Annual Report and Accounts

2010

PRINCIPALITY
BUILDING SOCIETY

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Annual Report and Accounts
for the year ended 31 December 2010

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

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Chairman's statement

Since the Society's modest beginnings 150 years ago, Principality has gone from strength to strength, successfully looking after the financial needs of its Members and taking pride of place at the heart of the local communities we serve.

With trust and fairness at the core of our organisation, we are committed to putting our Members' interests first, providing a high quality service both now and in the future.

During the year, we have attracted over 50,000 new customers to take our total to over 500,000 and with a presence in 64 localities across the country (60 in Wales and 4 in England), Principality has become a significant player in the Welsh economy and the 7th largest building society in the UK with total lending of £4.9 billion. Total savings balances broke the £5 billion barrier for the first time in our history, securing Principality's place as one of the most popular brands on the high street – further confirmation of the trust placed in us as an organisation.

Therefore, I am delighted to report that in 2010 we have delivered another credible and profitable business performance, adding further capital to retained earnings for our future security and growth.

Expansion and key developments

It is testament to the Society's strong performance that we were able to embark upon an exciting expansion of our network during the year with the creation of eight new agencies across Wales and the Borders.

Whilst a number of other financial institutions opted to cut costs by withdrawing from local high streets during 2010, we decided to invest in our face to face services to position us even closer to our communities and improve our personal service.

We are therefore delighted to have established a presence in Abertillery, Bargoed, Colwyn Bay, Newcastle Emlyn, Ross-on-Wye, Talbot Green, Treharris, and Ystradgynlais, presenting a clear opportunity to introduce our successful and strong brand in financial services to new territories, enabling us to deliver Principality products and services to a wider audience. By being part of these local communities for the first time we will provide access to financial services to new customers.

This expansion, and our plan to launch a new branch in Monmouth during 2011, is a fitting way to mark our 150th year at the heart of Wales. It demonstrates our unwavering support for the Welsh economy and our ongoing commitment to the people of Wales.

Celebrations and thanks

As we celebrated our 150th year anniversary in 2010, we took some time to reflect on our strong and proud history and say "Diolch" to you, our loyal Members, and to our dedicated staff, for building our Society and making this significant milestone achievement possible. To mark the occasion a host of activities took place including branch birthday celebrations and Members were also able to take advantage of special savings rates.

Our staff gave up their own time to help local community projects, improving services for local people. In our Big Birthday Giveaway, we donated £5,000 to a community project in each of our five operating areas across Wales. Clwyd Special Riding Centre benefitted from one such donation, which would enable the Centre to buy equipment allowing access to the riding facilities to 168 riders aged between 5 and 62, who have a range of special needs, from learning to physical disabilities.

In 2010 Principality's commitment to its sponsorship and charity projects was further enhanced. Our ongoing support for a range of sporting, arts and cultural sponsorships with a pan-Wales profile has remained central to our Corporate and Social Responsibility policies and has successfully raised the profile of our brand in Wales.

Sponsorship of the Welsh Rugby Union Principality Premiership continued, and to coincide with our own anniversary celebrations we also celebrated 30 consecutive years of our special relationship with The National Eisteddfod, a pinnacle event in the arts and cultural calendar in Wales.

Our Charity of the Year for 2010 was Macmillan Cancer Support, a very worthy charity dedicated to improving the lives of people affected by cancer. Staff across the Society tirelessly fundraised through a range of activities including:

- a sponsored 45 mile walk across Wales,

East Wales Big Birthday Giveaway Winner: Woody's Workers Healthy Living Project.

- completion of the Celtic Challenge (the world's longest rowing race),
- conquering the 3 Peaks Challenge in under 24 hours,
- cake bake sales, marathons, a darts competition and an abseil to name a few.

Together with money raised at our 2010 AGM, Principality and its staff donated over £55,000 to Macmillan Cancer Support and a further £25,000 to community projects to mark our 150th anniversary, a fantastic achievement.

Awards and accolades

It is always encouraging to receive recognition for the hard work and dedication of our staff and we are delighted to have won several awards during 2010 for our achievements.

Principality received two prestigious awards at the annual Mortgage Finance Gazette Awards earlier in the year. Having been shortlisted for two categories, the Society was delighted to win both awards for 'Community Services Award for Small to Medium Sized Lenders' and 'Best Arrears Management Strategy'.

Judged by a panel of industry experts, these awards recognise our strong involvement in our communities and a commitment to be fair and honest in arrears management, which are core values. This has also provided a basis for operational efficiency and is a testament to the strength of our internal processes.

Other accolades throughout the year include:

- Arts and Business Cymru Awards 2010: Winner: Arts, Business and Long Term Support – for the Society's 30 year partnership with the National Eisteddfod of Wales, raising the profile of choral singing, fostering the Welsh language and celebrating the cultural tradition and heritage of Wales within communities across Wales.
- Business in the Community Awards 2010: Highly Commended: Wales Responsible Company of the Year – for the Society's positive impact on the environment, its employees and on wider society through its responsible business strategy.
- FT Adviser Online Service Awards 2010: Winner: 5 Star Mortgage Lender and Packager – for the speed, accuracy and levels of support offered to intermediaries through the internet.

Member focus and having your say

Throughout 2010 we have continued our commitment to gathering your views and opinions by hosting a number of Member Talkback sessions across Wales. These sessions not only provided attendees with an opportunity to learn more about the Society, they also provided us with strong feedback on various aspects of our business plans.

At Principality we firmly believe that in partnership with our Members we can achieve more than we can on our own and that's why we have worked hard to ensure that you get an opportunity to have your say – whether that be face to face at our Member Talkback events, as part of our Member Forum panel or through our online customer research panel.

From helping to inform on our products and ensuring that our literature is clear and concise, to making branch improvements, your views have helped to ensure that we are one of the most recommended financial institutions in the industry. And with your continued help, we aim to become the most recommended.

Our Member Forum panel has created an atmosphere of mutual trust that has become central to our business. As a mutual building society, with no shareholders to satisfy, the panel is an outward expression of our commitment to openness and honesty, offering you the opportunity to contribute to the ongoing development of the Society.

As a custodian of the Society, I would like to express my thanks to this year's panel for their candid feedback on a number of projects that we have undertaken – your views have led to some significant improvements in our literature and product range.

In particular, I extend my warmest thanks to Meurig Williams, who has undertaken the position of Chairman of our Member Forum panel for the last four years with pride and professionalism. As he steps down from the position this year, we look back on a number of improvements and seek many more – all of which ensure that your interests remain at the heart of this business. I hope that Meurig will continue to take a keen interest in the Society, along with all of our Members, and I look forward to answering your questions at this, and future AGM's.

Board and management

Before I look forward to 2011, may I in my first Statement for Principality, pay tribute to my predecessor, David Williams. He served the Society in many different roles, but always with pride and dedication, and not least in his exemplary guidance on property and commercial lending. It is therefore humbling to suggest that I will try and follow in his footsteps. However, without doubt this is a role about which I am passionate and I am honoured to fulfil. I will do my utmost to guide the Society from the Board Chair for its next phase of development. I would further like to thank Haydn Warman and Eurfyl ap Gwilym who also retired from the Board during the year.

On behalf of the Board, I would like to thank all Principality employees for their continued hard work and dedication. On a personal note, the team have made me feel extremely welcome in my first year as Chairman and I am very proud of all they have achieved. My thanks also go to my fellow Board members for their support and commitment during the year.

2011 Outlook and future prospects

Having successfully weathered several economic downturns during our long history, we understand the need to be cautious, especially so in today's environment, where market conditions depend not only on domestic consumption and policy but also on the forces of exchange rates and the competitive position of the economy in relation to the global market.

Domestically, the short-term outlook will be testing - further house price falls predicted, interest rates remaining low for some time, rising unemployment and only a modest recovery in parts of the economy.

These factors in aggregate will demand a cautious yet balanced approach. However, as Principality embarks on the next chapter in its 150 year history I have every confidence that we have the management, experience and abilities to meet challenges as they arise and take realistic opportunities for Principality to grow and support our Members together with their communities.

With pride in our past and every confidence in our future I look forward to another successful year, committed to what matters most - providing safety and security, great value and first class service for our Members.

Dyfrig D. J. John
Chairman
4 February 2011

North Wales Big Birthday Giveaway Winner: Clwyd Special Riding Centre.

Chief Executive's review

Our predictions for 2010 proved to be accurate. In my report last year I concluded saying:

"We remain in the midst of a challenge between macro economic intervention on the one hand and the fractured banking system on the other. Recovery has been slow and will continue to be so. An election in 2010 could add a further new dimension. Regulatory demands for improved levels of high grade capital will continue unabated. The cost of savings will remain high and further sector consolidation appears inevitable. Our watchword is caution on every front. These remain the most testing of times. I believe that the recovery, slow as it is, has arrived. My expectation is that the year ahead will be one of uncertainty with many new challenges emerging. We remain well placed to meet these."

Those sentiments rang true during the year as conditions remained challenging, but as we reflect on the year gone by we can look back on a period of economic recovery which provided some room for optimism.

2010 trading highlights

- Profit before tax of £30.8m
- Savings balances increased by over 2.1% and now at an all time high - in excess of £5 billion
- Outstanding customer satisfaction levels
- Solid capital ratios with a Tier 1 ratio of 13.34% (2009: 12.49%)
- 52,000 new customers welcomed to the Society
- 101.6% (2009: 104.1%) of loans funded by customer deposits
- Acquisition of 8 branch agencies from competitors
- Cost income ratio of 48.1% (2009: 51.0%)

Your Society is in good shape and has dealt well with market and economic challenges. Our 150th year was a successful one and we look ahead with confidence and cautious optimism. It has been a difficult balancing act trying to deliver to all stakeholder agendas. We have launched a new set of loyalty savings products with enhanced returns. We have lent £934.8m of new money. Provisions for bad debts were at much lower levels than expected. At year end we only have 53 properties in possession. We have maintained robust capital and liquidity ratios and above all we have delivered strong profits to help further build our capital base for the future and provide a platform for growth when the market recovers.

Group overview

This was a year where the housing and mortgage market stagnated, where thrift returned and the consumer either reduced debt or increased their propensity to save. Debt remains a global phenomenon – be it sovereign, corporate or personal, but incomes remain stretched and real risks remain. Affordability of debt is currently under-pinned by low interest rates and whilst I expect rates to remain low for some time yet, unexpected and rapid rate rises would cause serious hardship. All of these uncertainties dislocated several markets, housing in particular, and made for difficult trading conditions.

The Society grew slightly during the year, bucking the trend of many financial services companies who shrank their balance sheets. A policy of low growth will continue in 2011, but we will seek to continue to support people in their home ownership aspiration. It was particularly pleasing to pass the £5 billion milestone on our savings book as we continue to prudently fund our loan books through the traditional, tried and trusted mutual model of Member savings supporting Member loans.

We were delighted to further embed our commitment to the high streets of Wales following the acquisition of new agency locations from competitors who chose to reduce their Welsh footprint. Early in 2011 we plan to open a new branch in Monmouth. Sales of investment and insurance products continue to improve year on year. Member satisfaction is at very high levels when benchmarked against other financial services and retail firms which is testament to the investment we have made in delivering a consistent, efficient and friendly service either face to face or through the medium of technology. The mutual dividend is not all about best price. It is a combination of price, service, quality and the ability to do business with us in the way you want from the location you want. Your Society has made significant investment in its technology platform during the year, especially in electronic channels as we seek to reach new geographies and Members through the most modern distribution methods.

The Nemo secured lending portfolio performed exceptionally well, delivering strong profits. Trends in default levels improved quarter on quarter. House price falls stabilised and arrears increases abated. In a tight market for credit we have further improved the quality of the loan book and the returns from it. The lending book shrank slightly in line with plan and is likely to do so again in the year ahead. Consumer demand for secured loans remains unfulfilled and this is a significant growth opportunity if we can find a partner to share the risk and opportunity of further growth in this asset class.

Our Commercial business turned in a solid performance albeit with a reduced operating profit from the previous record year. With a planned strategy of no-growth, the lending book remained flat and arrears and defaults remained at relatively low levels, comparing very well against sector benchmarks. This approach has impacted the bottom-line, but this is a high quality book which we expect to continue to perform well in the years ahead. We successfully launched a new set of business savings products with encouraging volumes which we expect to drive much higher in future to support our funding plans.

Peter Alan, our estate agency business, had a more testing time and delivered a profit lower than expected. Sales volumes were lower than planned in a depressed market. Our moves into lettings and asset management have strengthened our franchise and delivered record levels of income. These areas provide good growth opportunities going forward, as more people seek to rent not buy. Our property auctions have shown good success rates. Our surveyors' business performed as expected, albeit volumes remain low in a depressed mortgage market. The ongoing lack of credit availability will continue to constrain the market in the short term.

Group pre-tax profit of £30.8m, represents an increase of £16.5m from 2009 and was arrived at after charging a provision for loan impairment of £22.2m (2009: £39.5m).

During 2010, our secured lending subsidiary, Nemo Personal Finance, joined with the British Bankers' Association (BBA) in a judicial review of the Financial Services Authority's (FSA) proposed approach to the assessment and redress of complaints in respect of sales of Payment Protection Insurance (PPI). We strongly believe it to be in the best interests of our Members to have supported the BBA in this legal action. We believe that the outcome is important to ensure clarity over the approach being taken by the FSA in relation to PPI complaints and will assess the outcome of the judicial review to ensure that our Members' interests are best served. We have set aside provisions of £19.8m which we believe is sufficient, notwithstanding the uncertainties associated with this as described in note 2, pending the outcome of the judicial review.

Our earnings are strong and the benefit of our diversified model is demonstrable. The Group has, against the trend, increased its net interest margin during the year. The team can be proud of what we have achieved.

Peter Griffiths is joined by Robert Treharne Jones, the descendant of one of Principality's founding Members to cut the Queen Street branch birthday cake.

This has been another very demanding year and the results of their efforts are commendable. My thanks go to all staff for their commitment and passion for this business.

Market review

Sector profitability continues to be challenged. The cost of funding is increasing and repayment of Bank of England intervention support loans taken by banks and building societies during the crisis will gain momentum in the year ahead. Demand for retail savings to fund these repayments is likely to increase and funding costs could rise further. Increasing regulatory costs exacerbate the problem, but this is simply the new price of being in business and that cost has to be met.

Rising unemployment and affordability risk could coincide with a further fall in house prices and that could lead to a rise in impairment charges. Product pricing risk in a 'lower for longer' base rate environment is a key issue. It does not look likely that rapid rises in interest rates will happen in the near term and accordingly firms with large exposures to life-time tracker products will continue to be challenged. The cost of credit will no doubt increase and availability will be restricted.

Regulatory demand for more and better quality capital means that societies will need to find new and potentially innovative ways of raising Core Tier 1 capital. During the year we saw the introduction of US private equity capital into the sector as Kent Reliance Building Society members voted to accept an injection of external capital. As a result of this, that Society was transferred into a newly created industrial and provident society. Mergers continued with Yorkshire completing the merger with Chelsea, Stroud and Swindon joining Coventry and Skipton absorbing Chesham.

The drive for higher levels of Tier 1 capital will continue. Our own capital ratios are solid, but in common with all other societies, we will continue to consider all available capital options which we believe to be in the interests of our Members. The sector is starved of capital and unless a suitably priced new capital instrument is made available then some societies will be forced to re-appraise their strategies, business models and aspirations.

Challenges ahead

As we look forward, we believe it is fair to conclude that the credit markets will remain flat. Mortgage availability is low and lenders remain cautious as they come to terms with regulatory demands for higher capital and liquidity levels. Interest rates look likely to stay low which will help affordability for borrowers, but will continue to cause concern for savers. As we look ahead it is difficult to see anything but 'more of the same' as the economy slowly climbs toward full recovery.

My sense is that the aspiration for home ownership has not diminished and there is significant pent up demand from first time buyers. The absence of alternatives will force more people to live at home for longer or take on rented accommodation as they seek to save the considerable deposit needed to secure mortgage funding.

We look forward with cautious optimism to the year ahead, one that may well prove critical to the ongoing health and direction of the building society sector. We continue to seek to put our Members' interests first as we juggle the many demands and challenges before us. Over the last 150 years your Society has experienced several economic downturns and has weathered them all and continues to prosper. I am grateful for the support of my team, our Board and you our Members.

Peter L. Griffiths
Chief Executive
4 February 2011

Business review
for the year ended 31 December 2010

Statement of comprehensive income overview

The Group's profit before tax for the year to 31 December 2010 was £30.8m after recognising a gain of £3.1m on the repurchase of £10.0m of subordinated liabilities and after charging an additional Financial Services Compensation Scheme (FSCS) provision of £0.5m. Excluding these items and fair value movements, operating profit before tax for the Group was £28.0m (2009: £22.2m), an increase of over 26% on last year. This demonstrates a strong performance in continuing difficult market conditions as we continue to balance the challenge of a low interest environment and increased costs of regulation, against our commitment to provide Members with products and services which deliver long-term value. The results have again been enhanced by gains from the prudent management of liquid assets.

Profit

Net interest margin

Net interest income is the sum of the amount earned on assets (a combination of retail mortgages, commercial mortgages and liquid assets) less liabilities (savings products and borrowings) divided by total average assets. At 1.79% (2009: 1.69%) the Group's net interest margin continues to benefit from the higher margins earned in the secured personal lending business.

Margin continues to be impacted by a lack of wholesale funding, which traditionally has been cheaper than other forms of short-to-medium term funding. This is being supplemented by relatively more expensive retail funding offset by higher margins on new mortgage pricing. Given the continuing disruption in the wholesale funding markets and the resulting mix of wholesale and retail funding, along with the impact of holding more lower yielding sovereign securities in response to the Financial Services Authority's (FSA) new liquidity regime, it is expected that these margin pressures will continue for the foreseeable future.

Net interest margin has been enhanced by gains of £6.3m (2009: £3.8m), equivalent to 6bps (2009: 4bps) arising from the profit on the sale of gilts.

Other income

The Group's non-interest income at £17.1m (2009: £17.8m) includes insurance income, estate agency income, property services income and income generated from a number of other complementary activities. These together generated 13.25% (2009: 15.12%) of total income. The strong performance of sales in life, investment and general insurance products observed in the second half of 2009 has been maintained during 2010 and accounts for 31.42% (2009: 29.47%) of other income. This has been offset by reduced mortgage transfer fees as Members move to standard variable rate (SVR) products at the end of their redemption period.

Property services and lettings income is almost 20% ahead of last year as we seek to increase our market share in the lettings arena. The introduction of 'Payday', a rental guarantee product for landlords, has increased the number of managed properties which will help to drive future income as these are typically more profitable than let-only. The UK housing market continues to be affected by reduced lending, in particular for first time buyers, and this position is unlikely to change in the short term. We will continue to pursue our innovation strategy and invest in new products and technologies to gain market share in both the agency and lettings markets.

Administrative expenses

At 1.00% (2009: 0.95%), the ratio of operating expense as a percentage of total mean assets remains strong despite deteriorating slightly from last year as we seek to invest more to increase the diversity and value of our income streams. The development of previously underutilised space in Principality Buildings into a hotel is expected to cost £6.7m, but is expected to generate future income streams in excess of £0.4m per annum for the Society.

Impairment provisions for losses on loans and advances

The charge for impairment provisions of £22.2m for the Group was £17.3m less than last year. The underlying quality and average loan-to-value (LTV) ratio of 61.6% (2009: 64.2%) for first and second charge residential lending has improved in the year as a result of a modest recovery in house prices and new loans and mortgages being written at lower LTVs. There has been a significantly lower impairment charge in the secured personal lending business with provisions remaining broadly flat in first charge residential lending. Accumulated impairment on our mortgages secured on commercial property was 1.52% (2009: 0.86%) of balances, the increase being due to deterioration in market conditions in the commercial sector.

Provisions for other liabilities and charges

The Society has reviewed the level of provision in light of information published by the FSCS in the period and has charged £0.5m (2009: £1.4m). Other provisions of £16.6m (2009: £2.5m) have been made in respect of various customer claims, including claims in relation to previous sales of Payment Protection Insurance. It is expected that any liability will predominantly crystallise over the next 12 to 24 months.

Key Performance Indicators

The following indicators illustrate Principality Group's performance during 2010 compared to the preceding four years:

Year ended 31 December	2010	2009	2008	2007	2006
Capital and Profit					
Tier 1 capital ratio	13.34%	12.49%	11.69%	9.75%	11.21%
Gross capital ratio	8.71%	8.52%	8.00%	8.53%	9.99%
Free capital ratio	8.93%	8.71%	7.94%	8.07%	9.10%
Solvency ratio (2008: Basel II)	17.33%	17.13%	15.95%	13.33%	15.58%
General reserve	£310.6m	£287.9m	£283.5m	£277.3m	£257.8m
Profit before tax	£30.8m	£14.3m	£9.3m	£30.6m	£29.0m
Profit after tax as a % of mean total assets	0.37%	0.17%	0.09%	0.38%	0.44%
Profit after tax as a % of mean total assets (excluding FSCS levy)	0.37%	0.19%	0.15%	0.38%	0.44%
Net interest income as % of mean total assets	1.79%	1.69%	1.38%	1.28%	1.37%
Other income as % of net operating income	13.25%	15.12%	20.18%	34.45%	35.25%
Operating expenses as % of mean total assets	1.00%	0.95%	1.04%	1.27%	1.38%
Assets					
Total assets	£6,262.1m	£6,218.9m	£6,398.7m	£5,852.5m	£4,830.2m
Growth	0.69%	(2.81%)	9.33%	21.17%	10.17%
Loans and advances to customers	£4,960.4m	£4,736.9m	£4,884.3m	£4,584.0m	£3,887.9m
Gross lending in the year	£934.8m	£594.5m	£1,125.9m	£1,602.3m	£1,313.8m
Liquid assets	£1,194.8m	£1,380.3m	£1,382.0m	£1,196.7m	£875.6m
Liquid assets as % of shares and borrowings	21.12%	24.49%	23.98%	22.39%	20.12%
Funding					
Shares	£5,039.0m	£4,933.2m	£4,626.4m	£3,804.3m	£3,406.1m
Borrowings	£618.6m	£713.6m	£1,186.0m	£1,540.0m	£946.3m
Funding limit	11.03%	12.78%	20.60%	29.03%	22.05%
Employees					
Average number of people employed	1,126	1,049	997	1,206	1,004
Other measures					
Number of branches	51	51	50	50	50
Number of agency branches	13	5	5	5	5
Number of estate agency branches	23	23	23	26	25

Derivatives and hedge accounting

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

The £0.2m credit 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.

Taxation

The effective tax rate for the Group is 24.7% (2009: 24.5%) compared with the standard rate of tax of 28.0% (2009: 28.0%). The rate differential is mainly due to the repurchase of £10.0m of subordinated liabilities, the profit on which has been treated as non-taxable.

The reduction of the UK Corporation tax rate from 28.0% to 27.0% from 1 April 2011 has resulted in a deferred tax adjustment arising from the reduction in the statement of financial position carrying value of the net deferred tax liability to reflect the anticipated rate of tax at which the liability is expected to reverse.

Statement of financial position

Loans and advances to customers

The Group continues to focus on the quality of business written, concentrating on affordability and LTV ratios in underwriting loans and mortgages. Lending criteria remain tight and lending volumes, whilst deliberately low, are showing signs of improvement with residential mortgage completions in the year up £318.5m to £756.6m. The Board's primary focus remains the sustainability of the business so that it can deliver value to Members well into the future. Mortgage assets have increased by 4.7% to £4,960.4m from 2009 with balances in commercial and second charge lending remaining broadly flat year-on-year. Management will continue to prudently apply controls to the Group's lending including potential changes arising from the implementation of the FSA's Mortgage Market Review.

Treasury and liquid assets

Liquid assets have been managed down over the course of the year and represent 21.12% of shares and borrowings (2009: 24.49%). The quality and liquidity of the assets held remain a key management focus, with 57.18% of the portfolio being held in sovereign exposures (2009: 36.84%). Other than sovereign exposures, liquidity is held in the form of investments with other financial institutions with 98.91% (2009: 96.78%) of these exposures rated between A and AAA under Fitch credit ratings.

Graeme Yorston addresses the AGM in 2010.

The Group has a £10.0m (2009: £10.0m) exposure to Anglo Irish Bank Corporation Ltd due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. The Group continues to monitor this exposure in light of the ongoing political and economic situation in Ireland but, based on the current guarantee in place, we do not consider any impairment to be necessary at this time. Further detail is provided in note 2 to the financial statements.

An Individual Liquidity Adequacy Assessment (ILAA) was conducted by the Board during the year in accordance with the FSA's new liquidity guidelines. The Board are satisfied that the Group has sufficient liquid assets at its disposal, even under stressed scenarios, to meet obligations as they fall due.

Funding

The Society has a strong funding base, predominately represented by retail savings. As a result, minimal reliance is placed on wholesale markets. The savings environment is increasingly competitive as institutions who have previously relied on wholesale funds continue to seek a larger share of the retail market and savers choose to pay down their debts or seek higher returns from equity-linked investment products. Management's focus has been to retain the growth of savings balances achieved in 2008 and 2009, compensating for the restriction on access to the wholesale markets as a result of industry-wide downgrades over the same period.

During the year the Society achieved record savings balances of over £5 billion, an increase of 2.14% on 2009. These represent 101.6% (2009: 104.1%) of all mortgage balances. Fixed rate products represent 54.81% (2009: 54.12%) of all savings balances.

Borrowings from wholesale ('money market') sources, administered by the Group's treasury function, have fallen during the year. At 11.03% (2009: 12.78%) of all shares, deposits and loans, the Group's borrowings represent a low dependence on wholesale markets. Principality's strong retail brand and reputation has allowed choice over funding sources during a period when wholesale markets remain subdued. Balancing the mix of funding through wholesale markets and retail remains a key focus and the Board is committed to maintaining a prudent position.

The Society's long-term debt ratings with Fitch and Moody's, at BBB+ and Baa2 respectively, remain broadly unchanged from last year. These ratings continue to constrain access to the wholesale markets but this has been mitigated through our successful retail funding strategy.

Defined benefit pension scheme

The defined benefit scheme closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the Group Flexible Retirement Plan (GFRP). The Group injected £1.0m into the defined benefit scheme on closure and has committed to a further injection of £1.0m on the first anniversary of the closure to help reduce the current deficit. The triennial valuation of the defined benefit scheme is due as at 30 October 2010 however the results of this will not be known until later in 2011.

Capital

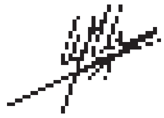
Capital comprises the Group's general reserve, permanent interest bearing shares (subscribed capital) and subordinated debt. This capital is held to support the development of the business, to protect Members' deposits and provide a buffer against unexpected losses. The amount of capital required is assessed in relation to the Group's overall risk appetite, the material risks to which the Group is exposed and the management strategies employed to manage those risks. Notwithstanding the repurchase of £10.0m of subordinated liabilities, total capital has increased from £480.4m at the beginning of the year to £492.5m.

Since 1 January 2008 and throughout the year, the Group has managed its capital in accordance with the EU Capital Requirements Directive (Basel II), as required by the FSA. At 31 December 2010, regulatory capital stood at £477.6m (2009: £462.9m). The Group's total solvency ratio, a measure of the Group's total capital as a proportion of the Group's risk weighted assets at the statement of financial position date, notwithstanding the repurchase of the subordinated liabilities, has increased to 17.45% (2009: 17.13%). This is well in excess of the minimum established by the FSA. At the end of the year, the Core Tier 1 and Tier 1 ratios were:

	2010	**2009**
	%	%
Core Tier 1	11.27	10.39
Tier 1	13.34	12.49

Core Tier 1 and Tier 1 ratios are well in excess of the minimum Basel III requirements as currently drafted.

During the year the Group has continued to perform internal stress tests regularly on its capital base, and these tests have consistently demonstrated a capital surplus after allowing for extreme stress scenarios.



W. Guy Thomas
Group Finance Director
4 February 2011

Risk management report

Risk overview

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

Governance structure

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

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

- **Group Risk Committee (GRC)** is chaired by the Board's Deputy Chairman, and has responsibility for ensuring a Group wide co-ordinated approach towards the oversight and management of key strategic and corporate risks.

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

- **Asset and Liability Committee (ALCO)** is chaired by the Group Finance Director and has responsibility for the assessment of exposure to Treasury Counterparty credit, market, liquidity and interest rate risk.

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

Primary responsibility for the identification, control and mitigation of risk rests with each strategic business unit. Oversight and governance are provided through specialist support functions including Group Risk, Group Treasury and Group Finance. 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 with those limits and generally to provide an oversight role in relation to the management of risk.

Principal risks

The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, operational risk and pension obligation risk. As a mutual, the Group maintains a relatively low risk appetite, as evidenced by the quality of the statement of financial position.

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

The key risks to the Group are linked to the overall performance of the economy and the resultant effect on unemployment, house price indices and overall liquidity as the markets seek to refinance borrowings made over the last five years. Specific risks to the Group are reviewed as part of the Individual Capital Adequacy Assessment Process (ICAAP) and are detailed below.

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 for liquidity requirements and for general business purposes.

Market background

The economic outlook remains uncertain, and for that reason the Group's forecasts and plans have taken account of scenarios that include the risk of further decreases in house prices, a sustained deterioration in the macro economic environment, and consequential increases in unemployment. These forecasts have been prepared by management and stressed accordingly in line with FSA guidance.

Risk mitigation

The controlled management of credit risk is critical to the success of the Group's lending strategy. The quality of individual lending decisions, subsequent management and control, together with the application of a credit policy that reflects the risk appetite of the business, has 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 policy scope, structures and responsibilities, definitions of risk and risk measurement and approach to monitoring. In addition, each business area maintains a detailed procedures manual setting out operating rules and standards.

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

Retail credit risk

The Group continues to focus on the underlying quality of business written. Lending criteria remain tight and volumes deliberately low, especially in the Group's second charge loan business. Applicant quality is monitored closely, defined in terms of credit, LTV ratios and affordability profile. The GCRC receives regular reports on the performance of retail credit risk portfolios with further oversight provided by the GRC.

The Group's collections and recoveries functions aim to provide a responsive and effective operation for the arrears management process. The Group encourages early two-way communication with borrowers, obtaining their commitment to maintain payment obligations, typically through repayment plans. Experience in these areas allows for feedback into the underwriting process. In common with other building societies, the Society participates in the Government's Mortgage Rescue Scheme but has chosen not to take part in the Homeowner Mortgage Support Scheme. When accounts are in default, careful consideration is given to the most appropriate realisation strategy likely to result in the best outcome for the Group and the customer.

Commercial credit risk

Commercial risk appetite is regularly reviewed in the light of changing economic and market conditions and is also subject to annual review. The Group remains cautious in regard to commercial lending which is undertaken on a prudent basis reflected in a broadly flat balance sheet position year-on-year. Commercial lending is operated within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

Concentration risk within the commercial portfolio is controlled and monitored via a series of credit exposure limits which are aimed at producing a diverse portfolio. Commercial lending relationships are subject to regular reviews to ensure that facilities are fully performing in accordance with the terms of original sanction. Watch-list procedures are in place which grade borrowers in line with the perceived severity of the risk and are designed to identify cases of potential cause for concern to facilitate early risk mitigation activity. When accounts are in default, careful consideration is given to the most appropriate realisation strategy for the Group and the customer. Responsibility for the overall quality of the lending book and the adequacy of credit procedures and controls rests with Commercial Liability & Asset Management Committee with oversight provided by Group Risk and the GRC.

Treasury credit risk

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

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

Liquidity risk

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

Market background

There has been limited observed easing of the wholesale markets and cost of funds is substantially higher than at the market high in 2007. The planned withdrawal of Government backed funding in January 2012 is expected to impact the availability and cost of both wholesale and retail funding in the forthcoming year.

The introduction of a new liquidity regime has led to increased demand for longer term funding and better quality government issued debt for use as liquid assets. This trend is expected to continue with the phased implementation of regulations in forthcoming years. Conditions in the wholesale market have led to greater competition and increased cost of retail savings, significantly impacted by institutions pursuing a retail funding strategy aimed at replacing potentially unavailable or expensive wholesale funding.

Risk mitigation

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

ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing. The Group's liquidity and funding policy has been fundamentally reviewed and enhanced in line with the FSA's new liquidity regime FSA Policy Statement PS09/16 "Strengthening Liquidity Standards".

As at 31 December 2010, 89.0% of the Group's funding was raised from retail sources. The Group has continued to be successful in securing and retaining retail deposits over the last year as savers look for a safe haven. The Society expects to face increasing levels of competition for retail savings over the next 12 months and will continue to review and enhance its product range to maintain its competitive position.

Market risk

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

Group Treasury Department is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's Treasury Policies. Oversight is provided by ALCO and GRC which 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 provision of fixed rate mortgage and savings products. The various interest rate features and maturity profiles for these products, and the use of wholesale funds to support their delivery, create interest rate risk exposures due to the imperfect matching of interest rates between different financial instruments and the timing differences on the re-pricing of assets and liabilities.

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

Market background

Over the last two years, customer preference has moved towards variable rate mortgages and fixed rate savings bonds. Along with other mortgage providers, the low interest rate environment and the availability of credit have exposed us to changes in customer behaviour, driven by associated changes in the financial dynamics of transactions, particularly with respect to early repayment of fixed rate mortgages. The effect of this, however, has not been material.

Risk mitigation

Interest rate risk is subject to continual management, within the risk appetite set by the Board, using appropriate financial instruments including derivatives. Risks relating to specific products are mitigated through appropriate related product terms and conditions, offer procedures, as well as close analysis of the mortgage pipeline and early redemption behaviour. Derivative instruments are used to manage various aspects of interest rate risk including the net basis positions where appropriate.

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

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

and stressed accordingly, in line with FSA guidance.

Use of derivatives

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

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

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

Foreign currency risk

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

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

Operational risk

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

Market background

With an increasingly diverse business model and a more competitive operating environment, it is recognised that the Group is exposed to increased levels of operational risk, for example in terms of systems capability and staff competencies. The financial services sector also faces growing levels of financial crime, particularly in relation to e-distribution channels, which require increasingly sophisticated anti-fraud controls.

Risk mitigation

The role of the Group's operational risk management function is to ensure appropriate strategies are in place to manage and mitigate the risks that could impact the ability of the Group to meet its business objectives whilst protecting its reputation. The Group manages its exposure to operational risk, considering the impact by reference to a number of discrete categories which include, for example, process management, systems failure, reputational issues, business continuity planning 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 the nature and extent of the impact on each business area and for embedding appropriate controls to mitigate those risks. The framework is updated periodically to take account of changes in business profile, new product development, and the external operating environment.

Oversight is provided by the GORC, and the assessment of the Group's exposure to operational risks is based on both quantitative and qualitative considerations. The crystallisation of operational risks is captured through the recording of operational losses (and near misses). The analysis of loss events is used to identify any potential systemic weaknesses in operational processes.

Pension obligation risk

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

To mitigate these risks, management, together with the Trustees of the Fund, regularly review reports prepared by the Fund's independent actuaries and takes appropriate actions which may, for example, include adjusting the investment strategy and/or contribution levels.

Capital management

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 ICAAP covers 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 capital requirements are presented to the Board for approval with the most recent review being completed in March 2010. The ICAAP is used by the FSA to determine and set the Group's Individual Capital Guidance (ICG).

The amounts and composition of the Group's capital requirements are determined by assessing the Basel II Pillar 1 minimum capital requirement, the Group's economic capital requirement, the impact of stress and scenario tests under Pillar 2 and the ICG. The Group manages its capital above the minimum ICG threshold, including a capital planning buffer, at all times. Capital levels for the Group are reported to, and monitored by the Board on a monthly basis.

To meet Basel 2 Pillar 3 requirements, the Group publishes further information about its exposures and its risk management procedures and policies. It is anticipated that the 2010 version of the Pillar 3 report will be published on the Society's website (www.principality.co.uk) in April 2011.

The Group has applied to the FSA for permission to use an Internal Ratings Based approach for 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.

R. Michael Jones
Director of Group Risk
4 February 2011

Board of directors at 31 December 2010

Dyfrig John CBE FCIB (age 60)
Chairman

Appointed a non-executive director on 1 July 2009 he became Chairman in April 2010. He is Chairman of the Nominations Committee and a member of the Remuneration Committee.

Other Directorships and Appointments:
Board member of the Wales Millennium Centre, member of the Advisory Board for Bangor Business School and President of the HSBC Bank UK Pension Association.

Christopher Rowlands (age 54)
Deputy Chairman

Appointed a non-executive director on 1 June 2009 having previously served on the Board from December 2004 to January 2007. He is Chairman of Group Risk Committee and a member of the Nominations Committee.

Other Directorships and Appointments:
Director of Gardens Pensions Trustees Limited and a member of the Board of Finance Wales plc, an advisor to Hermes GPE, and Chairman of the MMS Group.

Peter L. Griffiths OBE ACIB (age 52)
Chief Executive

Joined 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 Friary Two Limited. 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 60 - 61. He is Chairman of the Executive Committee, Commercial Lending Asset Management Committee and Building Society Management Board. He is a member of the Asset and Liability and Group Risk Committees.

W. Guy Thomas
BSc (Hons) ACA FCT C.Dir (age 55)
Group Finance Director

Joined the Society as Finance Director on 1 November 2003. He is a director of Peter Alan Limited, Nemo Personal Finance Limited, Loan Link Limited, Principality Covered Bond LLP and Friary Two Limited. He is also Chairman of the Asset and Liability Committee and a member of the Executive, Commercial Lending Asset Management and Group Risk Committees.

Gordon MacLean BA FCA (age 56)
Non-Executive Director

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

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

Christopher A. Jones BA (age 47)
Non-Executive Director

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

Other Directorships and Appointments:
Director of Dwr Cymru Cyf, Glas Cymru Cyf, Glas Cymru (Securities) Cyf, Dwr Cymru (Financing) Limited, Welsh Water Utilities Finance plc and Dwr Cymru (Holdings) Limited. He is also Deputy Chairman of the Council of The Prince's Trust Cymru.

Langley Davies BSc (Hons) ACA (age 51)
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 Nominations Committees.

Other Directorships and Appointments:
Partner in Ruperra Properties LLP and Hensol Properties LLP. Director of Vansdirect Limited, Raglan Consultancy Limited and Cardiff Hub Limited.

Keith Brooks (age 62)
Non-Executive Director

Appointed a non-executive director on 1 May 2007. He is a director of Peter Alan Limited and a member of the Group Risk, Remuneration and Nominations Committees.

Other Directorships and Appointments:
Chairman of Vista Retail Support Group Limited and a partner in Airport Investments and Enterprises.

Graeme H. Yorston FCIB MBA (age 53)
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 director of Nemo Personal Finance Limited and Loan Link Limited. He is a member of the Executive Committee, Building Society Management Board, Asset and Liability and Group Risk Committees.

Joanne Kenrick LLB (age 44)
Non-Executive Director

Appointed a non-executive director on 1 January 2009. She is a member of the Audit and Nominations Committees.

Other Directorships and Appointments:
Chief Executive of the Start Charity, a director of the 53 Rosslyn Hill Residents Association Limited and a director of MLC Contracting Limited.

Directors' report

for the year ended 31 December 2010

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 2010.

Directors

The names of the directors at the date of this report, together with brief biographical details, are listed on pages 16 and 17.

No new appointments were made to the Board during 2010. Keith Brooks, Gordon MacLean and Graeme Yorston 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, David Williams, Eurfyl ap Gwilym and Haydn Warman all resigned as directors.

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

The directors consider that no activities carried out during 2010 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

- In a year where other financial services firms were withdrawing from the high street, the Society opened eight new agencies across Wales.
- 2010 saw the Society redevelop its former Head Office premises in Cardiff. The lease of these newly refurbished hotel premises to Travelodge was signed in January 2011.
- We launched Principality Property Solutions, designed to provide consumers with access to high quality property maintenance services.
- We invested in new technology for Peter Alan Limited, our estate agency business, to allow us to maximise benefit from the growing rental market.

Profits and capital

Profit before tax was £30.8m (2009: £14.3m). The profit after tax transferred to the general reserve was £23.2m (2009: £10.8m).

Total Group general reserves at 31 December 2010 were £310.6m (2009: £287.9m).

Gross capital at 31 December 2010 was £492.5m (2009: £480.4m), including £112.3m of subordinated debt and £69.2m of permanent interest bearing shares (PIBS).

The ratio of gross capital as a percentage of shares and borrowings at 31 December 2010 was 8.71% (2009: 8.52%) and the free capital ratio was 8.93% (2009: 8.71%). The Annual Business Statement on page 75 contains an explanation of these ratios.

Important events since the year-end

On 28 January 2011, a 25 year lease of floors 1 to 4 of Principality Buildings was granted to Travelodge Hotels Limited. This will generate annual rental income of £418k for the Society.

Mortgage arrears

At 31 December 2010 there were 782 (2009: 438) 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 £39.0m (2009: £19.0m) and the total amount of arrears was £8.0m (2009: £3.2m), 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.

Corporate social responsibility

Charitable donations

During the year the Group donated £20,000 to Macmillan Cancer Support and a further £25,000 to community projects to mark our 150th anniversary (2009: £45k). No contributions were made for political purposes.

Environmental policy

The Society has continued its investment in environmental projects and remains committed to working with environmentally conscious partners. During 2010 a major investment was made into Principality Buildings. A team of internal and external experts have been developing our former Head Office building into a hotel which has been leased to Travelodge. 6.5 tonnes of asbestos was safely removed along with 35 tonnes of wood, 400 tonnes of hardcore, 13 tonnes of plasterboard and 15 tonnes of mechanical and electrical items, 95% of which was recycled.

In developing this building, we have protected one of our key assets for the next 25 years and in doing so are generating additional income for the Society. We have also undertaken complete condition surveys of all of our group assets and will now start re-developing our property management strategy. Environmental considerations will be high on our agenda.

Over 104 large (550 litre) recycling bins of waste were taken out of Principality House during 2010. This was an initiative that we started in 2009. In previous years, all of this waste would have gone to landfill.

During the year, we continued to investigate the use of alternative sources of energy. We are currently discussing a potential pilot of Solar PV Panels on one of our out of town locations.

Employees

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.

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.

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,

Wales rugby captain, Ryan Jones, leads his team out onto the field of the Millennium Stadium to face South Africa in the Principality Summer Test.

arrangements will be made for continuing the employment of, and arranging appropriate training for, employees who become disabled during their employment with the Society.

Supplier payment policy

It is the Society's policy to discharge suppliers' invoices for the complete provision of goods and services in full conformity with the conditions of the purchase and within the agreed payment terms. It is intended that this policy be continued in 2011.

At 31 December 2010 the total amount owed to suppliers was equivalent to 27 days' credit (2009: 22 days).

Auditors

At the Annual General Meeting on 23 April 2010 the Members passed a resolution that Deloitte LLP be re-appointed as auditors for the ensuing year.

Principality's Charity Champion, Colin Lewis, joins Wales' rugby star, Mike Phillips and MacMillan Cancer Support representatives, Liz Cole and Sue Pickin.

Responsibilities of the directors

The following statement, which should be read in conjunction with the statement of the auditors' responsibilities on page 30, is made by the directors to explain their responsibilities in relation to the preparation of the Annual Accounts, the Report of the Remuneration Committee, the Annual Business Statement and the Directors' Report.

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

- Select appropriate accounting policies and apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed, 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 7, together with the Business Review on pages 8 to 11, 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 65 to 73 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 12 to 15 and in note 40 on pages 65 to 73.

As presented in the consolidated statement of financial position, 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) and Individual Liquidity Adequacy Assessment (ILAA), which are processes required by our regulator to demonstrate appropriate levels of capital and liquidity respectively 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, even under stressed scenarios.

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 £367.7m (13.34% as a percent of risk-weighted assets) and a solvency ratio of 17.33% 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

We fully expect the strained economic conditions to continue for some time, with increased pressures due to reductions in public spending and higher levels of unemployment. There is no doubt that against that backdrop and increased demand for retail savings, there will be further consolidation within the sector. Public and political interest in financial services will not diminish and we maintain a watching brief on the impact of the shift in responsibilities from the Financial Services Authority to the Bank of England.

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

On behalf of the Board of Directors

Dyfrig D. J. John
Chairman
4 February 2011

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 five committees – Audit, Remuneration, Nominations, Group Risk and Commercial Lending Credit. During 2010, the Board undertook a review of its committee structure and membership. The current Board committee structure was ratified with some alterations to terms of reference and membership of those committees with effect from 1 January 2011.

Audit Committee

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

During the year the Committee met on six occasions. It monitored the integrity of the financial statements and formal announcements relating to the Group's financial performance and reviewed relevant accounting policies and any significant financial judgements contained in them. The Committee has reviewed the effectiveness of the Group's financial

Board and Committee membership and attendance record

	Board	Audit	Remuneration	Group Risk
David Williams	4/4	-	2/2	-
Eurfyl ap Gwilym	4/4	-	-	-
Keith Brooks	11/11	-	6/6	8/8
Langley Davies	11/11	6/6	-	-
Peter Griffiths	11/11	-	-	7/8
Dyfrig John	10/11	-	6/6	-
Christopher Jones	11/11	-	6/6	-
Jo Kenrick	11/11	6/6	-	-
Gordon MacLean	10/11	6/6	-	-
Christopher Rowlands	11/11	-	-	8/8
Guy Thomas	11/11	-	-	8/8
Haydn Warman	4/4	-	-	-
Graeme Yorston	11/11	-	-	7/8

The Nominations Committee meets as and when required to consider and recommend new appointments to the Board. There were no meetings of the Nominations Committee during 2010. The Commercial Lending Credit Committee met on an ad hoc basis to sanction individual commercial loan applications.

controls and the internal control and risk management systems, compliance with financial services legislation and regulations, and has monitored progress to ensure that any required remedial action has been or is being taken on any identified weaknesses.

The Committee reviewed Deloitte's overall work plan and approved their remuneration and terms of engagement and considered in detail the results of the audit, Deloitte's performance and independence and the effectiveness of the overall audit process. The Committee recommended Deloitte's re-appointment as auditors to the Board and this resolution will be put to Members at the 2011 Annual General Meeting.

The Committee has implemented the Group's policy which restricts the engagement of Deloitte in relation to non-audit services. The policy is designed to ensure that the provision of such services does not have an impact on the external auditors' independence and objectivity. It identifies engagements that can only be undertaken with appropriate authority from the Committee Chairman or the Committee where non-audit fees will exceed pre-set thresholds. The Committee receives an annual report on the non-audit services being provided and the cumulative total of non-audit fees. The non-audit work undertaken during 2010 related to tax advice and specialist management consultancy. The non-audit fees for the year were £158k and the audit fee for the year in respect of the Group was £129k.

The Committee has approved the Group Internal Audit plan and regularly reviewed the Internal Audit department's resources, work progress, results and management's implementation of its recommendations. Steven Fuse is the Head of Group Audit. He has direct access to the Committee Chairman and the Society Chairman. The Committee has held private meetings with him, the Head of Group Compliance and Deloitte during the year.

The Committee has reviewed the 'whistle blowing' procedures in place across the Group during the year and confirmed that arrangements are in place to enable individual employees to raise concerns about possible improprieties on a confidential basis.

Directors seeking re-election (L-R) Gordon MacLean, Graeme Yorston and Keith Brooks.

The Group has a financial crime policy and the Audit Committee receives an update at each meeting in relation to any material fraud and associated action taken.

The Committee reports on its activities to the Board.

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 and during 2010, the Audit Committee concluded that it will normally consider whether it wishes to commence the competitive tender process for the audit after 5 years and every year thereafter.

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.

Remuneration Committee

This Committee of non-executive directors is chaired by Christopher Jones. The other members during the year were David Williams, Keith Brooks and Dyfrig John. The Committee has written terms of reference which are reviewed annually.

It considers remuneration policy and the Board delegates to this Committee decisions on executives' remuneration and compensation packages. The Committee monitors changing trends in directors' remuneration in the market place including consideration of the FSA Code on Remuneration Practice. In performing its duties the Committee draws on the advice of independent consultants – Hewitt New Bridge Street – who have no other connection with the Society. No individual is present at a meeting when his or her own pay is decided. Fees payable to the Chairman and other non-executive directors are determined by the Board on recommendations from the executive directors. Details of directors' remuneration are set out on page 28. The Committee reports on its activities to the Board.

Nominations Committee

The Nominations Committee is chaired by Dyfrig John. 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 Group Secretary on request. The Committee reports on its activities to the Board.

Group Risk Committee

The Group Risk Committee is chaired by Christopher Rowlands, the Deputy Chairman. The other members of the Committee include Keith Brooks, also a non-executive director, the Chief Executive, the Group Finance Director and the Chief Operating Officer and a number of other senior managers across the Group. The Committee has written terms of reference which are reviewed annually. The Committee is responsible for considering and recommending the Group's risk appetite, capital and liquidity adequacy to the Board. It is responsible for maintaining an appropriate governance structure to ensure that risks across the Group are identified and managed effectively and for monitoring and reviewing internal and external risks. The Committee reports on its activities to the Board.

Commercial Lending Credit Committee

During 2010, the Committee was chaired by Peter Griffiths. The members included the following directors – Dyfrig John, Christopher Rowlands, Langley Davies, Keith Brooks, Guy Thomas and David Williams – together with certain senior managers from the Commercial Lending division. The Committee has written terms of reference which are reviewed annually. The Committee sanctioned significant commercial loan applications in accordance with a mandate approved by the Board. The Committee reported on its activities to the Board. As part of the review of overall Committee structures that was undertaken by the Board during 2010, the Board concluded that given the level of activity in the commercial lending market currently, it was appropriate that the sanctioning of any new significant commercial lending be moved to the Group Credit Risk Committee during 2011.

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

Board balance and independence

At the end of 2010 the Board comprised a non-executive Chairman and Deputy Chairman, five other non-executive directors and three 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 and is reviewed annually.

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 Group Secretary.

Information and training

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

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

The 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 2010 the Board undertook an evaluation of the performance of the Chairman and an evaluation of its own performance. The Audit, Remuneration and Group Risk Committees each undertook a review of their own effectiveness during the year.

Communication with Members and the Annual General Meeting

The Society is committed to maintaining good communications with Members. During the year 2 meetings were held by the Members' Forum as well as 3 Talkback Sessions with groups of Members. These meetings were attended by various Society directors. These meetings provide valuable means for Members' opinions about the Society to be canvassed by directors.

The Society 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; and
- 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. 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 and the Group Risk Committee of perceived strategic risks.

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

Dyfrig D. J. John
Chairman
4 February 2011

Report of the Remuneration Committee

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

Unaudited information

Remuneration principles

Principality is proud to be a mutually owned business, operated to provide benefits to its Members. Through our remuneration policy, we seek to promote the best interests of our Members and, in particular, to ensure that the business is run safely and successfully so as to keep our Members' savings safe and their other financial relationships with us secure and reliable. It follows that the 2 most important principles underlying our approach to remuneration, in particular of the executive directors, are:

- To set the overall remuneration at a level which is competitive but not excessive, so that we are able to attract and retain high quality people who can ensure that Principality continues to trade successfully in a highly competitive and uncertain marketplace; and
- To structure that remuneration, particularly the variable elements, in such a way that our people are incentivised and rewarded for good performance that furthers the interests of Members but does not encourage risk-taking that is excessive or in any other way inappropriate for a mutual institution.

Principality seeks to maintain high standards of corporate governance at all times. In this report, we set out information which meets the key disclosure requirements of the Combined Code on Corporate Governance.

Recent Regulatory Developments

During the year, there were significant regulatory developments. The Financial Services Authority (FSA) published a consultation paper in July seeking views on new principles for remuneration as well as another paper in November setting out proposals on the disclosure of remuneration.
In December 2010, the FSA published its final position on the revisions to its 'Remuneration Code' which will affect overall pay and incentive structures across a large part of the financial services sector. As a Tier 2 firm within the 'Remuneration Code' definitions, Principality will be subject to most of these new regulations. The work that we have put in place over the last 2 years has meant that we already comply with much of the Code, in particular having already put in place some elements of deferral for variable pay. During the first half of 2011, the Committee will be reviewing the 'Remuneration Code' and will make necessary changes to pay, incentive structures and disclosures in line with the required timescales.

The work of the Remuneration Committee

The Remuneration Committee comprises Chris Jones (Chairman), Keith Brooks and Dyfrig John, all of whom are independent non-executive directors. The Committee met on 6 occasions during the year (2009: 6) to set and review the remuneration practices for the Group.

In particular the Committee reviewed the following:

- The annual pay review for staff across the Group and supported a 2010 pay freeze for executives and senior managers whose base salary exceeded £60,000;
- Design of bonus schemes against targets for executives including consideration of the FSA Consultation Paper 'Revising the Remuneration Code';
- Changing trends in executive remuneration in the market place against benchmark data provided by Hewitt New Bridge Street; and
- The defined benefit pension scheme, and worked with the Society to close the scheme to future accrual and to offer a new and enhanced defined contribution scheme across the Group for executives and staff.

During 2010, we revised the scheme rules for both the executive Annual Bonus Scheme and the Group Performance Bonus, published a Group Reward Policy and updated the Terms of Reference for the Committee. Full terms of reference for the Committee can be found on the Society's website.

The Committee draws on the advice of independent external advisors if it considers this beneficial when performing its duties. This year Hewitt New Bridge Street provided benchmarking on executive, chairman and non-executive directors' remuneration packages. This consultancy has no other connection with the Society. KPMG and Eversheds provided advice on the closure of the defined benefits pension scheme and the launch of the new enhanced defined contribution scheme as well as forthcoming legislative changes relating to pensions and taxation.

Haydn Warman, Director and Secretary, retired in March and now Elaine Morris, Group Secretary, acts as secretary to the Committee.
The Group HR Director attends each Committee meeting.

The Chief Executive and the Director of Group Risk are invited to attend the Committee's meetings as needed and the Committee considers their views when reviewing the remuneration of senior executives, managers and staff. They are not involved in discussions concerning their own pay.

Components of executive remuneration

There are 5 elements of pay for executive directors – basic salary, Annual Bonus, Group Performance Bonus, pension benefits and benefits in kind (details of which are set out on page 28 to 29). Awards under both bonus schemes are non-pensionable.

Base salary

Base salary determined by the Committee reflects the individual's skills, experience and performance as well as the responsibilities of the role. The Committee considers salary levels for similar roles within a comparator group of the largest building societies. When determining executive salaries the Committee has regard to economic factors, remuneration trends and the general level of salary increases awarded through the Group. In 2010, due to the state of the economy, the executive management team proposed to implement a pay freeze for themselves and all senior managers whose base salary exceeded £60,000. The Committee accepted this proposal.

Annual Bonus

The Annual Bonus Scheme provides an opportunity to reward executive directors for achieving stretching targets for the financial year. It is based on the achievement of a basket of performance targets related to financial, customer service, people and process measures, together with personal objectives. To ensure affordability and to protect the interests of Members, the financial measure is a stretching profit target. The maximum bonus achievable under the Annual Bonus scheme is 40%. Two additional hurdles have been added to the scheme: before any award can be made the Society must at all times meet both regulatory capital and liquidity requirements.

3 executive directors, Peter Griffiths, Guy Thomas and Graeme Yorston, are eligible for annual bonus awards of 25% in respect of performance during 2010.

Principality staff put their new skills to use in the community at Yellow Wales in Maesteg as part of our leadership and management training programme.

Group Performance Bonus

The Group Performance Bonus (GPB) is designed to incentivise executive directors to achieve sustained returns, 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 largest building societies. The maximum bonus achievable under the GPB scheme is 60%. Payment is not made if the performance falls below 90% of the average of the comparator group.

The 2010 award will be paid in 3 equal instalments over 3 years, so long as the executive is still in employment. Under the scheme rules the remainder of the award may be reduced at the discretion of the Committee.

Since the most recent annual performance results of the comparator group will not be known until later in 2011, 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 by the Committee once the results for the comparator group have been published.

Non-executive directors' remuneration

The Chairman and non-executive directors do not have service contracts. They are appointed for an initial 3-year period which may be extended by a maximum of 2 further terms.

The Chairman, David Williams retired in April 2010 and was replaced by Dyfrig John. The new Chairman was appointed on the same terms as his predecessor. Eurfyl ap Gwilym, Deputy Chairman also retired in April 2010 and was replaced by Christopher Rowlands; he was also appointed on the same terms as his predecessor. Non-executive directors are paid a basic fee for participation on the Society Board. The non-executive directors receive additional fees payable for providing services on Board Committees and for their membership of subsidiary company boards.

The fees for the Chairman and non-executive directors are set by the Board on recommendations from the executive directors. Along with the executive and senior managers, the base fee and committee fees for the Chairman and non-executive directors were frozen in 2010.

In 2010, benchmarking data was sourced from Hewitt New Bridge Street as the Society recognises that the time demands and responsibilities for its non-executive directors have increased substantially during the credit crunch with ever more regulatory demands. The benchmarking data shows that the Society's non-executive director fees are below the market median for our comparator group of the largest building societies. The Society's executive management team will keep the situation under review. Details of non-executive directors' remuneration are set out on page 28. The Chairman and non-executive directors do not participate in any bonus schemes or any pension arrangements.

Audited information

Directors' remuneration in respect of the year to 31 December 2010

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

	Salary & fees £000	Benefits £000	Annual bonus £000	Group performance bonus £000	Sub-total £000	Increase in accrued pension £000	Pension £000	Total £000
Executive 2010								
Peter Griffiths	296	13	74	104	487	5	19	511
Haydn Warman (to 19/03/10)	34	3	-	12	49	3	-	52
Guy Thomas	207	13	52	72	344	3	13	360
Graeme Yorston	196	11	49	69	325	-	27	352
Total	**733**	**40**	**175**	**257**	**1,205**	**11**	**59**	**1,275**
Executive 2009								
Peter Griffiths	296	13	71	163	543	5	-	548
Haydn Warman	152	13	-	73	238	3	-	241
Guy Thomas	196	13	45	95	349	3	-	352
Graeme Yorston	196	10	47	108	361	-	25	386
Total	**840**	**49**	**163**	**439**	**1,491**	**11**	**25**	**1,527**

	Salary and fees	
	2010 £000	2009 £000
Non-executive		
David Williams (to 23/04/10)	22	66
Dyfrig John (from 01/07/09)	55	15
Eurfyl ap Gwilym (to 23/04/10)	20	50
Christopher Rowlands (from 01/06/09)	38	18
Christopher Jones	35	32
Gordon MacLean	44	44
Langley Davies	46	46
Keith Brooks	45	34
Jo Kenrick	32	28
Sub-total	337	333
Executive remuneration total	1,275	1,527
Total director's remuneration	**1,612**	**1,860**

1. The 2009 Group Performance Bonus (GPB) was calculated in July 2010 once the full set of results for the comparator group was available. This resulted in an additional bonus entitlement of £148k earned by executive directors in relation to the final outcome of the Scheme. This sum is payable over 3 years.
2. The 2010 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 2010 results are known.
3. The figures under Benefits include cars, fuel, and personal medical insurance.
4. The section on page 29 opposite, on executive directors' pension arrangements, explains the change in pension benefits in 2010.

Executive directors’ service contracts

The following directors have service contracts in relation to their executive duties which provide for a 12-month notice period or termination payment:

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

Executive directors’ pension arrangements

On 1 August 2010 the Society closed the defined benefit pension scheme to future accrual. Up to 31 July 2010 executive directors listed below were members of the Society’s defined benefit 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 provided dependants’ pensions and a lump sum of 4 times basic salary in the event of death in service.

From 1 August 2010 these 2 executive directors received pension contributions of 15% of basic salary payable into a defined contribution scheme or elected to be paid as a cash allowance. Graeme Yorston was not a member of the defined benefit pension scheme and instead received pension contributions into a defined contribution plan of 12.5%. In line with the other 2 executive directors, this was increased to 15% on 1 August 2010. This pension contribution level was set after reviewing comparator data. These contributions are recorded in the directors’ remuneration table above. Life assurance of 4 times basic salary in the event of death in service is maintained.

Information on the executive directors’ defined benefit pension arrangements to 31 December 2010 is set out below:

	Accrued pension entitlement at 31/12/10 £000 pa	Increase in accrued pension during the year £000	Transfer value of accrued pension at 31/12/09 £000	Transfer value of accrued pension at 31/12/10 £000	Director’s contributions during the year £000	Increase in transfer value over the year, net of director’s contributions £000
Executive						
Peter Griffiths	20	3	255	334	11	68
Guy Thomas	19	3	282	363	9	72

Conclusion

Principality has performed very well in 2010, with profits over double the level of 2009, reflecting sound management and the benefits of strategies put in place in previous years. This result has been achieved in a year of extremely challenging and uncertain market conditions. Our good trading performance has protected the interests of our Members and has enabled us to continue to provide strong Member value. The Committee believes that having appropriate remuneration arrangements and policies in place, as set out in this report, has contributed to this positive result.

The Committee recommends this report to Members for approval at our Annual General Meeting.

Christopher A. Jones
Chairman
4 February 2011

Independent Auditors' report to the Members of Principality Building Society

We have audited the Group and Society financial statements of Principality Building Society for the year ended 31 December 2010 which comprise the Consolidated and Society Statements of Comprehensive Income, the Consolidated and Society Statements of Recognised Income and Expense, the Consolidated and Society Statements of Financial Position, the Consolidated and Society Statements of Cash Flows and the related notes 1 to 42. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

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

Respective responsibilities of directors and auditor

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

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Society's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion the financial statements:

- Give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31 December 2010 and of the Group's and the Society's

Business in the Community Awards 2010: Principality was awarded Highly Commended for Wales' Responsible Company of the Year.

income and expenditure for the year then ended; and

- Have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Building Societies Act 1986

In our opinion:

- The Annual Business Statement and the Directors' Report have been prepared in accordance with the requirements of the Building Societies Act 1986;

- The information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the accounting records and the financial statements; and

- The information given in the Annual Business Statement (other than the information upon which we are not required to report) gives a true representation of the matters in respect of which it is given.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Building Societies Act 1986 requires us to report to you if, in our opinion:

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

- The Society financial statements are not in agreement with the accounting records; or

- We have not received all the information and explanations and access to documents we require for our audit.

Mark McQueen
(Senior Statutory Auditor)
For and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Cardiff, United Kingdom
4 February 2011

Consolidated statement of comprehensive income
for the year ended 31 December 2010

	Notes	2010 £m	2009 Restated £m
Interest receivable and similar income	4	222.4	226.7
Interest payable and similar charges	5	(110.6)	(120.3)
Net interest income		111.8	106.4
Fees and commission receivable	6	17.9	18.6
Fees and commission payable	7	(1.6)	(1.3)
Net fee and commission income		16.3	17.3
Other operating income		0.8	0.5
Other fair value gains/(losses)	8	0.2	(6.5)
Net operating income		129.1	117.7
Administrative expenses	9	(56.4)	(54.0)
Depreciation and amortisation	24 & 25	(5.7)	(6.0)
Operating expenses		(62.1)	(60.0)
Impairment provision for losses on loans and advances	21a	(22.2)	(39.5)
Provision for other liabilities and charges	21b	(17.1)	(3.9)
Operating profit		27.7	14.3
Other gains		3.1	-
Profit before taxation		30.8	14.3
Taxation expense	13	(7.6)	(3.5)
Profit for the year		**23.2**	**10.8**

Consolidated statement of total recognised income and expense

	Notes	2010 £m	2009 Restated £m
Profit for the year		23.2	10.8
Actuarial loss on retirement benefit obligations	12	(0.5)	(8.9)
Movement in deferred tax relating to retirement benefit obligations	34	-	2.5
Total recognised income for the year	**37**	**22.7**	**4.4**

Other provisions of £2.5m have been reclassified from fees and commission receivable to provision for other liabilities and charges in the period. There was no effect on profit for the year as a result of the reclassification.

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 38 to 74 form part of these accounts.

Statement of comprehensive income of the Society
for the year ended 31 December 2010

	Notes	2010 £m	2009 £m
Interest receivable and similar income	4	177.3	181.0
Interest payable and similar charges	5	(110.6)	(120.3)
Net interest income		66.7	60.7
Fees and commission receivable	6	10.1	11.2
Fees and commission payable	7	(0.5)	(0.6)
Net fee and commission income		9.6	10.6
Other operating income		1.2	0.8
Other fair value gains/(losses)	8	0.2	(6.5)
Net operating income		77.7	65.6
Administrative expenses	9	(42.4)	(40.0)
Depreciation and amortisation	24 & 25	(4.6)	(4.7)
Operating expenses		(47.0)	(44.7)
Impairment provision for losses on loans and advances	21a	(12.4)	(7.0)
Provision for other liabilities and charges	21b	(1.0)	(1.4)
Operating profit		17.3	12.5
Other gains		3.1	-
Profit before taxation		20.4	12.5
Taxation expense	13	(4.6)	(3.2)
Profit for the year		**15.8**	**9.3**

Statement of recognised income and expense of the Society

	Notes	2010 £m	2009 £m
Profit for the year		15.8	9.3
Actuarial loss on retirement benefit obligations	12	(0.5)	(8.9)
Movement in deferred tax relating to retirement benefit obligations	34	-	2.5
Total recognised income for the year	**37**	**15.3**	**2.9**

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 38 to 74 form part of these accounts.

Consolidated statement of financial position

at 31 December 2010

	Notes	2010 £m	2009 Restated £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		320.7	136.3
Loans and advances to credit institutions	14	73.3	159.5
Debt securities	15	800.8	1,084.5
		1,194.8	1,380.3
Derivative financial instruments	16	38.7	36.3
Loans and advances to customers:			
Loans fully secured on residential property	18	4,338.1	4,086.6
Other loans fully secured on land	19	571.5	594.6
Other loans	18	50.8	55.7
	20	4,960.4	4,736.9
Investment in joint venture	23	-	1.9
Intangible fixed assets	24	2.1	2.5
Property, plant and equipment	25	40.9	36.6
Deferred tax assets	34	3.3	3.9
Other assets	26	3.8	1.5
Prepayments and accrued income	27	18.1	19.0
Total assets		**6,262.1**	**6,218.9**

Liabilities			
Shares	28	5,039.0	4,933.2
Deposits and debt securities:			
Amounts owed to credit institutions	29	245.4	448.0
Amounts owed to other customers	30	286.9	172.6
Debt securities in issue	31	86.3	93.0
		618.6	713.6
Derivative financial instruments	16	55.7	50.6
Current tax liabilities		1.3	2.0
Other liabilities	32	6.7	5.8
Provisions for liabilities	21b	24.8	9.4
Accruals and deferred income	33	12.7	12.2
Deferred tax liabilities	34	1.5	1.8
Retirement benefit obligations	12	9.3	9.9
Subordinated liabilities	35	112.3	125.6
Subscribed capital	36	69.2	65.1
Total liabilities		**5,951.1**	**5,929.2**
General reserve	37	310.6	287.9
Other reserves	38	0.4	1.8
Total equity and liabilities		**6,262.1**	**6,218.9**

Loans and advances to customers of £37.3m have been reclassified from other loans to loans secured on residential property as this is considered to more appropriately represent the nature of the balance. There was no effect on net assets as a result of the reclassification.

The accounting policies and notes on pages 38 to 74 form part of these accounts.

These accounts were approved by the Board on 4 February 2011.
Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Peter L. Griffiths Chief Executive

W. Guy Thomas Group Finance Director

Statement of financial position of the Society

at 31 December 2010

	Notes	2010 £m	2009 £m
Assets			
Liquid assets:			
Cash in hand and balances with the Bank of England		320.7	86.0
Loans and advances to credit institutions	14	71.8	208.5
Debt securities	15	800.8	1,084.5
		1,193.3	1,379.0
Derivative financial instruments	16	38.7	36.3
Loans and advances to customers:			
Loans fully secured on residential property	18	3,711.2	3,475.3
Other loans fully secured on land	19	571.5	594.6
	20	4,282.7	4,069.9
Investments in subsidiary undertakings	22	653.7	668.8
Investment in joint venture	23	-	1.9
Intangible fixed assets	24	1.4	1.8
Property, plant and equipment	25	36.7	32.5
Deferred tax assets	34	3.1	3.3
Other assets	26	3.7	1.0
Prepayments and accrued income	27	17.3	18.4
Total assets		**6,230.6**	**6,212.9**

Liabilities			
Shares	28	5,039.0	4,933.2
Deposits and debt securities:			
Amounts owed to credit institutions	29	242.6	446.4
Amounts owed to other customers	30	286.9	172.6
Debt securities in issue	31	86.3	93.0
		615.8	712.0
Derivative financial instruments	16	55.7	50.6
Current tax liabilities		0.9	1.8
Other liabilities	32	4.9	4.5
Provisions for liabilities	21b	4.9	5.6
Accruals and deferred income	33	11.4	11.0
Deferred tax liabilities	34	1.5	1.8
Retirement benefit obligations	12	9.3	9.9
Subordinated liabilities	35	112.3	125.6
Subscribed capital	36	69.2	65.1
Total liabilities		**5,925.0**	**5,921.1**
General reserve	37	305.3	290.0
Other reserves	38	0.4	1.8
Total equity and liabilities		**6,230.6**	**6,212.9**

The accounting policies and notes on pages 38 to 74 form part of these accounts.

These accounts were approved by the Board on 4 February 2011.
Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Peter L. Griffiths Chief Executive

W. Guy Thomas Group Finance Director

Consolidated statement of cash flows

for the year ended 31 December 2010

	2010 £m	2009 £m
Net cash (outflow)/inflow from operating activities (see below)	(118.8)	45.4
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(9.9)	(3.5)
Purchase of investment securities	(2,228.2)	(3,475.6)
Proceeds from sale and maturity of investment securities	2,510.1	3,571.7
Disposal of shares in joint venture	1.9	-
Cash flows from financing activities		
Subordinated debt repurchase	(6.9)	-
Increase in cash and cash equivalents	148.2	138.0
Cash and cash equivalents at beginning of year	242.7	104.7
Cash and cash equivalents at end of year	**390.9**	**242.7**

Represented by:		
Cash and balances with the Bank of England	320.7	136.3
Loans and advances to credit institutions repayable on demand	70.2	106.4
	390.9	242.7
Net cash inflow from operating activities		
Profit before taxation	30.8	14.3
Adjusted for:		
Depreciation and amortisation	5.7	6.0
Loss on sale of property, plant and equipment	0.3	-
Increase in impairment losses on loans and advances to customers	22.2	39.4
Change in fair values	(1.2)	17.9
Other non-cash movements	(2.9)	0.4
Changes in net operating assets		
Decrease in loans and advances to credit institutions	50.0	52.0
(Increase)/decrease in loans and advances to customers	(242.5)	81.4
(Increase)/decrease in other assets	(2.6)	2.0
Decrease in prepayments and accrued income	0.9	15.1
Increase/(decrease) in derivative financial instruments	2.8	(15.3)
Increase in shares	103.8	309.8
(Decrease) in deposits and debt securities	(94.6)	(471.0)
Increase/(decrease) in other liabilities	1.0	(1.5)
Increase in accruals and deferred income	15.9	0.4
(Decrease) in pension fund obligations	(1.1)	-
Taxation	(7.3)	(5.5)
	(118.8)	**45.4**

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2010 amounted to £4.8m (2009: £4.4m).

Statement of cash flows of the Society
for the year ended 31 December 2010

	2010 £m	2009 £m
Net cash (outflow)/inflow from operating activities (see below)	(120.5)	45.1
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(8.5)	(2.9)
Purchase of investment securities	(2,228.2)	(3,475.6)
Proceeds from sale and maturity of investment securities	2,510.1	3,571.7
Disposal of shares in joint venture	1.9	-
Cash flows from financing activities		
Subordinated debt repurchase	(6.9)	-
Increase in cash and cash equivalents	147.9	138.3
Cash and cash equivalents at beginning of year	241.5	103.2
Cash and cash equivalents at end of year	**389.4**	**241.5**

Represented by:		
Cash and balances with the Bank of England	320.7	86.0
Loans and advances to credit institutions repayable on demand	68.7	155.5
	389.4	241.5
Net cash inflow from operating activities		
Profit before taxation	20.4	12.5
Adjusted for:		
Depreciation and amortisation	4.6	4.7
Loss on sale of property, plant and equipment	0.1	-
Increase in impairment losses on loans and advances to customers	12.4	7.0
Change in fair values	(1.2)	17.9
Other non-cash movements	(2.8)	(0.1)
Changes in net operating assets		
Decrease in loans and advances to credit institutions	49.9	52.0
(Increase)/decrease in loans and advances to customers	(222.0)	71.8
Decrease in loans to subsidiary companies	15.2	47.9
(Increase)/decrease in other assets	(2.7)	0.8
Decrease in prepayments and accrued income	1.0	15.3
Increase/(decrease) in derivative financial instruments	2.8	(15.3)
Increase in shares	103.7	309.8
(Decrease) in deposits and debt securities	(95.8)	(469.8)
Increase/(decrease) in other liabilities	0.4	(1.5)
(Decrease) in accruals and deferred income	(0.3)	(2.5)
(Decrease) in pension fund obligations	(1.1)	-
Taxation	(5.1)	(5.4)
	(120.5)	**45.1**

Notes to the accounts

for the year ended 31 December 2010

1. Accounting policies

Basis of preparation

The Group and Society's financial statements for the year ended 31 December 2010 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.

Within the consolidated statement of other comprehensive income other provisions of £2.5m in 2009 have been reclassified from fees and commissions receivable to provision for other liabilities and charges. In addition, loans and advances to customers of £37.3m in 2009 have been reclassified from other loans to loans fully secured on residential property in the statement of financial position. Both restatements are considered to more appropriately represent the nature of the balances. There was no effect on the 2009 profit for the year as a result of the reclassification and no effect on the 2009 opening and closing reserves. The effect of this reclassification on the 2008 statement of financial position would have resulted in other loans in the statement of financial position being £67.0m instead of £86.8m and loans fully secured on residential property being £4,228.8m instead of £4,209.0m. There would have been no effect on 2008 total loans and advances to customers which would remain at £4,884.3m and no effect on closing reserves. Accordingly, following these adjustments, no opening statement of financial position has been included in these financial statements.

The financial statements have been prepared on a going concern basis. This is discussed in the Directors' Report on page 21, under the heading 'Going concern'. At the date of authorisation of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue but not yet effective:

Pronouncement	Nature of Change	Effective Date
IFRS 9 Financial Instruments - Classification and Measurement	The new standard addresses phase 1 of the IASB's project to replace IAS 39 'Financial Instruments' and requires financial assets to be classified as at amortised cost or fair value. The available for sale (AFS) category currently used by the Group will not be available. Early adoption is permitted once endorsed by the EU. The impact of IFRS9 on the Group is currently being considered.	Accounting periods beginning on or after 1 January 2013
Improvements to IFRS's (May 2010)	Several small amendments with no significant impact for the Group.	Accounting periods beginning on or after 1 January 2011

The directors anticipate that the adoption of these standards and interpretations in future periods, with the exception of IFRS 9, will not have a material impact on the financial statements of the Group. The impact of IFRS 9 is being considered but any impact cannot be quantified.

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

Accounting convention

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

Basis of consolidation

The Group financial statements consist of the financial statements of the ultimate parent (Principality Building Society), all entities controlled by the Society (its subsidiaries) and the Group's interests in joint ventures.

i) Subsidiaries

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

ii) Joint ventures

A joint venture is an entity in which the Group holds an interest on a long-term basis and which is jointly controlled by the Group and one or more other venturers under a contractual agreement. Investments in joint ventures are carried in the statement of financial position at cost plus post-acquisition changes in the Group's investment.

Securitisation transactions

The Group has securitised certain mortgage loans by the transfer of the loans to a special purpose entity (SPE) controlled by the Group. The securitisation enables a subsequent issuance of debt by the Society to investors who gain the security of the underlying assets as collateral. The SPE is fully consolidated into the Group's accounts.

The transfer of the mortgage loans to the SPE are not treated as sales by the Society. The Society continues to recognise the mortgage loans on its own statement of financial position after the transfer because it retains their risks and rewards through the receipt of substantially all of the profits or losses of the SPE. In the accounts of the Society, the proceeds received from the transfer are accounted for as a deemed loan repayable by the SPE.

Interest receivable and payable

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

Interest income on available-for-sale investments, derivatives and other financial assets accounted at fair value through the statement of comprehensive income is included in interest receivable and similar income.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Fees and commissions

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

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 statement of comprehensive income.

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 statement of comprehensive income. The fair value of available-for-sale assets is derived from market data. Where this market data is not available, an independent third party provides a valuation. If the asset is sold before maturity, cumulative gains and losses recognised in reserves are recycled to the statement of comprehensive income.

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 statement of comprehensive income.

iv) Financial assets at fair value accounted through the statement of comprehensive income

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 statement of comprehensive income. Subsequent measurement is at fair value with changes in value reflected in the statement of comprehensive income.

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.

Impairment losses on loans and advances to customers

The Group assesses at the date of each statement of financial position whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset or group of financial assets is impaired. Evidence of impairment may include indications that the borrower or group of borrowers are experiencing significant financial difficulty, default or delinquency in interest or principal payments 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 asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions have been deducted from the appropriate asset values in the statement of financial position.

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

Notes to the accounts

1. Accounting policies (continued)

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

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 statement of comprehensive income.

Loans subject to individual impairment assessment are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

Derivative financial instruments and hedge accounting

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

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

Financial instruments are initially recognised at fair value.

i) Derivative financial instruments

Derivatives are initially measured at fair value and are subsequently re-measured to fair value at each reporting date with movements recorded in the statement of comprehensive income. Fair values are calculated by discounted cash flow models using yield curves that are based on observable market data or are based on valuations from counterparties. In the first instance fair values are calculated using mid-prices, with an adjustment then made to derivative assets and liabilities to value them on a bid and offer basis respectively. All derivatives are classified as assets where their fair value is positive and liabilities where their fair value is negative. Where there is the legal ability and intention to settle net, then the derivative is classified as a net asset or liability, as appropriate.

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

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 statement of comprehensive income.

iii) Hedge accounting

When transactions meet the criteria specified in IAS39, 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 statement of comprehensive income 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 statement of comprehensive income.

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

Foreign currency translation

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

Intangible assets

i) Goodwill

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

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

Notes to the accounts

ii) Computer software

IAS38 ‘Intangible Assets’ requires the capitalisation of certain expenditure relating to software development costs. Software development costs are capitalised if it is probable that the asset created will generate future economic benefits. Costs incurred to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

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

Where software costs are capitalised, they are amortised using the straight-line method over their estimated useful lives which is 3 to 5 years. The amortisation periods used are reviewed annually.

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

Taxation

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

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the statement of comprehensive income 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 statement of comprehensive income together with the deferred gain or loss.

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

Property, plant and equipment

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

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 statement of comprehensive income in the period in which they are incurred.

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

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

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

Pension costs

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

A defined contribution scheme is one into which the Group and the employee pay fixed contributions, without any further obligation to pay further contributions. Payments into the defined contribution scheme are charged to the statement of comprehensive income 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 and length of service. Pension scheme assets are measured using closing market values. Pension scheme liabilities are measured using the projected unit method and discounted at the current rate of return on a high quality corporate bond of equivalent term and currency to the liability. This scheme closed to future accruals on 31 July 2010.

The increase in the present value of the liabilities of the defined benefit scheme expected to arise from employee service in the period is charged to the statement of comprehensive income. 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 recognised income and expense.

Notes to the accounts

1. Accounting policies (continued)

Leases

Leases entered into by the Group are operating leases.

i) As lessee

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

ii) As lessor

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

Debt securities in issue, subordinated liabilities and Permanent Interest Bearing Shares

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

Segmental reporting

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

Cash and cash equivalents

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

Cash held in Principality Covered Bond LLP is restricted.

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.

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 statement of comprehensive income over the periods necessary to match them with the related costs to which they are intended to compensate, on a systematic basis.

Sale and repurchase agreements

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

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.

Collateral values are updated at the date of each statement of financial position based on the best information publically available.

Impairment provision on investment securities

The Group has a £10.0m (2009: £10.0m) exposure to Anglo Irish Bank Corporation Ltd due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. This scheme is approved by the European Commission under EC Treaty state aid rules. The recent agreement between the Irish government, the European Union and International Monetary Fund (IMF) for a restructuring plan in November 2010 contained guarantees for the full repayment of its senior unsecured bonds. In light of the agreement, this exposure is considered not impaired. The Group has no direct sovereign exposure to Greece, Italy, Portugal and Spain as at 31 December 2010.

Notes to the accounts

Fair value of derivatives and available-for-sale assets

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

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

Retirement benefit obligations

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

The impact of a 0.1% increase in the inflation assumptions would be to increase the carrying value of the pension obligations by approximately £0.9m. The impact of a 0.1% increase in the discount rate would be to reduce the value of pension obligations by approximately £1.0m. Further details on the assumptions used in valuing retirement benefit obligations can be found in note 12.

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, the estimated average cost of redress per case and the number of customers applying for redress where there would appear to be a supportable claim.

Provisions are only made where the Group has responsibility for the original sale of the product. No provision has been made for sales by third parties as there is significant uncertainty as to the Group's liability for redress in respect of such sales and it is therefore not possible to reasonably estimate the financial impact on the Group.

Taxation

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

Effective interest rate (EIR)

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

The impact of a 10% increase/decrease in the expected lives of financial instruments would result in an increase/decrease in the value of the loans in the statement of financial position by £0.3m/(£0.3m) respectively. The impact of a 10% increase/decrease in the anticipated level of early redemption would result in an increase/decrease in the value of the loans in the statement of financial position by £0.5m/(£0.5m) respectively.

3. Business segments

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

	2010					
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Property services £m	Adjustment for Group transactions £m	Total £m
Interest receivable and similar income	139.1	38.1	59.2	-	(14.0)	222.4
Interest payable and similar charges	(83.3)	(27.3)	(14.1)	-	14.1	(110.6)
Net interest income	55.8	10.8	45.1	-	0.1	111.8
Net fee and commission income	6.4	0.9	(0.1)	9.3	(0.2)	16.3
Other operating income	1.2	-	-	-	(0.4)	0.8
Fair value gains	0.2	-	-	-	-	0.2
Net operating income	**63.6**	**11.7**	**45.0**	**9.3**	**(0.5)**	**129.1**
Administrative expenses	(42.9)	(2.0)	(9.3)	(8.9)	1.0	(62.1)
Impairment provision for losses on loans and advances	(2.8)	(9.6)	(9.8)	-	-	(22.2)
Provision for other liabilities and charges	(0.5)	-	(16.2)	(0.4)	-	(17.1)
Operating profit/(loss)	**17.4**	**0.1**	**9.7**	**-**	**0.5**	**27.7**
Other gains	3.1	-	-	-	-	3.1
Profit before taxation	**20.5**	**0.1**	**9.7**	**-**	**0.5**	**30.8**

3. Business segments (continued)

	2009					
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Property services £m	Adjustment for Group transactions £m	Total £m
Interest receivable and similar income	141.0	40.0	61.6	-	(15.9)	226.7
Interest payable and similar charges	(92.5)	(27.8)	(16.2)	-	16.2	(120.3)
Net interest income	48.5	12.2	45.4	-	0.3	106.4
Net fee and commission income	7.8	2.2	0.6	6.8	(0.1)	17.3
Other operating income	0.8	-	-	-	(0.3)	0.5
Fair value gains	(6.5)	-	-	-	-	(6.5)
Net operating income	**50.6**	**14.4**	**46.0**	**6.8**	**(0.1)**	**117.7**
Administrative expenses	(43.1)	(2.0)	(8.7)	(6.2)	-	(60.0)
Impairment provision for losses on loans and advances	(2.0)	(5.0)	(32.5)	-	-	(39.5)
Provision for other liabilities and charges	(1.4)	-	(2.5)	-	-	(3.9)
Operating profit/(loss) and profit/(loss) before taxation	**4.1**	**7.4**	**2.3**	**0.6**	**(0.1)**	**14.3**

	Group	
	2010 £m	2009 £m
Total assets by business segment		
Retail financial services	4,640.0	4,587.1
Secured personal lending	680.2	669.7
Commercial lending	937.9	957.3
Property services	4.0	4.8
Total assets	**6,262.1**	**6,218.9**
Total liabilities by business segment		
Retail financial services	5,577.9	5,544.4
Secured personal lending	680.2	669.7
Commercial lending	-	-
Property services	4.0	4.8
Total liabilities	**6,262.1**	**6,218.9**

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

Notes to the accounts

4. Interest receivable and similar income

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
On loans fully secured on residential property	232.1	226.6	172.9	164.7
On other loans fully secured on land	22.2	24.4	22.2	24.4
On other loans to subsidiaries	-	-	14.1	16.2
On debt securities	11.7	23.1	11.7	23.1
Profit on realisation of investments	6.3	3.7	6.3	3.7
On other liquid assets	1.7	1.2	1.7	1.2
On derivative financial instruments	(51.6)	(52.3)	(51.6)	(52.3)
	222.4	**226.7**	**177.3**	**181.0**

5. Interest payable and similar charges

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
On shares held by individuals	124.5	112.5	124.5	112.5
On deposits and debt securities	7.9	23.0	7.9	23.0
On subscribed capital	4.2	4.2	4.2	4.2
On subordinated liabilities	5.9	6.5	5.9	6.5
On derivative financial instruments	(31.9)	(25.9)	(31.9)	(25.9)
	110.6	**120.3**	**110.6**	**120.3**

6. Fees and commission receivable

	Group		Society	
	2010 £m	2009 Restated £m	2010 £m	2009 £m
Insurance and related financial service products	6.3	6.0	5.4	5.8
Estate agency	4.9	4.5	-	-
Mortgage related fees	3.4	5.3	3.4	4.2
Other fees and commission	3.3	2.8	1.3	1.2
	17.9	**18.6**	**10.1**	**11.2**

7. Fees and commission payable

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Mortgage related fees	1.2	1.0	0.1	0.3
Bank charges	0.4	0.3	0.4	0.3
	1.6	**1.3**	**0.5**	**0.6**

Notes to the accounts

8. Other fair value gains and losses

	Group and Society	
	2010 £m	2009 £m
(Losses)/gains on derivatives	(2.8)	7.3
Gains/(losses) on hedged items attributable to the hedged risk	3.0	(13.8)
	0.2	**(6.5)**

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.

On an on-going basis, management review the appropriateness of assumptions used to calculate the fair value adjustments to hedged risk. During 2009, management revised their estimates relating to the fair value adjustments. This resulted in a £3.8m charge which is included within the £13.8m loss shown above.

9. Administrative expenses

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Wages and salaries	31.2	28.7	23.5	21.7
Social security costs	2.9	2.7	2.2	2.1
Other pension costs	1.1	1.1	1.0	1.0
	35.2	32.5	26.7	24.8
Other administrative expenses	21.2	21.5	15.7	15.2
	56.4	**54.0**	**42.4**	**40.0**

Other administrative expenses include:	£000	£000	£000	£000
Auditors' remuneration:				
For audit of the Society's Annual Accounts	103	99	103	99
For other services:				
For audit of the Society's subsidiaries	26	25	-	-
Tax advisory	107	117	107	47
Further assurance services	38	102	38	172
All other services	13	10	13	10
Operating lease charges - motor vehicles	257	272	228	241
- land and buildings	1,627	1,539	859	709

Notes to the accounts

10. Employees

The average number employed including executive directors was:

	Full-time		Part-time	
	2010 Number	2009 Number	2010 Number	2009 Number
Society's Customer Support Centre	443	414	71	65
Society branch offices	190	186	124	98
Employed by the Society	633	600	195	163
Subsidiaries	245	238	53	48
Employed by the Group	**878**	**838**	**248**	**211**

11. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on page 28 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 £1.6m (2009: £1.9m).

In addition, ex-gratia pensions amounting to £23k (2009: £23k) were paid to former directors.

12. Retirement benefit obligations

The Group operates two pension schemes, a defined benefit and a defined contribution scheme. A defined benefit scheme is one that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary. Staff, including executive directors, who entered service before 1 January 2001 were eligible to join the Society's Defined Benefit Scheme which is designed to provide pension entitlements based on career average salary (final salary until 31 December 2005) with assets held outside the Society in a separate fund administered by the Trustees. 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 closed to future accruals on 31 July 2010 and was replaced with an enhanced defined contribution scheme, the Group Flexible Retirement Plan (GFRP). The Group injected £1.0m into the Defined Benefit Scheme on its closure and has committed to a further injection of £1.0m on the first anniversary of the closure to help reduce the current deficit. The statement of comprehensive income reflects a curtailment gain of £0.2m recognised on the closure of the scheme.

The Defined Benefit Scheme was subject to a triennial valuation by the Scheme's independent actuary on 30 September 2010. It is expected that this valuation will be approved by the Trustees in the next 12 months.

A defined contribution scheme is one into which the Group and the employee pay fixed contributions, without any further obligation to pay further contributions. Staff employed after 1 January 2001 and those staff who were formerly a member of the defined benefit scheme are eligible to join this scheme. The cost to the Group and Society of employer's contributions (before salary sacrifice arrangements) to the scheme in 2010 was £486k (2009: £200k) of which £166k related to employees formerly a member of the defined benefit scheme. There were no contributions outstanding or prepaid at the end of the year.

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 Section 35 of the Pensions Act 1995. Assets supporting the Scheme are managed by Royal London Asset Management, BlackRock Investment Management (UK) Limited and Standard Life Investments. Assets were also held with UBS Global Assets Management during the year. In addition the Trustees may hold cash from time to time. The assets managed by Standard Life Investments, UBS Global Assets Management and BlackRock Investment Management (UK) Limited during the year were invested to target a long-term rate of return well in excess of inflation.

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

Updated calculations prepared by the scheme actuary on the IAS19 basis at 31 December 2010, including the unfunded liability referred to above, revealed a deficit amounting to £9.3m (2009: £9.9m). The assumed rate of pension revaluation in deferment and guaranteed minimum pensions was changed from the Retail Prices Index (RPI) to the Consumer Price Index (CPI) during the year. The impact of this change was to reduce the deficit by £1.3m.

Notes to the accounts

12. Retirement benefit obligations (continued)

The major assumptions used by the actuary were:

	At 31 December				
	2010 %	2009 %	2008 %	2007 %	2006 %
Rate of increase in pensionable salaries	3.55	3.60	2.70	3.20	2.75
Rate of increase of pensions in payment and deferred pensions	3.55	3.60	2.70	3.20	2.75
Discount rate	5.40	5.65	6.25	5.70	5.10
Inflation assumption (RPI)	3.55	3.60	2.70	3.20	2.75
Inflation assumption (CPI)	3.05	n/a	n/a	n/a	n/a
The long-term rates of return expected on investments in the schemes were:	6.30	6.50	6.50	6.50	6.00

The assumptions on mortality are determined by the following tables:

	2010	2009
Retired and non-retired members	SAPS LC1%B	PA92 MCB
The assumptions are illustrated by the following year of life expectancy at age 65:		
Retired members		
Males currently aged 65	22.8	22.0
Females currently aged 65	25.6	24.9
Non-retired members		
Males currently aged 45	24.8	23.1
Females currently aged 45	27.6	25.9

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

	At 31 December				
	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Target return funds	22.4	18.6	17.8	21.5	-
Debt securities	20.4	21.4	17.7	17.6	-
Equities	-	-	-	-	19.1
Bonds and cash	0.4	0.4	-	-	18.3
Total fair value of plan assets	43.2	40.4	35.5	39.1	37.4
Present value of funded obligations	(52.0)	(49.8)	(36.3)	(40.5)	(37.4)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.6)
Net deficit recognised in the statement of financial position	**(9.3)**	**(9.9)**	**(1.3)**	**(1.9)**	**(0.6)**

Notes to the accounts

12. Retirement benefit obligations (continued)

The amounts recognised in the statement of comprehensive income are as follows:

	Group and Society	
	2010 £m	2009 £m
Analysis of pension costs (included in administrative expenses)		
Current service cost	(0.5)	(0.7)
	(0.5)	**(0.7)**
Analysis of finance credit (included in other operating income)		
Expected return on pension scheme assets	(2.7)	(2.3)
Interest on pension scheme liabilities	2.8	2.3
Net credit to other financial income	**0.1**	**-**
Analysis of amount recognised in statement of total recognised income and expense		
Actuarial loss	**(0.5)**	**(8.9)**
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(9.9)	(1.3)
Movement in year:		
Current service cost	(0.5)	(0.7)
Other finance credit	0.1	-
Actuarial loss	(0.5)	(8.9)
Contributions paid	1.5	1.0
Deficit in scheme at end of year	**(9.3)**	**(9.9)**

	Group and Society				
Details of experience gains and losses	**2010**	**2009**	**2008**	**2007**	**2006**
Difference between the expected and actual return on scheme assets:					
(Loss)/gain amount	(£0.2m)	£2.8m	(£6.2m)	(£0.7m)	(£0.1m)
Percentage of scheme assets	0.4%	6.9%	17.5%	1.8%	0.1%
Experience gains and losses on scheme liabilities:					
(Loss)/gain amount	(£0.3m)	(£11.6m)	£6.9m	(£0.8m)	-
Percentage of the present value of scheme liabilities	0.6%	23.0%	18.8%	1.9%	-
Total amount recognised in statement of total recognised income and expense:					
(Loss)/gain amount	(£0.5m)	(£8.8m)	£0.7m	(£1.5m)	£1.6m
Percentage of the present value of scheme liabilities	1.0%	17.5%	1.8%	3.7%	4.1%

The actual return on plan assets was £2.6m (2009: £2.3m loss).

The Group estimates that its contributions to the defined benefit scheme during the year ending 31 December 2011 will be £1.1m including a further injection of £1.0m into the scheme on the first anniversary of its closure.

Notes to the accounts

13. Taxation

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Current tax				
UK corporation tax charge for the year	8.3	5.4	5.1	3.6
Adjustments in respect of prior years	(1.0)	(0.6)	(0.4)	(0.1)
	7.3	4.8	4.7	3.5
Deferred tax				
Deferred tax charge/(credit) for year	(0.3)	(1.0)	(0.2)	(0.3)
Adjustments in respect of prior years	0.6	(0.3)	0.1	-
	0.3	(1.3)	(0.1)	(0.3)
Taxation on profit on ordinary activities	**7.6**	**3.5**	**4.6**	**3.2**

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	30.8	14.3	20.4	12.5
Profit multiplied by the standard rate of corporation tax at 28%	8.6	4.0	5.7	3.5
Effects of:				
Depreciation in excess of capital allowances	-	-	-	-
Expenses not deductible for tax purposes	0.3	0.3	0.3	0.2
Adjustments to prior years	(0.4)	(0.9)	(0.3)	(0.1)
Other	(0.9)	0.1	(1.1)	(0.4)
Total taxation for the year	**7.6**	**3.5**	**4.6**	**3.2**

Included in the Group profit for the period is a gain of £3.1m on the repurchase of £10.0m of subordinated liabilities which is non-taxable.

14. Loans and advances to credit institutions

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Repayable from the date of the statement of financial position in the ordinary course of business:				
Accrued interest	0.1	0.1	0.1	0.1
On demand	45.7	93.9	44.2	142.9
Less than three months	3.0	53.0	3.0	53.0
Credit Support Annex (CSA) assets	24.5	12.5	24.5	12.5
	73.3	**159.5**	**71.8**	**208.5**

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. £24.5m has been pledged during the year (2009: £12.5m).

Notes to the accounts

15. Debt securities

	Group and Society	
	2010 £m	2009 £m
Issued by UK government	352.9	508.2
Issued by Supranational entities	26.6	-
Issued by other borrowers and unlisted	421.3	576.3
	800.8	**1,084.5**

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 statement of financial position in the ordinary course of business as follows:

	Group and Society	
	2010 £m	2009 £m
Accrued interest	3.0	4.9
Less than three months	330.1	275.0
Between three months and one year	271.2	208.9
Between one year and five years	196.5	595.7
	800.8	**1,084.5**

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

	Group and Society
	£m
At 1 January 2010	1,084.5
Additions	2,228.2
Disposals and maturities	(2,508.2)
Gains from changes in fair value	(1.8)
Decrease in accrued interest	(1.9)
At 31 December 2010	**800.8**

The Society engages in gilt stock lending.

Notes to the accounts

16. Derivative financial instruments

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

	Group and Society			
	Contract/ notional amount		Fair value	
	2010 £m	2009 £m	2010 £m	2009 £m
Derivative assets held for hedging purposes and designated fair value hedges:				
Interest rate swaps	2,048.2	1,639.1	28.3	24.1
Cross currency interest rate swaps	51.4	53.3	10.4	12.2
Total recognised derivative assets	**2,099.6**	**1,692.4**	**38.7**	**36.3**
Derivative liabilities held for hedging purposes and designated fair value hedges:				
Interest rate swaps	1,594.0	1,653.6	(55.7)	(50.6)
Total recognised derivative assets/(liabilities)	**1,594.0**	**1,653.6**	**(55.7)**	**(50.6)**

17. Assets measured at fair value

	Group and Society		
	2010 £m	Level 1 £m	Level 2 £m
Financial assets at fair value through profit or loss:			
Derivative financial instruments	38.7	-	38.7
Available-for-sale financial assets			
Debt securities	800.8	800.8	-
Total	**839.5**	**800.8**	**38.7**

	Group and Society		
	2010 £m	Level 1 £m	Level 2 £m
Financial assets at fair value through profit or loss:			
Derivative financial instruments	36.3	-	36.3
Available-for-sale financial assets			
Debt securities	1,084.5	1,084.5	-
Total	**1,120.8**	**1,084.5**	**36.3**

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

Level	Hierarchy for fair value disclosures
1	Quoted prices (unadjusted) in active markets for identical assets or liabilities
2	Inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly or indirectly (i.e. derived from prices)
3	Inputs for the asset or liability that are not based on observable market data. There are no instruments classified as level 3 in 2010 (2009: none).

Notes to the accounts

18. Loans fully secured on residential property

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Gross balances	4,357.7	4,105.2	3,682.1	3,441.9
Provision for impairment losses	(55.5)	(49.3)	(20.0)	(12.5)
Unamortised loan origination fees	35.1	38.0	(2.5)	(2.5)
Fair value adjustment for hedged risk	51.6	48.4	51.6	48.4
	4,388.9	**4,142.3**	**3,711.2**	**3,475.3**

Within the Group totals above there was £50.8m partially secured against residential property (2009: £55.7m restated).

Loans and advances to customers of £37.3m have been reclassified from other loans to loans secured on residential property as this is considered to more appropriately represent the nature of the balance. There was no effect on net assets as a result of the reclassification.

19. Other loans fully secured on land

	Group and Society	
	2010 £m	2009 £m
Other loans	571.5	594.6

20. Loans and advances to customers

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Maturity analysis of loans and advances to customers from the date of the statement of financial position:				
Repayable on demand	83.1	66.4	79.0	62.6
Less than three months	80.3	110.2	71.2	102.2
Between three months and one year	267.4	218.5	239.5	193.7
Between one year and five years	1,081.0	1,071.7	916.1	922.1
More than five years	3,417.4	3,233.0	2,947.8	2,755.9
	4,929.2	4,699.8	4,253.6	4,036.5
Provision for impairment losses	(55.5)	(49.3)	(20.0)	(12.5)
Unamortised loan origination fees	35.1	38.0	(2.5)	(2.5)
Fair value adjustment for hedged risk	51.6	48.4	51.6	48.4
	4,960.4	**4,736.9**	**4,282.7**	**4,069.9**

On 22 January 2009, the Group entered into a Covered Bond Programme. The Programme involved the formation of Principality Covered Bond LLP, a Limited Liability Partnership which is consolidated into the accounts of the Group. The LLP provides security to issues of covered bonds made by the Society as part of the Covered Bond Programme.

As at 31 December 2010, £917.8m of loans issued by the Society had been transferred to Principality Covered Bond LLP. These loans secure a £700m AAA rated bond issued internally by the Society. The loans remain on the balance sheet of the Society as the risks and rewards are retained by the Society.

Notes to the accounts

21a. Provision for impairment losses

	Loans fully secured on residential property	
	Collective £m	Specific £m
Group		
At 1 January 2010	6.7	42.6
Amounts written off during the year	-	(16.0)
Provision for loan impairment	5.2	17.0
At 31 December 2010	**11.9**	**43.6**
Society		
At 1 January 2010	6.7	5.8
Amounts written off during the year	-	(4.9)
Provision for loan impairment	5.2	7.2
At 31 December 2010	**11.9**	**8.1**
Group		
At 1 January 2009	1.5	36.8
Amounts written off during the year	-	(28.5)
Provision for loan impairment	5.2	34.3
At 31 December 2009	**6.7**	**42.6**
Society		
At 1 January 2009	1.5	10.8
Amounts written off during the year	-	(6.8)
Provision for loan impairment	5.2	1.8
At 31 December 2009	**6.7**	**5.8**

21b. Provisions for liabilities

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
At 1 January	9.4	6.8	5.6	6.3
Additions	17.1	4.7	1.0	1.4
Utilisation	(1.7)	(1.6)	(1.7)	(1.6)
Release for the year	-	(0.5)	-	(0.5)
At 31 December	**24.8**	**9.4**	**4.9**	**5.6**

Included in provisions is the Financial Services Compensation Scheme levy of £3.8m which is based on the Group's share of protected deposits. The contingent aspect of the levy is described in note 39.

Other provisions of £16.6m have been made in respect of various customer claims, including claims in relation to previous sales of payment protection insurance. It is expected that the liability will predominantly crystallise over the next 12 to 24 months. The contingent aspect of this provision is described in note 39.

Notes to the accounts

22. Investments in subsidiary undertakings

	Society	
	2010 £m	2009 £m
Shares in subsidiary undertakings:		
At cost	1.1	4.5
Amounts written off investments	-	(3.4)
	1.1	1.1
Loans to subsidiary undertakings	652.6	667.7
	653.7	**668.8**

	Subsidiary undertakings	
	Shares £m	Loans £m
Movement in investments in subsidiary undertakings:		
At 1 January 2010	1.1	667.7
Decrease	-	(15.1)
At 31 December 2010	**1.1**	**652.6**

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

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

	Place of registration	Principal activity	Class of shares held	Interest of Society	Direct or indirect
Peter Alan Limited	England and Wales	Estate agency and financial services	Ordinary and preference	100%	Direct
Nemo Personal Finance Limited	England and Wales	Secured personal lending	Ordinary	100%	Direct
Loan Link Limited	England and Wales	Loan broking	Ordinary	100%	Indirect
Principality Mortgage and Insurance Services Limited	England and Wales	Provision of advisory and administration services	Ordinary	100%	Direct
Principality Covered Bond LLP	England and Wales	Mortgage acquisition and guarantor of covered bonds	Ordinary	100%	Direct
Friary Two Limited	England and Wales	Special purpose vehicle	Ordinary	100%	Direct

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

23. Investment in joint venture

The Group had the following joint venture which operated in the United Kingdom during the year.

	Place of registration	Principal activity	Class of shares held	Interest of Society	Direct or indirect
Friary One Limited	England and Wales	Property Investment	Ordinary	50%	Direct

On 18 August 2010, the Group disposed of its 50% interest in Friary One Limited at par. The aggregate movement in investment in joint venture is as follows:

	Group and Society
	£m
At 1 January 2010	1.9
Disposal	(1.9)
31 December 2010	-

24. Intangible assets

2010	Goodwill		Computer software		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2010	0.7	-	4.4	4.4	5.1	4.4
Additions	-	-	0.4	0.4	0.4	0.4
Reclassifications	-	-	-	-	-	-
Disposals	-	-	-	-	-	-
At 31 December 2010	**0.7**	**-**	**4.8**	**4.8**	**5.5**	**4.8**
Amortisation:						
At 1 January 2010	-	-	2.6	2.6	2.6	2.6
Reclassifications	-	-	-	-	-	-
Charge for the year	-	-	0.8	0.8	0.8	0.8
Disposals	-	-	-	-	-	-
At 31 December 2010	**-**	**-**	**3.4**	**3.4**	**3.4**	**3.4**
Net carrying amount:						
At 31 December 2010	**0.7**	**-**	**1.4**	**1.4**	**2.1**	**1.4**
At 31 December 2009	0.7	-	1.8	1.8	2.5	1.8

Notes to the accounts

24. Intangible assets (continued)

2009	Goodwill		Computer software		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2009	0.7	-	4.7	4.3	5.4	4.3
Additions	-	-	0.1	0.1	0.1	0.1
Reclassifications	-	-	(0.4)	-	(0.4)	-
Disposals	-	-	-	-	-	-
At 31 December 2009	**0.7**	**-**	**4.4**	**4.4**	**5.1**	**4.4**
Amortisation:						
At 1 January 2009	-	-	2.1	1.8	2.1	1.8
Reclassifications	-	-	(0.3)	-	(0.3)	-
Charge for the year	-	-	0.8	0.8	0.8	0.8
Disposals	-	-	-	-	-	-
At 31 December 2009	**-**	**-**	**2.6**	**2.6**	**2.6**	**2.6**
Net carrying amount:						
At 31 December 2009	**0.7**	**-**	**1.8**	**1.8**	**2.5**	**1.8**
At 31 December 2008	0.7	-	2.6	2.5	3.3	2.5

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 IAS36, the Group completed an impairment review of the carrying value for goodwill as at 31 December 2010 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 & vechicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2010	46.7	42.8	25.5	17.4	72.2	60.2
Additions	5.5	5.4	4.0	2.7	9.5	8.1
Reclassifications	-	-	-	-	-	-
Disposals	(0.6)	(0.4)	(0.2)	-	(0.8)	(0.4)
At 31 December 2010	**51.6**	**47.8**	**29.3**	**20.1**	**80.9**	**67.9**
Depreciation:						
At 1 January 2010	18.3	16.6	17.3	11.1	35.6	27.7
Charge for the year	1.5	1.4	3.4	2.4	4.9	3.8
Reclassifications	-	-	-	-	-	-
Disposals	(0.3)	(0.3)	(0.2)	-	(0.5)	(0.3)
At 31 December 2010	**19.5**	**17.7**	**20.5**	**13.5**	**40.0**	**31.2**
Net book amount:						
At 31 December 2010	**32.1**	**30.1**	**8.8**	**6.6**	**40.9**	**36.7**
At 31 December 2009	28.4	26.2	8.2	6.3	36.6	32.5

Included within land and buildings additions is £4.6m (2009: £nil) on account of assets in the course of construction.

	2010		2009	
	Group £m	Society £m	Group £m	Society £m
Land and buildings:				
Freehold	29.4	28.0	25.2	23.6
Long leasehold	0.7	0.5	0.7	0.6
Short leasehold	2.0	1.6	2.5	2.0
	32.1	**30.1**	**28.4**	**26.2**
Occupied by the Society and subsidiary undertakings	24.9	23.9	26.9	25.2

	Land and buildings		Equipment, fixtures, fittings & vechicles		Total	
	Group £m	Society £m	Group £m	Society £m	Group £m	Society £m
Cost:						
At 1 January 2009	45.9	42.1	24.1	16.8	70.0	58.9
Additions	0.8	0.7	2.6	2.1	3.4	2.8
Reclassifications	-	-	0.4	-	0.4	-
Disposals	-	-	(1.6)	(1.5)	(1.6)	(1.5)
At 31 December 2009	**46.7**	**42.8**	**25.5**	**17.4**	**72.2**	**60.2**
Depreciation:						
At 1 January 2009	16.6	15.0	15.0	10.3	31.6	25.3
Charge for the year	1.7	1.6	3.6	2.3	5.3	3.9
Reclassifications	-	-	0.3	-	0.3	-
Disposals	-	-	(1.6)	(1.5)	(1.6)	(1.5)
At 31 December 2009	**18.3**	**16.6**	**17.3**	**11.1**	**35.6**	**27.7**
Net book amount:						
At 31 December 2009	**28.4**	**26.2**	**8.2**	**6.3**	**36.6**	**32.5**
At 31 December 2008	29.3	27.1	9.1	6.5	38.4	33.6

Notes to the accounts

26. Other assets

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Due within one year:				
Other	3.8	1.5	3.7	1.0

27. Prepayments and accrued income

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Accrued interest on derivative financial instruments	15.0	15.5	15.0	15.5
Other	3.1	3.5	2.3	2.9
	18.1	**19.0**	**17.3**	**18.4**

28. Shares

	Group and Society	
	2010 £m	2009 £m
Held by individuals	5,020.2	4,915.2
Other shares	5.4	6.6
Fair value adjustment for hedged risk	13.4	11.4
	5,039.0	**4,933.2**

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

	Group and Society	
	2010 £m	2009 £m
Fair value adjustment for hedged risk	13.4	11.4
Accrued interest	59.6	63.0
On demand	1,337.5	1,361.3
Less than three months	1,206.2	1,215.0
Between three months and one year	1,137.0	1,107.1
Between one year and five years	1,285.3	1,175.4
	5,039.0	**4,933.2**

Notes to the accounts

29. Amounts owed to credit institutions

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

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Accrued interest	0.4	0.3	0.4	0.3
Credit Support Annex (CSA) liabilities	5.2	12.5	5.2	12.5
On demand	2.8	9.6	-	8.0
Less than three months	230.0	174.7	230.0	174.7
Between three months and one year	7.0	250.9	7.0	250.9
	245.4	**448.0**	**242.6**	**446.4**

As part of the Covered Bond Programme, and included in amounts owed to credit institutions, is £200.0m relating to securities sold under short-term agreements to repurchase.

30. Amounts owed to other customers

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

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Accrued interest	1.5	2.4	1.5	2.4
On demand	7.3	24.0	7.3	24.0
Less than three months	144.2	103.0	144.2	103.0
Between three months and one year	127.4	43.2	127.4	43.2
Between one year and five years	6.5	-	6.5	-
	286.9	**172.6**	**286.9**	**172.6**

31. Debt securities in issue

	Group and Society	
	2010 £m	2009 £m
Certificates of deposit	24.6	14.0
Fixed and floating rate notes	61.5	78.3
Fair value adjustment for hedged risk	0.2	0.7
	86.3	**93.0**

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

	Group and Society	
	2010 £m	2009 £m
Fair value adjustment for hedged risk	0.2	0.7
Accrued interest	0.1	0.1
Less than three months	19.5	9.0
Between three months and one year	5.0	29.9
Between one year and five years	61.5	53.3
More than five years	-	-
	86.3	**93.0**

Notes to the accounts

31. Debt securities in issue (continued)

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

	Group and Society	
	2010 £m	2009 £m
Certificates of deposit	0.94%	1.61%
Fixed and floating rate notes	0.90%	0.74%

32. Other liabilities

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Due within one year:				
Income tax	0.9	0.3	0.9	0.3
Other taxation and social security	0.9	0.9	0.6	0.7
Other creditors	4.9	4.6	3.4	3.5
	6.7	**5.8**	**4.9**	**4.5**

33. Accruals and deferred income

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Interest accrued on subordinated liabilities	2.8	3.1	2.8	3.1
Interest accrued on subscribed capital	0.4	0.4	0.4	0.4
Other	9.5	8.7	8.2	7.5
	12.7	**12.2**	**11.4**	**11.0**

34. Deferred tax

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
At 1 January	(2.1)	1.7	(1.5)	1.3
Charged to the statement of comprehensive income	0.3	(1.3)	(0.1)	(0.3)
Charged to statement of recognised income and expense on actuarial (losses)	-	(2.5)	-	(2.5)
	(1.8)	**(2.1)**	**(1.6)**	**(1.5)**

The reduction of the UK Corporation tax rate from 28% to 27% from 1 April 2011 has resulted in a deferred tax charge arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the asset is expected to reverse. The relevant charge is not material.

Notes to the accounts

34. Deferred tax (continued)

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

	Group			Society		
	Accelerated tax depreciation	Other	Total	Accelerated tax depreciation	Other	Total
	£m	£m	£m	£m	£m	£m
Deferred tax liabilities						
At 1 January 2010	0.6	1.2	1.8	0.4	1.4	1.8
Credited to the statement of comprehensive income	(0.1)	(0.2)	(0.3)	(0.1)	(0.2)	(0.3)
At 31 December 2010	**0.5**	**1.0**	**1.5**	**0.3**	**1.2**	**1.5**

	Group			Society		
	Retirement benefit obligations	Other	Total	Retirement benefit obligations	Other	Total
	£m	£m	£m	£m	£m	£m
Deferred tax assets						
At 1 January 2010	(2.8)	(1.1)	(3.9)	(2.8)	(0.5)	(3.3)
Credited to the statement of comprehensive income	0.3	0.3	0.6	0.3	(0.1)	0.2
Charged to statement of recognised income and expense	-	-	-	-	-	-
At 31 December 2010	**(2.5)**	**(0.8)**	**(3.3)**	**(2.5)**	**(0.6)**	**(3.1)**

35. Subordinated liabilities

	Group and Society	
	2010 £m	2009 £m
5 3/8% Subordinated Notes due 2016	110.0	120.0
Unamortised premiums and issue costs	(0.1)	(0.3)
Fair value adjustment for hedged risk	2.4	5.9
	112.3	**125.6**

The Society's subordinated liabilities are unsecured. The Society may, with prior consent of the Financial Services Authority, redeem all of the subordinated liabilities 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 liabilities has been mitigated through the use of interest rate swaps.

On 15 January 2010 a subsidiary of the Society repurchased £10.0m of subordinated debt at a discount. As a result, whilst remaining adequately capitalised, the Group has benefited from a one-off gain of £3.1m.

Notes to the accounts

36. Subscribed capital

	Group and Society	
	2010 £m	2009 £m
7.00% Permanent Interest Bearing Shares	60.0	60.0
Unamortised issue costs	(0.8)	(0.9)
Fair value adjustment for hedged risk	10.0	6.0
	69.2	**65.1**

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	
	2010 £m	2009 £m	2010 £m	2009 £m
Balance at 1 January	287.9	283.5	290.0	287.1
Profit for the financial year	23.2	10.8	15.8	9.3
Actuarial loss on retirement benefit obligations	(0.5)	(8.9)	(0.5)	(8.9)
Movement in deferred tax relating to retirement benefit obligations	-	2.5	-	2.5
Total recognised income for the year	22.7	4.4	15.3	2.9
Balance at 31 December	**310.6**	**287.9**	**305.3**	**290.0**
Reserves excluding pension liability	319.9	297.8	314.6	299.9
Pension liability	(9.3)	(9.9)	(9.3)	(9.9)
	310.6	**287.9**	**305.3**	**290.0**

38. Other reserves

	Group and Society	
	2010 £m	2009 £m
Other reserves comprise		
Revaluation reserve – available-for-sale investments	0.4	1.8
Movement in other reserves		
Balance at 1 January	1.8	1.5
Net losses from changes in fair value, net of taxation	(1.4)	0.3
Balance at 31 December	**0.4**	**1.8**
Balance at 1 January	1.8	1.5
Loss transferred to equity	4.4	3.7
Gains recycled to profit and loss on sales	(6.3)	(3.3)
Taxation	0.5	(0.1)
Balance at 31 December	**0.4**	**1.8**

Notes to the accounts

39. Financial commitments and contingent liabilities

a) Financial Services Compensation Scheme levy

Based on its share of protected deposits, the Society pays levies to the Financial Services Compensation Scheme (FSCS) to enable the FSCS to meet claims against it. In 2008 a number of institutions were declared in default by the FSA. The FSCS has met the claims by way of loans received from HM Treasury. The terms of these loans are interest only for the first three years and the FSCS will seek to recover the interest cost, together with ongoing management expenses, by way of annual levies on member firms over this period. The FSCS has, in turn, acquired the rights to the realisation of the assets of these financial institutions. The FSCS may have a further liability if there are insufficient funds available from the realisation of the assets of the financial institutions to fully repay the HM Treasury loans. To the extent that the loans have not been repaid in full by 31 March 2012, the FSCS will agree a schedule of repayments with HM Treasury. The FSCS will then levy the industry, including the Society, accordingly.

The Society has reviewed the level of provision in light of information published by the FSCS and a further provision of £0.5m has been recognised in the year. A provision of £3.8m (31 December 2009: £5.0m) is held in respect of these levies and represents the Society's best estimate of future levies payable. The Society has not been directly notified of the levies payable as a result of the claims against the FSCS and there are a number of factors that prevent accurate calculation of this future liability. As more information becomes available the Society will continue to review provision levels as appropriate.

b) Payment Protection Insurance (PPI)

During the year, the FSA published a Consultation Paper (CP10/06) on The Assessment and Redress of PPI Complaints which provides feedback on the earlier Consultation Paper of the same name (CP09/23). The proposals apply to all types of PPI policies, which, in the Group's case, relate to secured personal lending PPI products.

Nemo Personal Finance, our secured personal lending subsidiary, joined with the British Bankers Association in a judicial review of the Financial Services Authority's proposed approach to the assessment and redress of complaints in respect of sales of Payment Protection Insurance. We strongly believe it to be in the best interests of our Members to have supported the BBA in this legal action. We believe that the outcome is important to ensure clarity over the approach being taken by the FSA in relation to PPI complaints and assess the outcome of the judicial review to ensure that our Members' interests are best served. Provisions of £19.8m are held pending the outcome of the review.

Provisions are only made where the Group has responsibility for the original sale of the product. No provision has been made for sales by third parties as there is significant uncertainty as to the Group's liability for redress in respect of such sales and it is therefore not possible to reasonably estimate the financial impact on the Group.

c) Defined benefit pension scheme

The Group will inject £1.0m into the defined benefit pension scheme on the first anniversary of its closure on 31 July 2011.

d) Capital commitments:

	2010		2009	
	Property	Vehicles, plant and equipment	Property	Vehicles, plant and equipment
	£m	£m	£m	£m
Group commitments in respect of operating lease rentals:				
Due within one year	1.7	0.2	1.8	0.2
Due between two and five years	6.6	0.4	6.9	0.3
Due after five years	8.3	-	10.2	-
	16.6	**0.6**	**18.9**	**0.5**
Society commitments in respect of operating lease rentals:				
Due within one year	0.8	0.2	0.8	0.2
Due between two and five years	3.3	0.4	3.3	0.2
Due after five years	4.0	-	4.4	-
	8.1	**0.6**	**8.5**	**0.4**

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Capital expenditure contracted for but not provided for	1.0	1.0	1.0	1.0

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 tables analyses the financial assets and liabilities in the statement of financial position by the class of financial instrument to which they are assigned and by the measurement basis.

Group and Society As at 31 December 2010	Financial assets and liabilities at amortised cost £m	Loans and receivables £m	Financial assets available for sale £m	Financial assets held to maturity £m	Financial assets and liabilities designated at fair value £m	Derivatives designated as fair value hedging instruments £m	Total £m
Society assets							
Cash in hand and balances with Bank of England	320.7	-	-	-	-	-	320.7
Loans and advances to credit institutions	-	71.8	-	-	-	-	71.8
Debt securities	-	-	800.8	-	-	-	800.8
Derivative financial instruments	-	-	-	-	11.1	27.6	38.7
Loans and advances to customers	-	4,282.7	-	-	-	-	4,282.7
Loans and advances to subsidiaries	-	653.7	-	-	-	-	653.7
Total financial assets	**320.7**	**5,008.2**	**800.8**	**-**	**11.1**	**27.6**	**6,168.4**
Total non-financial assets							62.2
Total Society assets							**6,230.6**
Additional Group assets							
Cash in hand and balances with Bank of England	-	-	-	-	-	-	-
Loans and advances to credit institutions	-	1.4	-	-	-	-	1.4
Loans and advances to customers	-	677.7	-	-	-	-	677.7
Elimination of loans and advances to subsidiaries	-	(653.7)	-	-	-	-	(653.7)
Non-financial assets							6.0
Group total assets							**6,262.1**
Society liabilities							
Shares	5,039.0	-	-	-	-	-	5,039.0
Amounts owed to credit institutions	242.6	-	-	-	-	-	242.6
Amounts owed to other customers	286.9	-	-	-	-	-	286.9
Debt securities in issue	86.3	-	-	-	-	-	86.3
Derivative financial instruments	-	-	-	-	0.3	55.4	55.7
Subordinated liabilities	112.3	-	-	-	-	-	112.3
Subscribed capital	69.2	-	-	-	-	-	69.2
Total financial liabilities	**5,836.3**	**-**	**-**	**-**	**0.3**	**55.4**	**5,892.0**
Total non-financial liabilities							32.9
General reserve and other reserves							305.7
Total Society reserves and liabilities							**6,230.6**
Additional Group liabilities							
Amounts owed to credit institutions	2.8	-	-	-	-	-	2.8
Amounts owed to other customers	-	-	-	-	-	-	-
Non-financial liabilities							23.4
General reserve and other reserves							5.3
Group total liabilities							**6,262.1**

Notes to the accounts

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Group and Society As at 31 December 2009	Financial assets and liabilities at amortised cost £m	Loans and receivables £m	Financial assets available for sale £m	Financial assets held to maturity £m	Financial assets and liabilities designated at fair value £m	Derivatives designated as fair value hedging instruments £m	Total £m
Society assets							
Cash in hand and balances with Bank of England	86.0	-	-	-	-	-	86.0
Loans and advances to credit institutions	-	208.5	-	-	-	-	208.5
Debt securities	-	-	1,084.5	-	-	-	1,084.5
Derivative financial instruments	-	-	-	-	12.9	23.4	36.3
Loans and advances to customers	-	4,069.9	-	-	-	-	4,069.9
Loans and advances to subsidiaries	-	668.8	-	-	-	-	668.8
Total financial assets	**86.0**	**4,947.2**	**1,084.5**	**-**	**12.9**	**23.4**	**6,154.0**
Total non-financial assets							58.9
Total Society assets							**6,212.9**
Additional Group assets							
Cash in hand and balances with Bank of England	50.3	-	-	-	-	-	50.3
Loans and advances to credit institutions	-	(49.0)	-	-	-	-	(49.0)
Loans and advances to customers	-	667.0	-	-	-	-	667.0
Elimination of loans and advances to subsidiaries	-	(668.8)	-	-	-	-	(668.8)
Non-financial assets							6.5
Group total assets							**6,218.9**
Society liabilities							
Shares	4,933.2	-	-	-	-	-	4,933.2
Amounts owed to credit institutions	446.4	-	-	-	-	-	446.4
Amounts owed to other customers	172.6	-	-	-	-	-	172.6
Debt securities in issue	93.0	-	-	-	-	-	93.0
Derivative financial instruments	-	-	-	-	0.6	50.0	50.6
Subordinated liabilities	125.6	-	-	-	-	-	125.6
Subscribed capital	65.1	-	-	-	-	-	65.1
Total financial liabilities	**5,835.9**	**-**	**-**	**-**	**0.6**	**50.0**	**5,886.5**
Total non-financial liabilities							34.2
General reserve and other reserves							292.2
Total Society reserves and liabilities							**6,212.9**
Additional Group liabilities							
Amounts owed to credit institutions	1.6	-	-	-	-	-	1.6
Amounts owed to other customers	-	-	-	-	-	-	-
Non-financial liabilities							6.5
General reserve and other reserves							(2.1)
Group total liabilities							**6,218.9**

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 2010		Society 2010	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets					
Cash in hand and balances with Bank of England		320.7	320.7	320.7	320.7
Loans and advances to credit institutions (excluding CSA deposits)	i.	48.8	48.8	47.3	47.3
CSA deposits		24.5	24.5	24.5	24.5
Debt securities – available-for-sale	ii.	800.8	800.8	800.8	800.8
Derivative financial instruments					
Interest rate swaps		28.3	28.3	28.3	28.3
Cross currency interest rate swaps		10.4	10.4	10.4	10.4
Loans and advances to customers	iv.	4,960.4	4,925.3	4,282.7	4,285.2
Loans and advances to subsidiaries		-	-	653.7	653.7
		6,193.9	6,158.8	6,168.4	6,170.8
Financial liabilities					
Shares	vi.	5,039.0	5,039.0	5,039.0	5,039.0
Amounts owed to credit institutions	vii.	240.2	240.2	237.4	237.4
CSA liabilities	vii.	5.2	5.2	5.2	5.2
Amounts owed to other customers	vii.	287.0	287.5	287.0	287.5
Debt securities in issue		86.3	84.4	86.3	84.4
Derivative financial instruments					
Interest rate swaps		55.7	55.7	55.7	55.7
Subordinated liabilities	viii.	112.3	72.5	112.3	72.5
Subscribed capital	viii.	69.2	44.9	69.2	44.9
		5,894.9	5,829.4	5,892.1	5,826.6

	Note	Group 2009		Society 2009	
		Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
Financial assets					
Cash in hand and balances with Bank of England		136.3	136.3	86.0	86.0
Loans and advances to credit institutions (excluding CSA deposits)	i.	147.0	147.0	196.0	196.0
CSA deposits		12.5	12.5	12.5	12.5
Debt securities – available-for-sale	ii.	1,084.5	1,084.5	1,084.5	1,084.5
Derivative financial instruments					
Interest rate swaps		24.1	24.1	24.1	24.1
Cross currency interest rate swaps		12.2	12.2	12.2	12.2
Loans and advances to customers	iv.	4,736.9	4,698.9	4,069.9	4,072.4
Loans and advances to subsidiaries		-	-	668.8	668.8
		6,153.5	6,115.5	6,154.0	6,156.5
Financial liabilities					
Shares	vi.	4,933.2	4,933.2	4,933.2	4,933.2
Amounts owed to credit institutions	vii.	448.0	448.0	446.4	446.4
Amounts owed to other customers	vii.	172.6	173.6	172.6	173.6
Debt securities in issue	vii.	93.0	92.4	93.0	92.4
Derivative financial instruments					
Interest rate swaps		50.6	50.6	50.6	50.6
Subordinated liabilities	viii.	125.6	57.3	125.6	57.3
Subscribed capital	viii.	65.1	32.4	65.1	32.4
		5,888.1	5,787.5	5,886.5	5,785.9

The gross amount of foreign currency swaps held was €60.0m (2009: €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 date of the statement of financial position.

vii) The fair values of amounts owed to credit institutions, amounts owed to other customers and debt securities in issue are established by using discounted cash flow valuation models or are assumed to approximate to the amount payable at the date of the statement of financial position.

viii) The fair 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 tables 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 in the statement of financial position, the exposure to credit risk equals their carrying amount. For loan commitments and guarantees the exposure to credit risk is the full amount committed.

	Group		Society	
	2010 £m	2009 £m	2010 £m	2009 £m
Financial assets				
Loans and advances to credit institutions	73.3	147.0	71.8	196.0
Debt securities	800.8	1,084.5	800.8	1,084.5
Loans and advances to customers	4,960.4	4,736.9	4,282.7	4,069.9
Loans and advances to subsidiaries	-	-	653.7	668.8
Derivative financial instruments				
Interest rate swaps	33.4	36.3	33.4	36.3
	5,867.9	**6,004.7**	**5,842.4**	**6,055.5**
In respect of loans and advances to credit institutions, debt securities and derivate instruments:				
UK government securities and amounts held with central banks	683.3	592.3	683.3	592.3
Supranational securities	26.6	-	26.6	-
UK financial institutions	197.6	737.8	196.2	736.5
	907.5	**1,330.1**	**906.2**	**1,328.8**

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 ratings for 2010 is 98.9% (2009: 96.8%).

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £5.3m (2009: £12.1m) 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 Group has a £10.0m (2009: £10.0m) exposure to Anglo Irish Bank Corporation Ltd due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. This scheme is approved by the European Commission under EC Treaty state aid rules. The recent agreement between the Irish government, the European Union and International Monetary Fund (IMF) for a restructuring plan in November 2010 contained guarantees for the full repayment of its senior unsecured bonds. In light of the agreement, this exposure is considered not impaired. The Group has no direct sovereign exposure to Greece, Italy, Portugal or Spain as at 31 December 2010.

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 2010		Society 2010	
	£m	%	£m	%
In respect of loans and advances to customers:				
Fully secured by a first charge on residential property	3,711.2	74.8	3,711.2	86.7
Fully secured by a first charge on land	571.5	11.5	571.5	13.3
Fully secured by a second charge on residential property	626.9	12.7	-	-
Partially secured by a second charge on residential property	50.8	1.0	-	-
	4,960.4	**100.0**	**4,282.7**	**100.0**
Retail financial services	3,344.8	67.4	3,344.8	78.1
Commercial loans	937.9	18.9	937.9	21.9
Secured personal loans	677.7	13.7	-	-
	4,960.4	**100.0**	**4,282.7**	**100.0**
Using the retail credit risk grading system, retail lending can be distributed as follows:				
Fully secured by a first charge on residential property				
Grades 1 to 3 satisfactory	2,746.0	82.1	2,746.1	82.1
Grades 4 to 5 watch list	525.2	15.7	525.1	15.7
Grades 5 to 6 special mention but not impaired	73.6	2.2	73.6	2.2
	3,344.8	**100.0**	**3,344.8**	**100.0**
Using the commercial credit risk grading system, commercial lending can be distributed as follows:				
Grades 1 to 5 satisfactory	875.8	93.4	875.8	93.4
Grades 6 to 7 watch list	62.1	6.6	62.1	6.6
	937.9	**100.0**	**937.9**	**100.0**
Fully secured by a second charge on residential property				
Personal loans - employed	584.2	86.2	-	-
Personal loans - self-employed	93.5	13.8	-	-
	677.7	**100.0**	**-**	**-**
Total loans secured on residential property	**4,022.5**	**-**	**3,344.8**	**-**

Notes to the accounts

40. Financial instruments (continued)

c) Credit risk (continued)

	Group 2009		Society 2009	
	£m	%	£m	%
In respect of loans and advances to customers:				
Fully secured by a first charge on residential property	3,475.3	73.4	3,475.3	85.4
Fully secured by a first charge on land	594.6	12.6	594.6	14.6
Fully secured by a second charge on residential property	611.3	12.9	-	-
Partially secured by a second charge on residential property	55.7	1.1	-	-
	4,736.9	**100.0**	**4,069.9**	**100.0**
Retail financial services	3,112.5	65.7	3,112.6	76.5
Commercial loans	957.3	20.2	957.3	23.5
Secured personal loans	667.1	14.1	-	-
	4,736.9	**100.0**	**4,069.9**	**100.0**
Using the retail credit risk grading system, retail lending can be distributed as follows:				
Fully secured by a first charge on residential property				
Grades 1 to 3 satisfactory	2,415.3	77.6	2,415.3	77.6
Grades 4 to 5 watch list	616.3	19.8	616.3	19.8
Grades 5 to 6 special mention but not impaired	80.9	2.6	80.9	2.6
	3,112.5	**100.0**	**3,112.5**	**100.0**
Using the commercial credit risk grading system, commercial lending can be distributed as follows:				
Grades 1 to 5 satisfactory	891.8	93.2	891.8	93.2
Grades 6 to 7 watch list	65.5	6.8	65.5	6.8
	957.3	**100.0**	**957.3**	**100.0**
Fully secured by a second charge on residential property				
Personal loans - employed	565.4	84.8	-	-
Personal loans - self-employed	101.6	15.2	-	-
	667.0	**100.0**	**-**	**-**
Total loans secured on residential property	**3,779.5**	**-**	**3,112.5**	**-**

The average index-linked loan to value (LTV) in respect of the Group's loans secured on residential property including mortgages under offer is estimated to be 61.6% (2009: 64.2%). Index-linked LTV banding is shown below:

	Group		Society	
	2010 %	2009 %	2010 %	2009 %
Less than 70%	59.4	55.8	67.1	63.2
More than 70% but less than 80%	14.8	13.0	14.3	12.9
More than 80% but less than 90%	10.7	11.5	9.4	10.6
More than 90%	15.1	19.7	9.2	13.3
	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. As at 31 December 2010, approximately 37.3% (2009: 41.2%) of residential exposures by account and 37.5% (2009: 41.3%) by value were concentrated in Wales.

Notes to the accounts

40. Financial instruments (continued)

c) Credit risk (continued)

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 1.04% (2009: 1.02%) which compares favourably with the industry average of 1.55% (CML arrears and possession data at 30 September 2010).

Total arrears balances on residential lending fully secured by a first charge were £1.6m (2009: £1.8m) and there are 197 (2009: 198) residential cases six months or more in arrears.

The percentage of secured personal loans currently in arrears by number is 9.25% (2009: 8.64%), which by value is 11.39% (2009: 10.13%).

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

	Group 2010		Group 2009	
	£m	%	£m	%
Current	3,841.1	95.5	3,540.1	93.7
Past due up to 3 months	122.5	3.0	128.5	3.4
Past due 3 months up to 6 months	27.5	0.7	35.3	0.9
Past due 6 months up to 12 months	14.9	0.4	33.7	0.9
Past due over 12 months	13.3	0.3	36.6	1.0
Possessions	3.2	0.1	5.4	0.1
	4,022.5	**100.0**	**3,779.6**	**100.0**

	Society 2010		Society 2009	
	£m	%	£m	%
Current	3,228.6	96.5	2,988.2	96.0
Past due up to 3 months	85.7	2.6	86.5	2.8
Past due 3 months up to 6 months	19.6	0.6	19.7	0.6
Past due 6 months up to 12 months	6.9	0.2	11.3	0.4
Past due over 12 months	0.9	0.0	1.4	-
Possessions	3.2	0.1	5.4	0.2
	3,344.8	**100.0**	**3,112.5**	**100.0**

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £7.1m (2009: £6.1m) of collateral is held against possession cases. Repossessed properties are made available-for-sale in accordance with statutory guidelines with proceeds used to reduce or repay the outstanding loan. The Group has a statutory duty to obtain the best reasonable price and to sell as soon as it reasonably can.

During the difficult economic conditions we have continued to explore all forbearance options with borrowers in difficulty and our mutual values ensure that repossession is the last resort. Around 2,500 short term arrangements were made and 724 more formal agreements with first and second charge borrowers (excluding Buy-to-Let borrowers) including term extensions, a temporary switch to 'interest only' repayment, capitalisation, repayment holidays and assisted voluntary sale, all subject to predefined criteria. 19 borrowers were able to remain in their homes under a Mortgage Rescue Scheme and we continue to work with the Welsh Assembly Government, Local Authorities and debt advice agencies in Wales & England to ensure all options are available. Whilst we invest considerable time and resource reviewing individual financial circumstances to ensure forbearance is a sustainable option, repossession is inevitable in some cases and 57 properties were repossessed in 2010. In addition, LPA Receivers were appointed in 17 cases where we could not reach a sustainable agreement with Buy-to-Let borrowers. There were 6 commercial accounts subject to forbearance activities during the year. Amounts rescheduled and the impact on provisioning is not material.

	Group and Society			
	2010		2009	
	£m	%	£m	%
Commercial loans – Registered Social Landlords secured on residential property	135.4	14.4	121.8	12.7
Commercial loans – other	802.5	85.6	835.5	87.3
	937.9	**100.0**	**957.3**	**100.0**

Loans secured on commercial property are well diversified by industry type with the largest exposure to one counterparty amounting to £40.6m (2009: £46.7m) or 4% (2009: 5%) of gross balances. Asset quality remains strong with total arrears balances of £1.8m and only 7 commercial cases three months or more in arrears.

Interest has been suspended on 6 commercial accounts (2009: 3) and amounts to £0.3m (2009: £0.4m).

The average index-linked loan to value (LTV) in respect of the Group's commercial loans is estimated to be 77.1% (2009: 79.4%).

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 and Society			
	2010		2009	
	£m	%	£m	%
Current	923.3	98.4	949.4	99.2
Past due up to 3 months	7.1	0.8	0.2	-
Past due 3 months up to 6 months	-	-	-	-
Past due 6 months up to 12 months	4.9	0.5	2.2	0.2
Past due over 12 months	2.6	0.3	5.5	0.6
Possessions	-	-	-	-
	937.9	**100.0**	**957.3**	**100.0**

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 2010						
Non-derivative liabilities						
Shares	5,375.5	1.7	2,648.9	1,324.0	1,400.9	-
Amounts owed to credit institutions, other customers and debt securities in issue	621.4	2.9	407.2	157.2	54.1	-
Subordinated liabilities	116.0	-	3.0	113.0	-	-
Subscribed capital	99.9	-	-	4.2	16.8	78.9
	6,212.8	**4.6**	**3,059.1**	**1,598.4**	**1,471.8**	**78.9**
Society						
As at 31 December 2010						
Non-derivative liabilities						
Shares	5,375.5	1.7	2,648.9	1,324.0	1,400.9	-
Amounts owed to credit institutions, other customers and debt securities in issue	618.6	0.1	407.2	157.2	54.1	-
Subordinated liabilities	116.0	-	3.0	113.0	-	-
Subscribed capital	99.9	-	-	4.2	16.8	78.9
	6,210.0	**1.8**	**3,059.1**	**1,598.4**	**1,471.8**	**78.9**
Group and Society						
As at 31 December 2010						
Derivative liabilities						
Interest rate swaps – outflows	(137.1)	-	(13.7)	(31.7)	(60.3)	(31.4)
Interest rate swaps – inflows	101.6	-	8.2	33.6	42.4	17.4
Cross currency interest rate swaps - outflows	(53.0)	-	(0.2)	(17.5)	(35.3)	-
Cross currency interest rate swaps - inflows	53.0	-	0.2	17.5	35.3	-
	(35.5)	**-**	**(5.5)**	**1.9**	**(17.9)**	**(14.0)**

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

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 2009						
Non-derivative liabilities						
Shares	4,976.6	1.2	2,608.9	1,188.5	1,178.0	-
Amounts owed to credit institutions, other customers and debt securities in issue	703.3	1.6	345.1	307.7	35.3	13.6
Subordinated liabilities	132.9	-	3.2	3.2	126.5	-
Subscribed capital	104.1	-	-	4.2	16.8	83.1
	5,916.9	**2.8**	**2,957.2**	**1,503.6**	**1,356.6**	**96.7**
Society						
As at 31 December 2009						
Non-derivative liabilities						
Shares	4,976.6	1.2	2,608.9	1,188.5	1,178.0	-
Amounts owed to credit institutions, other customers and debt securities in issue	701.7	-	345.1	307.7	35.3	13.6
Subordinated liabilities	132.9	-	3.2	3.2	126.5	-
Subscribed capital	104.1	-	-	4.2	16.8	83.1
	5,915.3	**1.2**	**2,957.2**	**1,503.6**	**1,356.6**	**96.7**
Group and Society						
As at 31 December 2009						
Derivative liabilities						
Interest rate swaps – outflows	(174.5)	-	(16.7)	(41.1)	(82.7)	(34.0)
Interest rate swaps – inflows	107.8	-	6.7	36.2	45.8	19.1
Cross currency interest rate swaps - outflows	(54.9)	-	(0.2)	(0.4)	(36.5)	(17.8)
Cross currency interest rate swaps - inflows	54.9	-	0.2	0.4	36.5	17.8
	(66.7)	**-**	**(10.0)**	**(4.9)**	**(36.9)**	**(14.9)**

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 account of management's action to hedge inherent exposures is measured using interest rate gap analysis. In this method each of the Group's financial instruments including on and off the statement of financial position assets and liabilities is assigned to future time periods on the basis of their contractual maturity or contractual re-pricing arrangements. In calculating the net exposure for each future period, account is also taken of those assets and liabilities with embedded optionality, such as pipeline and prepayment risk on fixed rate mortgages. If there was a 1% parallel upward shift in interest rates the adverse impact on reserves would be £4.2m (2009: £4.2m).

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

The remuneration of the directors (including non-executive directors), who are the key management personnel of the Group, is set out in the Report of the Remuneration Committee on pages 26 to 29.

Loans to and shares held by directors

There was an aggregate of £0.5m (2009: £0.8m) 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(I) 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 21 April 2011.

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 £1.2m (2009: £0.6m).

Directors' transactions

A £75k payment was made to one director as part compensation in relation to remediation costs for a property purchased as part of relocation where defects had not been identified during the building survey.

Transactions with Group companies

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

	Interest received from Society	Interest paid to Society	Fees received from Society	Fees paid to Society	Rent received from Society	Rent paid to Society
	£m	£m	£m	£m	£m	£m
Year ended 31 December 2010						
Nemo Personal Finance Limited	-	14.1	-	0.1	-	-
Peter Alan Limited	-	-	-	-	-	0.2
	-	14.1	-	0.1		0.2
Year ended 31 December 2009						
Nemo Personal Finance Limited	-	16.2	-	0.1	-	-
Peter Alan Limited	-	-	-	0.1	-	0.2
	-	16.2	-	0.2	-	0.2

At the year end the following balances were outstanding:

	Loans owed to Society	Loans owed by Society	Loans owed to Society	Loans owed by Society
	2010 £m	2010 £m	2009 £m	2009 £m
Nemo Personal Finance Limited	651.3	-	665.3	-
Peter Alan Limited	1.2	-	2.4	-
	652.5	-	667.7	-

42. Events after the statement of financial position

On 28 January 2011, a 25 year lease of floors 1 to 4 of Principality Buildings was granted to Travelodge Hotels Limited. This will generate annual rental income of £418k for the Society.

Annual Business Statement

for the year ended 31 December 2010

1. Statutory percentages

	At 31 December 2010 %	At 31 December 2009 %	Statutory limit %
The lending limit	13.2	15.0	25.0
The funding limit	11.0	12.8	50.0

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

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

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

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

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

2. Other percentages

Calculated from consolidated accounts:

	2010 %	2009 %
As a percentage of shares and borrowings:		
Gross capital	8.71	8.52
Free capital	8.93	8.71
Liquid assets	21.12	24.49
As a percentage of mean total assets:		
Profit after taxation (excluding Financial Services Compensation Scheme levy)	0.37	0.19
Management expenses	1.00	0.95

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

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

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

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

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

3. Directors

Details of directors are contained on pages 16 and 17.
Details of directors' service contracts are included in the Report of the Remuneration Committee on page 29.
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
Michael Jones
Elaine Morris

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, PO Box 89, Principality Buildings, Queen Street, Cardiff CF10 1UA
Telephone 029 2077 3000 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 Tynewydd 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	39 Town Wall, St David's Centre CF10 2EW	029 2022 7788
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 8DF	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

ABERTILLERY	11 Market Street NP13 1AH	01495 213958
AMMANFORD	6 High Street SA18 2LY	01269 591884
BALA	87 High Street LL23 7AG	01678 520495
BARGOED	65 Hanbury Road CF81 8QX	01443 831100
CARDIGAN	3 Heathfield Pendre SA43 1JT	01239 615050
COLWYN BAY	14 Penrhyn Road LL29 8LG	01492 877299
MACHYNLLETH	Maldwyn House, Penrallt Street SY20 8AG	01654 703110
NEWCASTLE EMLYN	College Street SA38 9AJ	01239 710481
PORTHMADOG	103 High Street LL49 9EY	01766 512011
ROSS ON WYE	8 Broad Street HR9 7EA	01989 763553
TALBOT GREEN	38 Talbot Road CF72 8AF	01443 224000
TREHARRIS	12 Fox Street CF46 5HE	01443 412097
YSTRADGYNLAIS	18 Station Road SA9 1NT	01639 842013

Notes