the requirements of IAS 36, the Group completed an impairment review of the carrying value for goodwill as at 31 December 2008 to ensure that the carrying value is stated at no more than its recoverable amount. No impairment provision is required as a result of this review.

Notes to the accounts

25. Property, plant and equipment

| | Land and buildings | | Equipment, fixtures, fittings & vehicles | | Total | |
|----------------------------|--------------------|---------------|--|---------------|-------------|---------------|
| | Group £m | Society £m | Group £m | Society £m | Group £m | Society £m |
| Cost: | | | | | | |
| At 1 January 2008 | 46.2 | 42.4 | 21.1 | 14.7 | 67.3 | 57.1 |
| Additions | 0.4 | 0.3 | 4.3 | 2.9 | 4.7 | 3.2 |
| Disposals | (0.7) | (0.6) | (1.3) | (0.8) | (2.0) | (1.4) |
| At 31 December 2008 | 45.9 | 42.1 | 24.1 | 16.8 | 70.0 | 58.9 |
| Depreciation: | | | | | | |
| At 1 January 2008 | 15.2 | 13.8 | 12.3 | 8.8 | 27.5 | 22.6 |
| Charge for the year | 1.7 | 1.5 | 3.5 | 2.3 | 5.2 | 3.8 |
| Disposals | (0.3) | (0.3) | (0.8) | (0.8) | (1.1) | (1.1) |
| At 31 December 2008 | 16.6 | 15.0 | 15.0 | 10.3 | 31.6 | 25.3 |
| Net book amount: | | | | | | |
| At 31 December 2008 | 29.3 | 27.1 | 9.1 | 6.5 | 38.4 | 33.6 |
| At 31 December 2007 | 31.0 | 28.6 | 8.8 | 5.9 | 39.8 | 34.5 |

| | Land and buildings | | Equipment, fixtures, fittings & vehicles | | Total | |
|----------------------------|--------------------|---------------|--|---------------|-------------|---------------|
| | Group £m | Society £m | Group £m | Society £m | Group £m | Society £m |
| Cost: | | | | | | |
| At 1 January 2007 | 41.4 | 37.9 | 17.9 | 13.1 | 59.3 | 51.0 |
| Additions | 4.8 | 4.5 | 5.1 | 3.2 | 9.9 | 7.7 |
| Disposals | - | - | (1.9) | (1.6) | (1.9) | (1.6) |
| At 31 December 2007 | 46.2 | 42.4 | 21.1 | 14.7 | 67.3 | 57.1 |
| Depreciation: | | | | | | |
| At 1 January 2007 | 13.7 | 12.3 | 10.6 | 8.0 | 24.3 | 20.3 |
| Charge for the year | 1.5 | 1.5 | 3.1 | 2.1 | 4.6 | 3.6 |
| Disposals | - | - | (1.4) | (1.3) | (1.4) | (1.3) |
| At 31 December 2007 | 15.2 | 13.8 | 12.3 | 8.8 | 27.5 | 22.6 |
| Net book amount: | | | | | | |
| At 31 December 2007 | 31.0 | 28.6 | 8.8 | 5.9 | 39.8 | 34.5 |
| At 31 December 2006 | 27.7 | 25.6 | 7.3 | 5.1 | 35.0 | 30.7 |

| Land and buildings: | 2008 | | 2007 | |
|---|-------------|---------------|-------------|---------------|
| | Group £m | Society £m | Group £m | Society £m |
| Freehold | 26.2 | 24.6 | 27.6 | 25.8 |
| Long leasehold | 0.6 | 0.3 | 0.6 | 0.3 |
| Short leasehold | 2.5 | 2.2 | 2.8 | 2.5 |
| | 29.3 | 27.1 | 31.0 | 28.6 |
| Occupied by the Society and subsidiary undertakings | 24.1 | 23.0 | 22.4 | 20.6 |

Notes to the accounts

26. Other assets

| | Group | | Society | |
|----------------------|------------|------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Due within one year: | | | | |
| Other | 4.7 | 5.5 | 1.8 | 3.9 |

27. Prepayments and accrued income

| | Group | | Society | |
|--|-------------|------------|-------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Accrued interest on derivative financial instruments | 31.1 | 5.4 | 31.1 | 5.4 |
| Other accrued interest | 0.1 | - | 0.1 | - |
| Other | 3.0 | 2.9 | 2.4 | 2.5 |
| | 34.2 | 8.3 | 33.6 | 7.9 |

28. Shares

| | Group and Society | |
|---------------------------------------|-------------------|----------------|
| | 2008 £m | 2007 £m |
| Held by individuals | 4,602.0 | 3,791.2 |
| Other shares | 10.0 | 11.6 |
| Fair value adjustment for hedged risk | 14.4 | 1.5 |
| | 4,626.4 | 3,804.3 |

The repayment of the above balances from the date of the balance sheet in the ordinary course of business is as follows:

| | Group and Society | |
|---------------------------------------|-------------------|----------------|
| | 2008 £m | 2007 £m |
| Fair value adjustment for hedged risk | 14.4 | 1.5 |
| Accrued interest | 138.7 | 129.0 |
| On demand | 1,895.4 | 1,733.9 |
| Less than three months | 1,395.4 | 1,327.7 |
| Between three months and one year | 856.5 | 320.2 |
| Between one year and five years | 326.0 | 292.0 |
| | 4,626.4 | 3,804.3 |

Notes to the accounts

29. Amounts owed to credit institutions

| | Group | | Society | |
|--|-------------|-------------|-------------|-------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| The repayment from the date of the balance sheet in the ordinary course of business is as follows: | | | | |
| Accrued interest | 0.2 | 0.4 | 0.2 | 0.4 |
| On demand | 2.8 | 13.2 | - | 3.3 |
| Less than three months | 65.2 | 24.4 | 65.2 | 24.4 |
| Between three months and one year | - | 3.0 | - | 3.0 |
| | 68.2 | 41.0 | 65.4 | 31.1 |

30. Amounts owed to other customers

| | Group | | Society | |
|--|--------------|----------------|--------------|----------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| The repayment from the date of the balance sheet in the ordinary course of business is as follows: | | | | |
| Accrued interest | 14.0 | 11.8 | 14.0 | 11.8 |
| On demand | 5.5 | 4.8 | 5.5 | 4.8 |
| Less than three months | 413.1 | 782.4 | 413.1 | 785.8 |
| Between three months and one year | 263.8 | 201.9 | 263.8 | 227.2 |
| Between one year and five years | 37.5 | 63.0 | 37.5 | 34.5 |
| | 733.9 | 1,063.9 | 733.9 | 1,064.1 |

31. Debt securities in issue

| | Group and Society | |
|---------------------------------------|-------------------|--------------|
| | 2008 £m | 2007 £m |
| Certificates of deposit | 98.5 | 163.8 |
| Fixed and floating rate notes | 283.5 | 270.7 |
| Fair value adjustment for hedged risk | 1.9 | 0.6 |
| | 383.9 | 435.1 |

The repayment from the date of the balance sheet in the ordinary course of business is as follows:

| | Group and Society | |
|---------------------------------------|-------------------|--------------|
| | 2008 £m | 2007 £m |
| Fair value adjustment for hedged risk | 1.9 | 0.6 |
| Accrued interest | 3.2 | 3.1 |
| Less than three months | 83.5 | 124.3 |
| Between three months and one year | 213.0 | 38.1 |
| Between one year and five years | 63.2 | 254.3 |
| More than five years | 19.1 | 14.7 |
| | 383.9 | 435.1 |

Notes to the accounts

31. Debt securities in issue (continued)

| The effective interest rates at the balance sheet dates were as follows: | 2008 | 2007 |
|--|-------|-------|
| Certificates of deposit | 5.63% | 6.35% |
| Fixed and floating rate notes | 4.14% | 6.61% |

32. Other liabilities

| | Group | | Society | |
|--|------------|-------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Due within one year: | | | | |
| Income tax | 0.7 | 0.6 | 0.6 | 0.6 |
| Other taxation and social security | 1.3 | 1.5 | 1.2 | 0.6 |
| Other creditors | 5.3 | 10.2 | 4.2 | 7.6 |
| | 7.3 | 12.3 | 6.0 | 8.8 |
| Other creditors include amounts due to subsidiary undertakings | | | 0.3 | 0.3 |

33. Accruals and deferred income

| | Group | | Society | |
|--|-------------|-------------|-------------|-------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Interest accrued on subordinated liabilities | 3.6 | 3.1 | 3.6 | 3.1 |
| Interest accrued on subscribed capital | 1.2 | 0.4 | 1.2 | 0.4 |
| Other | 9.6 | 16.5 | 8.0 | 12.9 |
| | 14.4 | 20.0 | 12.8 | 16.4 |

34. Deferred tax

| | Group | | Society | |
|---|------------|------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| At 1 January | 0.7 | 0.4 | 0.7 | 0.4 |
| Charged to income and expenditure statement | 0.7 | 0.7 | 0.4 | 0.7 |
| Charged to statement of total recognised income and expense on actuarial gains/(losses) | 0.2 | (0.4) | 0.2 | (0.4) |
| At 31 December | 1.6 | 0.7 | 1.3 | 0.7 |

Notes to the accounts

34. Deferred tax (continued)

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

| | Group | | | Society | | |
|---|--------------------------------|--------------|--------------|--------------------------------|--------------|--------------|
| | Retirement benefit obligations | Other | Total | Retirement benefit obligations | Other | Total |
| | £m | £m | £m | £m | £m | £m |
| Deferred tax assets | | | | | | |
| At 1 January 2008 | (0.5) | (1.6) | (2.1) | (0.5) | (1.6) | (2.1) |
| Credited to income and expenditure statement | - | 0.9 | 0.9 | - | 0.9 | 0.9 |
| Charged to statement of total recognised income and expense | 0.2 | - | 0.2 | 0.2 | - | 0.2 |
| At 31 December 2008 | (0.3) | (0.7) | (1.0) | (0.3) | (0.7) | (1.0) |

| | Accelerated tax depreciation | Other | Total | Accelerated tax depreciation | Other | Total |
|--|------------------------------|------------|------------|------------------------------|------------|------------|
| | £m | £m | £m | £m | £m | £m |
| Deferred tax liabilities | | | | | | |
| At 1 January 2008 | 0.9 | 1.9 | 2.8 | 0.9 | 1.9 | 2.8 |
| Credited to income and expenditure statement | - | (0.2) | (0.2) | (0.3) | (0.2) | (0.5) |
| At 31 December 2008 | 0.9 | 1.7 | 2.6 | 0.6 | 1.7 | 2.3 |

Deferred tax assets are available for offset against deferred tax liabilities and the net deferred liability at 31 December 2008 is £nil (2007: £0.7m net liability).

The reduction of the UK corporation tax rate from 30% to 28% from 1 April 2008 has resulted in a deferred tax credit arising from the reduction in the balance sheet carrying value of the net deferred tax liability to reflect the anticipated rate of tax at which the liability is expected to reserve. The relevant credit is not material.

35. Subordinated liabilities

| | Group and Society | |
|---|-------------------|--------------|
| | 2008 £m | 2007 £m |
| 5 ³ / ₈ % Subordinated Notes due 2016 | 120.0 | 120.0 |
| Unamortised premiums and issue costs | (0.5) | (0.7) |
| Fair value adjustment for hedged risk | 6.4 | 1.6 |
| | 125.9 | 120.9 |

The Society's subordinated liabilities are unsecured. The Society may, with prior consent of the Financial Services Authority, redeem all of the subordinated notes at par on 8 July 2011 by giving not less than 15 nor more than 30 days' notice to all holders. In the event that the Society does not redeem the notes on 8 July 2011, the rate of interest will become LIBOR plus 1.005% reset quarterly.

The subordinated notes rank pari passu with each other and behind the claims against the Society of all depositors, creditors and investing members of the Society.

The interest rate risk arising from the issue of fixed rate subordinated debt has been mitigated through the use of interest rate swaps.

Notes to the accounts

36. Subscribed capital

| | Group and Society | |
|---|-------------------|-------------|
| | 2008 £m | 2007 £m |
| 7.00% Permanent Interest Bearing Shares | 60.0 | 60.0 |
| Unamortised issue costs | (1.0) | (1.1) |
| Fair value adjustment for hedged risk | 9.9 | (1.3) |
| | 68.9 | 57.6 |

The Permanent Interest Bearing Shares (PIBS) are unsecured and denominated in Sterling. They were issued on 1 June 2004. Net proceeds of the issue were £58.6m.

The PIBS are repayable, at the option of the Society, in whole on 1 June 2020 or any fifth anniversary thereafter. Repaying the PIBS requires the prior consent of the Financial Services Authority. If the PIBS are not repaid on a call date then the interest rate is reset at 1 June 2020 at 3% above the relevant equivalent gilt yield at the time.

PIBS are deferred shares of the Society and rank behind the claims of all depositors, creditors and investing members of the Society.

The interest rate risk arising from the issuance of fixed rate PIBS has been mitigated through the use of interest rate swaps.

37. Analysis of general reserve

| | Group | | Society | |
|---|--------------|--------------|--------------|--------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Balance at 1 January | 277.3 | 257.8 | 268.3 | 249.6 |
| Profit for the financial year | 5.7 | 20.5 | 18.3 | 19.7 |
| Actuarial gain/(loss) on retirement benefit obligations | 0.7 | (1.5) | 0.7 | (1.5) |
| Movement in deferred tax relating to retirement benefit obligations | (0.2) | 0.5 | (0.2) | 0.5 |
| Total recognised income for the year | 6.2 | 19.5 | 18.8 | 18.7 |
| Balance at 31 December | 283.5 | 277.3 | 287.1 | 268.3 |
| Reserves excluding pension liability | 284.8 | 279.2 | 288.4 | 270.2 |
| Pension liability | (1.3) | (1.9) | (1.3) | (1.9) |
| | 283.5 | 277.3 | 287.1 | 268.3 |

38. Other reserves

| | Group and Society | |
|--|-------------------|--------------|
| | 2008 £m | 2007 £m |
| Other reserves comprise: | | |
| Revaluation reserve – available-for-sale investments | 1.5 | (0.5) |
| Movement in other reserves: | | |
| Balance at 1 January | (0.5) | (0.5) |
| Net losses from changes in fair value, net of taxation | 2.0 | - |
| Balance at 31 December | 1.5 | (0.5) |
| Balance at 1 January | (0.5) | (0.5) |
| Loss transferred to equity | 3.0 | 1.4 |
| Gains recycled to profit and loss on sales | (0.3) | (1.4) |
| Taxation | (0.7) | - |
| Balances at 31 December | 1.5 | (0.5) |

Notes to the accounts

39. Financial commitments

a) Financial Services Compensation Scheme Levy

Under the terms of the Government's Transfer Order of 29 September 2008, (the Order) to restructure Bradford and Bingley PLC, the Financial Services Compensation Scheme, (the FSCS) paid out approximately £14bn, and borrowed an equivalent amount from the Bank of England. Under this Order, all registered deposit takers in the United Kingdom are liable to fund the FSCS for interest on these loans and may have a further liability if there are insufficient funds from the realisation of the assets of Bradford and Bingley PLC to fully repay these loans. Further calls on the FSCS were made in October 2008, in relation to the restructuring of the Icelandic banking industry and in November 2008 for the London Scottish Bank PLC.

Payments to the FSCS are made in three instalments with the first payment due in September 2009. Interest is calculated based on deposit balances as at 31 December 2007 and an interest rate set at 12 month LIBOR plus 30 basis points reset each month. The further two instalments will be made with reference to deposit balances as at 31 December 2008 and 31 December 2009 respectively. Due to the inherent uncertainty in respect of the matter, the ultimate liability for the Society is presently unknown. As at 31 December 2008, the Society estimates this future liability to be £3.3m.

b) Commitments under non-cancellable operating leases:

| | 2008 | | 2007 | |
|--|-------------|-------------------------------|-------------|-------------------------------|
| | Property | Vehicles, plant and equipment | Property | Vehicles, plant and equipment |
| | £m | £m | £m | £m |
| Group commitments in respect of operating lease rentals: | | | | |
| Expiring within one year | 1.6 | 0.3 | 1.1 | 0.4 |
| Expiring between two and five years | 5.9 | 0.1 | 4.5 | 0.4 |
| Expiring after five years | 9.9 | - | 9.0 | - |
| | 17.4 | 0.4 | 14.6 | 0.8 |
| Society commitments in respect of operating lease rentals: | | | | |
| Expiring within one year | 0.6 | 0.3 | 0.6 | 0.3 |
| Expiring between two and five years | 2.4 | 0.1 | 2.4 | 0.3 |
| Expiring after five years | 3.7 | - | 4.5 | - |
| | 6.7 | 0.4 | 7.5 | 0.6 |

c) Capital commitments:

| | Group | | Society | |
|---|------------|------------|------------|------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Capital expenditure contracted for but not provided for | 0.8 | 0.9 | 0.7 | 0.9 |

Notes to the accounts

40. Financial instruments

a) Categories of financial instruments

Financial assets and liabilities are measured on an on-going 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 table analyses the financial assets and liabilities in the balance sheet by the class of financial instrument to which they are assigned and by the measurement basis.

| Group and Society As at 31 December 2008 | Financial assets and liabilities at amortised cost | Loans and receivables | Financial assets available for sale | Financial assets held to maturity | Financial assets and liabilities designated at fair value | Derivatives designated as fair value hedging instruments ^{a)} | Total |
|---|--|--------------------------|--|---|---|--|----------------|
| | £m | £m | £m | £m | £m | £m | £m |
| Society assets | | | | | | | |
| Cash in hand and balances with Bank of England | 6.1 | - | - | - | - | - | 6.1 |
| Loans and advances to credit institutions | - | 202.2 | - | - | - | - | 202.2 |
| Debt securities | - | - | 1,180.3 | - | - | - | 1,180.3 |
| Derivative financial instruments | - | (8.0) | - | - | 18.8 | 30.1 | 40.9 |
| Loans and advances to customers | - | 4,175.2 | - | - | - | - | 4,175.2 |
| Loans and advances to subsidiaries | - | 715.2 | - | - | - | - | 715.2 |
| Total financial assets | 6.1 | 5,084.6 | 1,180.3 | - | 18.8 | 30.1 | 6,319.9 |
| Total non-financial assets | | | | | | | 75.9 |
| Total Society assets | | | | | | | 6,395.8 |
| Additional Group assets | | | | | | | |
| Loans and advances to credit institutions | - | 1.4 | - | - | - | - | 1.4 |
| Loans and advances to customers | - | 709.1 | - | - | - | - | 709.1 |
| Elimination of loans and advances to subsidiaries | | (715.2) | | | | | (715.2) |
| Non-financial assets | | | | | | | 7.6 |
| Group total assets | | | | | | | 6,398.7 |
| Society liabilities | | | | | | | |
| Shares | 4,626.4 | - | - | - | - | - | 4,626.4 |
| Amounts owed to credit institutions | 65.4 | - | - | - | - | - | 65.4 |
| Amounts owed to other customers | 733.9 | - | - | - | - | - | 733.9 |
| Debt securities in issue | 383.9 | - | - | - | - | - | 383.9 |
| Derivative financial instruments | - | - | - | - | 1.5 | 69.0 | 70.5 |
| Subordinated liabilities | 125.9 | - | - | - | - | - | 125.9 |
| Subscribed capital | 68.9 | - | - | - | - | - | 68.9 |
| Total financial liabilities | 6,004.4 | - | - | - | 1.5 | 69.0 | 6,074.9 |
| Total non-financial liabilities | | | | | | | 30.9 |
| General reserve and other reserves | | | | | | | 290.0 |
| Total Society reserves and liabilities | | | | | | | 6,395.8 |
| Additional Group liabilities | | | | | | | |
| Amounts owed to credit institutions | 2.9 | - | - | - | - | - | 2.9 |
| Group total liabilities | | | | | | | 6,398.7 |

^{a)}Instruments at fair value classified as held for trading, with movements in value taken through the income statement.

Notes to the accounts

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

| Group and Society As at 31 December 2007 | Financial assets and liabilities at amortised cost | Loans and receivables | Financial assets available for sale | Financial assets held to maturity | Financial assets and liabilities designated at fair value | Derivatives designated as fair value hedging instruments ^{a)} | Total |
|--|--|--------------------------|--|---|---|--|----------------|
| | £m | £m | £m | £m | £m | £m | £m |
| Society assets | | | | | | | |
| Cash in hand and balances with Bank of England | 6.3 | - | - | - | - | - | 6.3 |
| Loans and advances to credit institutions | - | 146.2 | - | - | - | - | 146.2 |
| Debt securities | - | - | 1,041.4 | - | - | - | 1,041.4 |
| Derivative financial instruments | - | - | - | - | 4.7 | 6.1 | 10.8 |
| Loans and advances to customers | - | 3,898.9 | - | - | - | - | 3,898.9 |
| Loans and advances to subsidiaries | - | 668.6 | - | - | - | - | 668.6 |
| Total financial assets | 6.3 | 4,713.7 | 1,041.4 | - | 4.7 | 6.1 | 5,772.2 |
| Total non-financial assets | | | | | | | 53.8 |
| Total Society assets | | | | | | | 5,826.0 |
| Additional Group assets | | | | | | | |
| Loans and advances to credit institutions | - | 2.8 | - | - | - | - | 2.8 |
| Loans and advances to customers | - | 685.1 | - | - | - | - | 685.1 |
| Elimination of loans and advances to subsidiaries | - | (668.6) | - | - | - | - | (668.6) |
| Non-financial assets | | | | | | | 7.2 |
| Group total assets | | | | | | | 5,852.5 |
| Society liabilities | | | | | | | |
| Shares | 3,804.3 | - | - | - | - | - | 3,804.3 |
| Amounts owed to credit institutions | 31.1 | - | - | - | - | - | 31.1 |
| Amounts owed to other customers | 1,064.1 | - | - | - | - | - | 1,064.1 |
| Debt securities in issue | 435.1 | - | - | - | - | - | 435.1 |
| Derivative financial instruments | - | - | - | - | 0.2 | 9.7 | 9.9 |
| Subordinated liabilities | 120.9 | - | - | - | - | - | 120.9 |
| Subscribed capital | 57.6 | - | - | - | - | - | 57.6 |
| Total financial liabilities | 5,513.1 | - | - | - | 0.2 | 9.7 | 5,523.0 |
| Total non-financial liabilities | | | | | | | 35.2 |
| General reserve and other reserves | | | | | | | 267.8 |
| Total Society reserves and liabilities | | | | | | | 5,826.0 |
| Additional Group liabilities | | | | | | | |
| Amounts owed to credit institutions | 9.9 | - | - | - | - | - | 9.9 |
| Amounts owed to other customers | (0.2) | - | - | - | - | - | (0.2) |
| Non-financial liabilities | | | | | | | 7.3 |
| General reserve and other reserves | | | | | | | 9.5 |
| Group total liabilities | | | | | | | 5,852.5 |

^{a)}Instruments at fair value classified as held for trading, with movements in value taken through the income statement.

Notes to the accounts

40. Financial instruments (continued)

b) Carrying values and fair values

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

| | Note | Group 2008 | | Society 2008 | |
|--|-------|----------------------|------------------|----------------------|------------------|
| | | Carrying value £m | Fair value £m | Carrying value £m | Fair value £m |
| Financial assets | | | | | |
| Cash in hand and balances with Bank of England | | 6.1 | 6.1 | 6.1 | 6.1 |
| Loans and advances to credit institutions | i. | 203.6 | 203.6 | 202.2 | 202.2 |
| Debt securities – available-for-sale | ii. | 1,180.3 | 1,180.3 | 1,180.3 | 1,180.3 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | iii. | 32.7 | 32.7 | 32.7 | 32.7 |
| Cross currency interest rate swaps | iv. | 16.2 | 16.2 | 16.2 | 16.2 |
| CSA deposits | | (8.0) | (8.0) | (8.0) | (8.0) |
| Loans and advances to customers | v. | 4,884.3 | 4,841.0 | 4,175.2 | 4,177.1 |
| Loans and advances to subsidiaries | | - | - | 715.2 | 715.2 |
| | | 6,315.2 | 6,271.9 | 6,319.9 | 6,321.8 |
| Financial liabilities | | | | | |
| Shares | vi. | 4,626.4 | 4,626.4 | 4,626.4 | 4,626.4 |
| Amounts owed to credit institutions | vii. | 68.3 | 68.3 | 65.4 | 65.5 |
| Amounts owed to other customers | vii. | 733.9 | 739.7 | 733.9 | 739.7 |
| Debt securities in issue | vii. | 383.9 | 382.0 | 383.9 | 382.0 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | iii. | 70.5 | 70.5 | 70.5 | 70.5 |
| Subordinated liabilities | viii. | 125.9 | 105.0 | 125.9 | 105.0 |
| Subscribed capital | viii. | 68.9 | 38.2 | 68.9 | 38.2 |
| | | 6,077.8 | 6,030.1 | 6,074.9 | 6,027.3 |

| | Note | Group 2007 | | Society 2007 | |
|--|-------|----------------------|------------------|----------------------|------------------|
| | | Carrying value £m | Fair value £m | Carrying value £m | Fair value £m |
| Financial assets | | | | | |
| Cash in hand and balances with Bank of England | | 6.3 | 6.3 | 6.3 | 6.3 |
| Loans and advances to credit institutions | i. | 149.0 | 149.0 | 146.2 | 146.2 |
| Debt securities – available-for-sale | ii. | 1,041.4 | 1,041.4 | 1,041.4 | 1,041.4 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | iii. | 7.8 | 7.8 | 7.8 | 7.8 |
| Cross currency interest rate swaps | iv. | 3.0 | 3.0 | 3.0 | 3.0 |
| Loans and advances to customers | v. | 4,584.0 | 4,539.5 | 3,898.9 | 3,898.6 |
| Loans and advances to subsidiaries | | - | - | 668.6 | 668.6 |
| | | 5,791.5 | 5,747.0 | 5,772.2 | 5,771.9 |
| Financial liabilities | | | | | |
| Customer Accounts | vi. | 3,804.3 | 3,804.3 | 3,804.3 | 3,804.3 |
| Amounts owed to credit institutions | vii. | 41.0 | 41.0 | 31.1 | 31.1 |
| Amounts owed to other customers | vii. | 1,063.9 | 1,064.6 | 1,064.1 | 1,064.9 |
| Debt securities in issue | vii. | 435.1 | 432.0 | 435.1 | 432.0 |
| Derivative financial instruments | | | | | |
| Interest rate swaps | iii. | 9.9 | 9.9 | 9.9 | 9.9 |
| Subordinated liabilities | viii. | 120.9 | 119.1 | 120.9 | 119.1 |
| Subscribed capital | viii. | 57.6 | 63.6 | 57.6 | 63.6 |
| | | 5,532.7 | 5,534.5 | 5,523.0 | 5,424.9 |

The gross amount of foreign currency swaps held was €60.0m (2007: €60.0m).

Notes to the accounts

40. Financial instruments (continued)

b) Carrying values and fair values (continued)

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

- i) The carrying amount of loans and advances to credit institutions with a maturity of under 12 months is assumed to equate to their fair value.
- ii) Debt securities classified as available-for-sale are measured at fair value by reference to market prices.
- iii) All derivatives are held for economic hedging purposes. The fair value of interest rate swaps is calculated by utilising discounted cash flow valuation models. The fair value of cross currency interest rate swaps is obtained from external counterparties.
- iv) The fair value of loans and advances to customers at a variable rate is assumed to approximate to their carrying amounts. The fair value of loans and advances to customers at a fixed rate of interest represents the discounted amount of estimated future cash flows expected to be received after taking account of expected levels of early repayment and discounting at current market rates.
- v) The fair value of loans and advances to subsidiaries at a variable rate is assumed to approximate to their carrying amounts.
- vi) The fair value of customer accounts is assumed to approximate to the amount payable at the balance sheet date.
- vii) The fair values of amounts owed to credit institutions, amounts owed to other customers and debt securities in issue are established by using discounted cash flow valuation models or are assumed to approximate to the amount payable at the balance sheet date.
- viii) The fair value of subordinated liabilities and subscribed capital are obtained from market prices.

c) Credit risk

The classes of financial instruments which the Group is most exposed to credit risk are loans and advances to customers, loans and advances to credit institutions, debt securities and financial derivatives.

The following table show the Group's estimated maximum exposure to credit risk without taking into account any collateral held or other credit enhancements.

For financial assets recognised on the balance sheet, the exposure to credit risk equals their carrying amount. For loan commitments and guarantees the exposure to credit risk is the full amount committed.

| | Group | | Society | |
|--|----------------|----------------|----------------|----------------|
| | 2008 £m | 2007 £m | 2008 £m | 2007 £m |
| Financial assets | | | | |
| Loans and advances to credit institutions | 203.6 | 149.0 | 202.2 | 146.2 |
| Debt securities | 1,180.3 | 1,041.4 | 1,180.3 | 1,041.4 |
| Loans and advances to customers | 4,884.3 | 4,584.0 | 4,175.2 | 3,898.9 |
| Loans and advances to subsidiaries | - | - | 715.2 | 668.6 |
| Derivative financial instruments | | | | |
| Interest rate swaps | 48.9 | 10.8 | 48.9 | 10.8 |
| | 6,317.1 | 5,785.2 | 6,321.8 | 5,765.9 |
| In respect of loans and advances to credit institutions, debt securities and derivative instruments: | | | | |
| UK government securities | 251.7 | - | 251.7 | - |
| UK financial institutions authorised by FSA | 1,173.1 | 1,201.2 | 1,171.7 | 1,198.4 |
| | 1,424.8 | 1,201.2 | 1,423.4 | 1,198.4 |

Notes to the accounts

40. Financial instruments (continued)

c) Credit risk (continued)

The percentage of these exposures that are rated between A and AAA under Fitch IBCA credit ratings for 2008 is 96.0% (2007: 91.9%). Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £8.0m is held over derivative financial instruments.

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.

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.

| | Group 2008 | | Society 2008 | |
|---|----------------|--------------|-----------------|--------------|
| | £m | % | £m | % |
| In respect of loans and advances to customers: | | | | |
| Fully secured by a first charge on residential property | 3,586.7 | 73.4 | 3,586.7 | 85.9 |
| Fully secured by a first charge on land | 588.5 | 12.0 | 588.5 | 14.1 |
| Fully secured by a second charge on residential property | 622.3 | 12.8 | - | - |
| Partially secured by a second charge on residential property | 86.8 | 1.8 | - | - |
| | 4,884.3 | 100.0 | 4,175.2 | 100.0 |
| Retail financial services | 3,228.5 | 66.1 | 3,228.5 | 77.3 |
| Commercial loans | 946.7 | 19.4 | 946.7 | 22.7 |
| Secured personal loans | 709.1 | 14.5 | - | - |
| | 4,884.3 | 100.0 | 4,175.2 | 100.0 |
| Using the Group's standard credit risk grading system, residential lending can be distributed as follows: | | | | |
| Fully secured by a first charge on residential property | | | | |
| Grades 1 to 3 satisfactory | 2,644.2 | 81.9 | 2,644.2 | 81.9 |
| Grades 4 to 5 watch list | 513.3 | 15.9 | 513.3 | 15.9 |
| Grades 5 to 6 special mention but not impaired | 71.0 | 2.2 | 71.0 | 2.2 |
| | 3,228.5 | 100.0 | 3,228.5 | 100.0 |
| Fully secured by a second charge on residential property | | | | |
| Personal loans - employed | 585.5 | 82.6 | - | - |
| Personal loans - self employed | 123.6 | 17.4 | - | - |
| | 709.1 | 100.0 | - | - |
| Total loans secured on residential property | 3,937.6 | | 3,228.5 | |

Notes to the accounts

40. Financial instruments (continued)

c) Credit risk (continued)

| | Group 2007 | | Society 2007 | |
|---|----------------|--------------|-----------------|--------------|
| | £m | % | £m | % |
| In respect of loans and advances to customers: | | | | |
| Fully secured by a first charge on residential property | 3,367.9 | 73.5 | 3,367.9 | 86.4 |
| Fully secured by a first charge on land | 531.0 | 11.6 | 531.0 | 13.6 |
| Fully secured by a second charge on residential property | 614.1 | 13.4 | - | - |
| Partially secured by a second charge on residential property | 71.0 | 1.5 | - | - |
| | 4,584.0 | 100.0 | 3,898.9 | 100.0 |
| Retail financial services | 3,033.9 | 66.2 | 3,033.9 | 77.8 |
| Commercial loans | 865.0 | 18.9 | 865.0 | 22.2 |
| Secured personal loans | 685.1 | 14.9 | - | - |
| | 4,584.0 | 100.0 | 3,898.9 | 100.0 |
| Using the Group's standard credit risk grading system, residential lending can be distributed as follows: | | | | |
| Fully secured by a first charge on residential property | | | | |
| Grades 1 to 3 satisfactory | 2,615.2 | 86.2 | 2,615.2 | 86.2 |
| Grades 4 to 5 watch list | 379.2 | 12.5 | 379.2 | 12.5 |
| Grades 5 to 6 special mention but not impaired | 39.5 | 1.3 | 39.5 | 1.3 |
| | 3,033.9 | 100.0 | 3,033.9 | 100.0 |
| Fully secured by a second charge on residential property | | | | |
| Personal loans - employed | 533.0 | 77.8 | - | - |
| Personal loans - self employed | 152.1 | 22.2 | - | - |
| | 685.1 | 100.0 | - | - |
| Total loans secured on residential property | 3,719.0 | | 3,033.9 | |

2007 has been restated due to changes in the categorisation of commercial asset classes during 2008.

The average loan to original value (LTV) in respect of the Group's loans secured on residential property is estimated to be 68.4% (2007: 68.2%). Further LTV information based on original security valuation is shown below:

| | Group | | Society | |
|---------------------------------|--------------|--------------|--------------|--------------|
| | 2008 % | 2007 % | 2008 % | 2007 % |
| Less than 70% | 45.8 | 47.0 | 55.9 | 56.0 |
| More than 70% but less than 80% | 18.5 | 19.5 | 17.5 | 18.4 |
| More than 80% but less than 90% | 17.9 | 17.9 | 14.1 | 16.8 |
| More than 90% | 17.8 | 15.6 | 12.5 | 8.8 |
| | 100.0 | 100.0 | 100.0 | 100.0 |

The Group provides loans secured on residential property across England and Wales and the Society, as a regional building society, has a geographical concentration in Wales. At 31 December 2008, approximately 58.3% of residential exposures by account and 49.5% by value were concentrated in Wales.

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 1.03% (2007: 0.62%) which compares favourably with the industry average of 1.57% (CML arrears and possession data at 31 December 2008). Total arrears balances on retail lending fully secured by a first charge were £1,343k and there are 114 residential cases six months or more in arrears.

The percentage of secured personal loans currently in arrears by number is 6.30% (2007: 3.16%), which by value is 7.22% (2007: 3.56%).

Notes to the accounts

40. Financial instruments (continued)

c) Credit risk (continued)

The table below provides further information on the Group's loans secured on residential property by payment due status.

| | Group 2008 | | Group 2007 | |
|-----------------------------------|----------------|--------------|----------------|--------------|
| | £m | % | £m | % |
| Current | 3,748.4 | 95.2 | 3,576.7 | 96.2 |
| Past due up to 3 months | 124.6 | 3.2 | 108.8 | 2.9 |
| Past due 3 months up to 6 months | 29.1 | 0.7 | 15.4 | 0.4 |
| Past due 6 months up to 12 months | 23.8 | 0.6 | 9.2 | 0.2 |
| Past due over 12 months | 6.3 | 0.2 | 6.2 | 0.2 |
| Possessions | 5.4 | 0.1 | 2.7 | 0.1 |
| | 3,937.6 | 100.0 | 3,719.0 | 100.0 |

| | Society 2008 | | Society 2007 | |
|-----------------------------------|----------------|--------------|----------------|--------------|
| | £m | % | £m | % |
| Current | 3,113.6 | 96.4 | 2,940.0 | 96.9 |
| Past due up to 3 months | 82.6 | 2.6 | 78.7 | 2.6 |
| Past due 3 months up to 6 months | 18.2 | 0.6 | 9.7 | 0.3 |
| Past due 6 months up to 12 months | 8.1 | 0.2 | 2.7 | 0.1 |
| Past due over 12 months | 0.7 | - | 0.1 | - |
| Possessions | 5.3 | 0.2 | 2.7 | 0.1 |
| | 3,228.5 | 100.0 | 3,033.9 | 100.0 |

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. Against possession cases, £5.8m (2007: £2.9m) of such collateral is held. 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.

The Group has mortgage indemnity guarantee insurance which after a set first value of "excess" provides additional protection up to an agreed level.

| | Group and Society | | | |
|--|-------------------|--------------|--------------|--------------|
| | 2008 | | 2007 | |
| | £m | % | £m | % |
| Commercial loans – Registered Social Landlords secured on residential property | 97.2 | 10.3 | 82.1 | 9.5 |
| Commercial loans – other | 849.5 | 89.7 | 782.9 | 90.5 |
| | 946.7 | 100.0 | 865.0 | 100.0 |

Loans secured on commercial property are well diversified by industry type with the largest exposure to one counterparty amounting to £48.4m (2007: £72.4m) or 5% (2007: 8%) of gross balances. Asset quality remains strong with total arrears balances of £1,460k and only 6 commercial cases three months or more in arrears.

Notes to the accounts

40. Financial instruments (continued)

c) Credit risk (continued)

The table below provides further information on commercial loans and advances by payment due status.

| | Group and Society | |
|---------------------------------------|-------------------|--------------|
| | 2008 £m | 2007 £m |
| Current | 922.8 | 831.6 |
| Past due up to 3 months | 11.3 | 17.1 |
| Past due 3 months and up to 6 months | 2.1 | 8.7 |
| Past due 6 months and up to 12 months | 4.5 | 7.6 |
| Past due over 12 months | 6.0 | - |
| | 946.7 | 865.0 |

Loans and advances to subsidiaries are unsecured obligations and have no fixed repayment date. None of these exposures was either past due or impaired.

d) Liquidity risk

For each material class of non-derivative financial liability a maturity analysis is provided in Notes 28 to 31, which represents contractual maturities. In practice, customer deposits will be repaid later than on the contractual date on which repayment can be required.

The following is an analysis of gross contractual cash flows payable under financial liabilities:

| | Total | Payable on demand | Up to 3 months | 3-12 months | 1-5 years | More than 5 years |
|---|----------------|-------------------|----------------|----------------|--------------|-------------------|
| | £m | £m | £m | £m | £m | £m |
| Group | | | | | | |
| As at 31 December 2008 | | | | | | |
| Non derivative liabilities | | | | | | |
| Shares | 4,652.7 | 1,915.1 | 1,470.4 | 942.6 | 324.6 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 1,232.2 | 14.8 | 608.7 | 494.2 | 100.0 | 14.5 |
| Subordinated liabilities | 139.3 | - | 3.2 | 3.2 | 132.9 | - |
| Subscribed capital | 108.3 | - | - | 4.2 | 16.8 | 87.3 |
| | 6,132.5 | 1,929.9 | 2,082.3 | 1,444.2 | 574.3 | 101.8 |
| Society | | | | | | |
| As at 31 December 2008 | | | | | | |
| Non derivative liabilities | | | | | | |
| Shares | 4,652.7 | 1,915.1 | 1,470.4 | 942.6 | 324.6 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 1,229.4 | 11.9 | 608.7 | 494.3 | 100.0 | 14.5 |
| Subordinated liabilities | 139.3 | - | 3.2 | 3.2 | 132.9 | - |
| Subscribed capital | 108.3 | - | - | 4.2 | 16.8 | 87.3 |
| | 6,129.7 | 1,927.0 | 2,082.3 | 1,444.3 | 574.3 | 101.8 |
| Group and Society | | | | | | |
| As at 31 December 2008 | | | | | | |
| Derivative liabilities | | | | | | |
| Interest rate swaps – outflows | 100.7 | - | 15.3 | 23.9 | 38.5 | 23.0 |
| Interest rate swaps – inflows | (112.1) | - | (17.9) | (38.7) | (37.3) | (18.2) |
| Cross currency interest rate swaps - outflows | 68.1 | - | 0.6 | 1.9 | 45.1 | 20.5 |
| Cross currency interest rate swaps - inflows | (68.1) | - | (0.6) | (1.9) | (45.1) | (20.5) |
| | (11.4) | - | (2.6) | (14.8) | 1.2 | 4.8 |

The balances in the above table will not agree directly to the balances in the consolidated balance sheet as the table incorporates all cash flows on an undiscounted basis related to both principal as well as future interest payments based on rates prevailing at the balance sheet date.

For information on annual commitments under non-cancellable operating leases see Note 39 of the financial statements.

Notes to the accounts

40. Financial instruments (continued)

d) Liquidity risk (continued)

| | Total | Payable on demand | Up to 3 months | 3-12 months | 1-5 years | More than 5 years |
|---|----------------|-------------------|----------------|--------------|--------------|-------------------|
| | £m | £m | £m | £m | £m | £m |
| Group | | | | | | |
| As at 31 December 2007 | | | | | | |
| Non derivative liabilities | | | | | | |
| Shares | 3,831.7 | 1,733.6 | 1,470.8 | 520.4 | 106.9 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 1,711.4 | 26.9 | 980.0 | 237.7 | 419.6 | 47.2 |
| Subordinated liabilities | 145.8 | - | 3.2 | 3.2 | 139.4 | - |
| Subscribed capital | 112.5 | - | - | 4.2 | 16.8 | 91.5 |
| | 5,801.4 | 1,760.5 | 2,454.0 | 765.5 | 682.7 | 138.7 |
| Society | | | | | | |
| As at 31 December 2007 | | | | | | |
| Non derivative liabilities | | | | | | |
| Shares | 3,831.7 | 1,733.6 | 1,470.8 | 520.4 | 106.9 | - |
| Amounts owed to credit institutions, other customers and debt securities in issue | 1,701.9 | 17.1 | 980.3 | 237.7 | 419.6 | 47.2 |
| Subordinated liabilities | 145.8 | - | 3.2 | 3.2 | 139.4 | - |
| Subscribed capital | 112.5 | - | - | 4.2 | 16.8 | 91.5 |
| | 5,791.9 | 1,750.7 | 2,454.3 | 765.5 | 682.7 | 138.7 |
| Group and Society | | | | | | |
| As at 31 December 2007 | | | | | | |
| Derivative liabilities | | | | | | |
| Interest rate swaps – outflows | (62.0) | - | (6.1) | (11.8) | (20.0) | (24.1) |
| Interest rate swaps – inflows | 90.8 | - | 5.2 | 24.8 | 44.1 | 16.7 |
| Cross currency interest rate swaps - outflows | (55.5) | - | (0.6) | (1.6) | (36.9) | (16.4) |
| Cross currency interest rate swaps - inflows | 55.5 | - | 0.6 | 1.6 | 36.9 | 16.4 |
| | 28.8 | - | (0.9) | 13.0 | 24.1 | (7.4) |

e) 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. The Group's exposure to interest rate risk in terms of the net risk after taking accounting 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 balance sheet assets and liabilities is assigned to future time periods on the basis of their contractual maturity or contractual re-pricing arrangements. In calculating the net exposure for each future period, account is also taken of those assets and liabilities with embedded optionality, such as pipeline and prepayment risk on fixed rate mortgages. If there was a 1% parallel upward shift in interest rates the adverse impact on reserves would be £14.0m (2007: £5.5m), and on profit and loss would be £1.1m (2007: £5.4m).

Currency risk

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

Notes to the accounts

41. Related party transactions

Loans to and shares held by directors

There was an aggregate of £832k (2007: £959k) 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 fifteen days prior to the Annual General Meeting to be held on 24 April 2009.

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 £0.18m (2007: £0.38m).

Transactions with Group companies

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

| | Interest received from Society | Interest paid to Society | Fees received from Society | Fees paid to the Society | Rent received from Society | Rent paid to Society |
|-------------------------------|--------------------------------|--------------------------|----------------------------|--------------------------|----------------------------|----------------------|
| | £m | £m | £m | £m | £m | £m |
| Year ended 31 December 2008 | | | | | | |
| Nemo Personal Finance Limited | - | 42.7 | - | 0.1 | - | - |
| Peter Alan Limited | - | - | - | - | - | 0.2 |
| | - | 42.7 | - | 0.1 | - | 0.2 |
| Year ended 31 December 2007 | | | | | | |
| Nemo Personal Finance Limited | - | 33.6 | - | 0.2 | - | - |
| Peter Alan Limited | 0.1 | - | 0.1 | - | 0.1 | 0.1 |
| | 0.1 | 33.6 | 0.1 | 0.2 | 0.1 | 0.1 |

At the year end the following balances were outstanding:

| | Loans owed to Society | Loans owed by Society | Loans owed to Society | Loans owed by Society |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | 2008 £m | 2008 £m | 2007 £m | 2007 £m |
| Nemo Personal Finance Limited | 713.2 | - | 665.5 | - |
| Peter Alan Limited | 2.0 | - | 1.1 | - |
| Principality Independent Financial Advisers Limited | - | 0.2 | - | 0.2 |
| Principality Mortgage Corporation Limited | - | 0.1 | - | 0.1 |
| Principality Mortgage and Insurance Services Limited | - | - | 2.0 | - |
| | 715.2 | 0.3 | 668.6 | 0.3 |

42. Events after the balance sheet

On 22 January 2009, the Society entered into a €3bn covered bond programme. The first issue of £700m was made on 27 January 2009.

Annual Business Statement

for the year ended 31 December 2008

1. Statutory percentages

| | At 31 December 2008 % | At 31 December 2007 % | Statutory limit % |
|-------------------|--------------------------|--------------------------|----------------------|
| The lending limit | 14.7 | 13.8 | 25.0 |
| The funding limit | 20.6 | 29.0 | 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 balance sheet.

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

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

Business assets are the total assets of the Society and its subsidiary undertakings as shown in the balance sheet plus provision for loan impairment, less fixed assets and liquid assets.

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

2. Other percentages

Calculated from consolidated accounts:

| | 2008 % | 2007 % |
|---|-----------|-----------|
| As a percentage of shares and borrowings: | | |
| Gross capital | 8.00 | 8.53 |
| Free capital | 7.94 | 8.07 |
| Liquid assets | 23.98 | 22.39 |
| As a percentage of mean total assets: | | |
| Profit after taxation (excluding Financial Services Compensation Scheme levy) | 0.15 | 0.38 |
| Management expenses | 1.04 | 1.27 |

Gross capital represents retained earnings, subscribed capital and subordinated liabilities as shown in the consolidated balance sheet.

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

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

Mean total assets represent the average of the total assets in the consolidated balance sheet 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 12 to 13.

Details of directors' service contracts are included in the Report of the Remuneration Committee on pages 21 to 23.

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

Managers

David Cunningham-Jones
Peter Hughes
Susan Lane

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

Subsidiary companies

Peter Alan Limited
Managing Director: Michael McGuire

Nemo Personal Finance Limited

Managing Directors: Phillip E. Jones
Samuel F. Marshall

Branch addresses

Principality Building Society

Customer Support Centre, P.O. Box 89, Principality Buildings, Queen Street, Cardiff CF10 1UA
Telephone 029 2038 2000 www.principality.co.uk

| | | |
|-------------------|---|---------------|
| ABERDARE | 10 Victoria Square CF44 7LA | 01685 872400 |
| ABERGAVENNY | 68 Frogmore Street NP7 5AU | 01873 856256 |
| ABERYSTWYTH | 15 Terrace Road SY23 1NY | 01970 612728 |
| BANGOR | 220 High Street LL57 1NY | 01248 364127 |
| BARRY | 1a Tynwydd Road CF62 8HB | 01446 733506 |
| BLACKWOOD | 129 High Street NP12 1AB | 01495 224687 |
| BRIDGEND | 28 Caroline Street CF31 1DQ | 01656 655120 |
| CAERPHILLY | The Twyn CF83 1JL | 029 2086 9364 |
| CARDIFF | Principality Buildings, Queen Street CF10 1UA | 0845 045 0007 |
| CARDIFF | 105/107 Albany Road CF24 3LP | 029 2048 7030 |
| CARDIFF | 95 Caerphilly Road, Birchgrove CF14 4AE | 029 2061 5928 |
| CARDIFF | 174 Cowbridge Road East, Canton CF11 9NE | 029 2037 3153 |
| CARDIFF | 36/38 High Street, Llandaff CF5 2DZ | 029 2056 3094 |
| CARDIFF | 21 Merthyr Road, Whitchurch CF14 1DA | 029 2062 4537 |
| CARDIFF | 796 Newport Road, Rumney CF3 4FH | 029 2079 4721 |
| CARDIFF | 18 Station Road, Llanishen CF14 5LT | 029 2076 4151 |
| CARMARTHEN | 13 Guildhall Square SA31 1PR | 01267 235403 |
| CHESTER | 14 Bridge Street CH1 1NQ | 01244 323039 |
| COWBRIDGE | 28 High Street CF71 7AG | 01446 773954 |
| DENBIGH | 11 Vale Street LL16 3AD | 01745 814549 |
| EBBW VALE | 2A The Walk NP23 6AY | 01495 305569 |
| FISHGUARD | 29 West Street SA65 9AL | 01348 873473 |
| GORSEINON | 86 High Street SA4 4BL | 01792 896389 |
| HAVERFORDWEST | 5 Victoria Place SA61 2JX | 01437 762147 |
| HEREFORD | 2 St. Peter's Square HR1 2PG | 01432 273039 |
| LAMPETER | 45 High Street SA48 7BB | 01570 422844 |
| LLANDEILO | 40 Rhosmaen Street SA19 6HD | 01558 822638 |
| LLANDRINDOD WELLS | Carlton House, Middleton Street LD1 5ET | 01597 823511 |
| LLANDUDNO | 85 Mostyn Street, Llandudno LL30 2PD | 01492 876326 |
| LLANELLI | Unit 13, St Elli Square SA15 1SH | 01554 746950 |
| LLANTWIT MAJOR | 1 The Precinct CF61 1XA | 01446 794238 |
| MAESTEG | 139 Commercial Street CF34 9DW | 01656 737111 |
| MERTHYR TYDFIL | Beacons Place, CF47 8ED | 01685 385421 |
| MOLD | 39 High Street CH7 1BQ | 01352 756345 |
| NEATH | 1-3 Green Street SA11 1DR | 01639 635316 |
| NEWPORT | 33 High Street NP20 1RU | 01633 258206 |
| PENARTH | 1 Stanwell Road CF64 2AB | 029 2070 2094 |
| PONTYPOOL | 3 Commercial Street NP4 6JJ | 01495 758577 |
| PONTYPRIDD | 93-94 Taff Street CF37 4SL | 01443 404027 |
| PORTHCAWL | 23 John Street CF36 3AP | 01656 788257 |
| PORT TALBOT | 7 Riverside Walk SA13 1NY | 01639 884055 |
| PRESTATYN | 99 High Street LL19 9AP | 01745 852531 |
| PWLLHELI | 55a High Street LL53 5RT | 01758 613331 |
| SHREWSBURY | 2 The Square SY1 1LA | 01743 353430 |
| SWANSEA | 64-65 The Kingsway SA1 5HW | 01792 655791 |
| SWANSEA | 53 Newton Road, Mumbles SA3 4BD | 01792 360223 |
| SWANSEA | 101 Woodfield Street, Morriston SA6 8AS | 01792 795589 |
| TONYPANDY | 30 Dunraven Street CF40 1AL | 01443 422893 |
| TREORCHY | 220 High Street CF42 6AS | 01443 772190 |
| WREXHAM | 20-22 Regent Street LL11 1SA | 01978 261788 |

Agency offices

| | | |
|-------------|---|--------------|
| AMMANFORD | 6 High Street, Dyfed SA18 2LY | 01269 591884 |
| BALA | 87 High Street, Gwynedd LL23 7AG | 01678 520495 |
| CARDIGAN | 3 Heathfield, Pendre SA43 1JT | 01239 615050 |
| MACHYNLLETH | Maldwyn House, Penrallt Street SY20 8AG | 01654 703110 |
| PORTHMADOG | 103 High Street, Gwynedd LL49 9EY | 01766 512011 |

