Annual Report and Accounts 2012

At the heart of our communities

PRINCIPALITY
BUILDING SOCIETY

Highlights

for the year ended 31 December 2012

An increase of £9.6 million in interest paid to savers

£1.2 billion of gross new lending

49,000 new customers welcomed to the Society

£25.1 million profit before tax

Tier 1 ratio of 13.6%

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Chairman's statement

Principality Building Society's Chairman, Dyfrig John

Principality has had another successful year despite very difficult market conditions and economic uncertainty. In the face of these challenges, we have bolstered our capital position, increased net lending by almost £400m and continued to provide competitive savings products for our Members.

We have achieved a profit before tax of £25.1m (2011: £24.5m), further consolidating our strong Tier 1 capital position, and are the seventh largest building society in the UK, with assets of over £6.7bn. We remain committed to making a strong contribution to the Welsh economy through our network of 69 branches and agencies.

Key achievements

On your high street

In 2012 we continued to invest in ensuring that we are able to meet our Members' needs in High Streets across Wales and the Borders. We saw the opening of two new agencies on Anglesey, taking our total number of outlets in the north of Wales to 16. I am delighted that we have opened a new branch in Cwmbran in late 2012, against a trend of branch closures in financial services in general.

Investing in our communities

This year has seen us work closely with the Welsh Government to develop a new cutting- edge funding structure for housing with the first project planned at Ely Bridge in Cardiff. Work is now underway to transform 53 acres of urban wasteland into a £100m housing development that will create up to 700 new homes and generate more than 1,000 jobs. This innovative housing model could well become one of the blue prints for future development of domestic housing across Wales – I firmly believe it is important to create the right conditions for investors in an environment where grants and more traditional lending is constrained.

Our Members

We believe that listening to our Members, and acting on what we hear, is essential to enhancing customer experience through process improvement, product development and innovation. We strive to make sure that the products and services we offer meet your needs and are competitive in the market place. Indeed, many positive changes have emanated from Member feedback in 2012.

Talking to our Members is central to making sure that you remain involved in the business, contribute to our strategic direction and provide a valued voice in our Boardroom. In 2012, we held three 'Member Talkback' sessions – Members met with key Board members, asked questions and discussed planned changes. Our Members' Forum (a panel of 12 Members who meet with the Executives regularly to represent the views of customers) met four times in 2012. I would like to express our thanks to this year's forum and its Chairman, Mr Andre Jacob, for their grass root contribution to our business.

Community

Over the years, Principality has been actively involved in the communities we serve and our staff are proud to do this through programmes such as our sponsorship schemes and nominated Charity of the Year policy. Staff chose to support Cancer Research Wales as their dedicated charity for 2012 - the Society's Annual General Meeting in April saw this boosted by the Society donating £20,000 to the charity. In a difficult economic climate, this has been a fantastic year for raising money, and over £50,000 was raised through sponsored walks, sky dives, taking part in the Three Peaks Challenge and rowing across the Irish Sea (on a ferry). It is credit to our staff that they give so much time, energy and support to these initiatives and to other local community projects, such as helping plant a flower and vegetable garden for pupils at Rumney Primary School.

Staff from the Llanishen branch help plant a flower and vegetable garden at Rumney Primary School

Principality has also expanded its sponsorship programme. This aims to promote and support social and community life, enable young people to develop life skills and support creativity and encourage the best of Wales in a safe and supportive environment. This year the sponsorship programme included golf's Junior Wales Open, Principality Rugby Premiership and, of course, Only Boys Aloud – whose success in the television show Britain's Got Talent recognises the work that this choir has done in changing the lives of boys in the South Wales valleys. The success of the partnership was again recognised at the Arts and Business Cymru Awards 2012 when Principality picked up the award for 'Arts, Business and Young People'. The judges recognised the partnership with Only Boys Aloud as a model for excellence and deemed it to be the most effective and creative business partnership with the arts in Wales.

In addition to sponsoring the National Eisteddfod of Wales, the Royal Welsh Agricultural Show and Wales Millennium Centre we also supported Llangollen International Eisteddfod, Anglesey Show, Access all Eirias at Colwyn Bay and the Shrewsbury Flower Show.

Our Board

Your Board is highly experienced and has ensured that your interests are well protected during challenging economic conditions. There have been some significant changes to the Board in 2012. October 2012 saw the appointment of Graeme Yorston as our new Group Chief Executive, and I am confident that in Graeme we have a fine custodian who will ensure that the future of this business is safe and assured in these uncertain times. Peter Griffiths, our former Group Chief Executive, left after ten very successful years. Sadly Chris Jones, one of our non-executive directors, has confirmed that he will not be standing for re-election and will step down from the Board after this year's Annual General Meeting. Both Peter and Chris leave with our best wishes and thanks for steering the Society through one of the worst economic periods in history.

We have recruited two new non-executive directors, Menna Richards and Natalie Elphicke, whose skills and experience will enhance and strengthen your Board further, and I welcome both Menna and Natalie to the Board. My thanks go to the whole Board for the very significant additional time commitment and support throughout the year. On behalf of the Board, I would also like to thank all of Principality Group's employees for their continued hard work. Without their commitment, Principality would not be the strong and thriving business it is today.

2013 outlook

The year ahead will not be an easy one. With continued economic upheaval, the prospect of further austerity measures and turmoil in world markets, we know that 2013 will be a further tough year. The weak outlook for growth may again adversely impact property prices across the UK and Wales, and this may serve to dent already weak levels of consumer confidence.

In the face of this, Principality Group will continue to manage its business with care and appropriate caution. With a strong Board and management team, and healthy capital position, Principality remains well placed to serve our Members and our communities and to effectively contribute to the Welsh economy.

Dyfrig D. J. John
Chairman
29 January 2013

Group Chief Executive's review

Principality's new Group Chief Executive, Graeme Yorston

Having worked at Principality for six years as Chief Operating Officer, I am delighted to have taken over as Group Chief Executive of such an excellent organisation. Peter Griffiths did an outstanding job of leading the business through very difficult times and left the business on the back of a very solid performance in 2011. I am pleased that this performance continued during 2012 and I am confident about the future.

Our aims

The market continues to be challenging, with global and European uncertainties impacting on the UK economy which remains painfully stubborn to any signs of real and sustainable recovery. Against this backdrop we continue to manage our group of businesses prudently, but with one eye on the future making strategic investments for the longer-term good.

During the year we have seen the Bank of England take further steps to ensure that the supply side of the lending market is supported with £80bn being made available through the Funding for Lending Scheme (FLS). Principality is ready to take advantage of this during 2013 as we seek to continue to grow lending. The effect of this scheme has been two-fold; firstly there was a reduction in the costs of mortgage products and, secondly, interest rates paid to already badly hit savers also fell.

Mortgage completions exceeded £1bn for the first time in the Society's history

We are very much aware of the damage done to Banking, and to a much lesser extent, Building Society reputations, over recent years and we know that we are fortunate that we benefit from a high degree of trust placed in us by our Members. We have a very clear aim and that is to ensure that our Member's savings are kept safe and to deliver an excellent service to both savers and borrowers alike to allow us to pursue our aim of being the leading financial services provider on the Welsh High Street.

Delivering exceptional customer service

We have focused very hard on earning and maintaining our Members' trust and our teams work tirelessly to provide levels of service that our Member's expect. We are Wales' most recommended savings provider* - a real accolade to the efforts put in by so many people.

Staff satisfaction remains high and I recognise the importance of employee engagement to the success of business.

We have received many accolades for our service provision during the year, including:

- FTAdviser.com Online Service Awards – Principality was awarded a 5 Star rating and was the top lender in this category
- Financial Adviser Service Awards – Principality was awarded 4 Stars for mortgages
- Peter Alan won the Gold Award for Wales at the Sunday

* Source: GfK NOP FRS, 12 months ending September 2012. Proportion of Welsh savings account customers giving scores '10-8' in likelihood to recommend their savings provider when compared with other major high street providers, c.2,400 adults interviewed.

Breaking of the ground at the Ely Mill development. L-R John Lovell, Dyfrig John, Edwina Hart

Times Letting Agency of The Year Awards

- Peter Alan won the Gold Award for Estate Agency in Wales at the Sunday Times Estate Agency of The Year Awards

During 2012 we have tried to maintain a competitive position in both savings and mortgages, in particular our Members in Wales have benefited through our 'Member only' products where we opened almost 5,000 accounts for the exclusive benefit of existing Members. We also had to ensure that we continued to compete in the wider market and appeared no less than 458 times in savings 'best buy tables'.

Maintaining a high level of financial strength

We continued our resilient performance during 2012 in what are very testing times. Our financial performance is such that we are able to absorb one-off adverse financial impacts, such as increases in the Financial Services Compensation Scheme charges, and we had to do this again this year. In addition we have continued to invest in our business in areas such as branches and technology which will deliver benefits to our Members over the long term. Our balance sheet has grown and we have a strong capital surplus as well as robust liquidity levels.

Highest ever annual customer satisfaction levels

Key highlights in 2012 were:

- Our highest ever annual customer satisfaction levels
- Over 49,000 new customers joined the Society
- Group lending grew by 18.7% to £1.2bn
- Profit before tax increased to £25.1m (2011: £24.5m)
- An increase of £9.6m in interest paid to savers
- Through continued investment, we created an extra 96 jobs in the Group
- Growth in assets to over £6.7bn
- Solid capital ratios with a Tier 1 ratio of 13.63% (2011: 13.49%)
- Properties in possession at their lowest levels since 2008

Group overview

Group pre-tax profit increased slightly to £25.1m from £24.5m in 2011. Profit was in line with internal expectations and reflects increased interest paid to savers, offset by increased interest received and reduced impairment provisions. The Financial Services Compensation Scheme (FSCS) charge increased from £1.5m to £3.2m.

The core Building Society continues to perform well with high quality, low-risk lending, and our second charge business (Nemo) has delivered strong profits for the Group. Our estate agency, Peter Alan, and surveying businesses have delivered increased profits this year. Our Commercial lending business continues to perform relatively well but we have to recognise that the commercial sector is facing a challenging time. A number of casualties on the high street in 2012 and early 2013 has increased pressure in this market and while we do not lend directly to these businesses, this is having an impact on the sector overall. Recognising this challenging and difficult environment, we have increased provisions in the Commercial lending business.

The Building Society saw record lending levels in 2012 with over £1bn in gross advances to customers – a clear sign of our commitment to support recovery in Wales and the UK. This has resulted in a growth in the first charge residential lending book of over £400m. For most of 2012 savers were benefiting from strong competition for their deposits and the Society paid some £9.6m more in savings interest. We also attracted over 37,000 new savers.

Our second charge business, Nemo Personal Finance, has made another significant contribution to Group profits in 2012. Our strategy for this business is clear. We will continue to manage the business prudently, but will not seek to grow the level of the loan book.

Peter Alan, pa black and our surveying business have all had better years in what has been a very difficult property market, with profit ahead of 2011. We have achieved this by focusing hard on customer service and by growing a very successful lettings management business. We have also acquired and successfully integrated a letting agent in the Cardiff area, and we will continue to pursue this approach where it clearly delivers value. In Peter Alan our lettings portfolio has grown by a further 37% and we opened another branch in Cathays, Cardiff, which brings the number of branches to 26, the number of branches we had before the credit crunch in 2007 – a clear demonstration of our strength in this area. Our surveying business is recognised as one of the leading residential surveying practices in Wales and has established a strong reputation with other lenders both from within and outside Wales.

Peter Alan awarded Welsh Estate Agency of the Year by the Sunday Times

Our Commercial Lending business is feeling the impacts of the wider economy which is significantly affecting confidence in the sector. Against a backdrop of continued uncertainty, we have taken a cautious position on providing for the potential of any likely losses in this book. This is a continuation of the approach we have taken both pre and post credit crunch. We have also continued to take a prudent approach to any new lending where our emphasis is on supporting clients with a proven strong track record in this sector. This lending book continues to perform well when benchmarked across the commercial sector. There are no plans to grow the balance sheet in this division in the immediate future.

That being said, the Commercial Lending team was a major contributor to the scheme we announced with the Welsh Government in March 2012 where the former Ely Mill site in Cardiff will be redeveloped and provide up to 700 homes, including affordable homes. We will continue to use our expertise to work with the Welsh Government and other partners to find innovative schemes to deliver housing initiatives that are so vital to the Welsh economy.

Our teams

The results of our regular staff surveys show that our staff are committed to and engaged in the delivery of our plans. The results show a high level of staff satisfaction, which is key to the success of the business, but we will continue to work with people across the businesses to ensure that we provide an inclusive, friendly culture and that they are rewarded fairly and in a way that reinforces the right behaviours – so key to ensuring that our Members receive the very best service we can deliver.

Looking ahead

It is very clear to most commentators that this current downturn in the world, European and UK economy will persist for a considerable time yet. With austerity measures set to continue for a number of years, it is unlikely we will see any real recovery in 2013 and interest rates are likely to remain low throughout 2013 and beyond. All of the risk remains firmly on the downside; however, we believe that there will continue to be opportunities for us as a mutual based on good value products, effective risk management and excellent service. We will continue to invest in these areas to differentiate us from the competition to support our aim of being the leading financial services provider on the Welsh High Street.

The implementation of new regulations relating to the provision of mortgage services and financial advice (PS 12/16 Mortgage Market Review and the Retail Distribution Review) will have an uncertain, but potentially significant impact on the marketplace and customer behaviour. We continue to monitor these developments closely, and will work to ensure that we are able to meet the expectations of our Members in a manner consistent with emerging regulatory requirements.

Through all of this, we will not forget that Members look to us to provide a safe haven for their hard-earned savings, and in return we will seek to continue to lend prudently, enabling people to buy a home both in Wales and beyond. We will continue to support our communities in Wales through a variety of activities and support the cultural and sporting programmes that are in place.

We are very well placed to be able to cope with unforeseen scenarios with a strong balance sheet, highly competent and experienced management and an excellent team of staff to continue serving you, our Members.

Graeme H. Yorston
Group Chief Executive
29 January 2013

Business review
for the year ended 31 December 2012

Income statement overview
The Group's profit before tax for the year to 31 December 2012 was £25.1m (2011: £24.5m). Underlying profit, excluding items not reflective of current trading performance, which can vary significantly in their nature and value year-on-year, were:

	2012	2011
	£m	£m
Profit before tax	25.1	24.5
Gain on repurchase of subordinated liabilities	(1.5)	(1.0)
Provisions for other liabilities and charges	12.9	11.2
Underlying profit	**36.5**	**34.7**

Profit
Net interest margin
Net interest margin is the sum of the amount earned on assets (a combination of retail mortgages, commercial mortgages and liquid assets) less amounts paid on liabilities (savings products and borrowings) divided by total average assets. At 1.50% (2011: 1.65%) the Group's net interest margin continues to benefit from the higher margins earned in the secured personal lending business. The Society has not unilaterally increased back-book mortgage rates.

The net interest margin is impacted by the full year costs of the Residential Mortgage Backed Security (RMBS) issued during 2011 and this has reduced margin by £3.9m, equivalent to 6bps on the same period last year.

Retail interest payable has increased by 7.2% on last year, reflecting higher returns paid to Members. The retail cost of funding has started to decrease during the latter half of 2012 which is in part due to the Funding for Lending Scheme (FLS) announced in July by the Bank of England. It is likely that the retail cost of funding will decrease in 2013 as competition for retail savings abates.

The Group's current funding strategy means that the risk associated with obtaining short-term wholesale funding is largely mitigated. However, the medium-term outlook remains uncertain, reflecting continued uncertainty in the European financial markets.

Net interest margin has been enhanced by gains of £3.2m (2011: £0.8m), equivalent to 5bps (2011: 1bps), arising from the profit on the sale of gilts.

Other income
The Group's non-interest income at £24.5m (2011: £20.6m) includes insurance income, estate agency income, property services income and income generated from a number of other complementary activities. These together generated 19.6% (2011: 16.4%) of total income. Fee income has also been derived from the commercial lending portfolio where a number of loans have been restructured on maturity.

The secured personal lending subsidiary sold loan portfolios totalling £42.4m with a profit of £1.6m received during the year. No write-downs were applied to the portfolios prior to sale. The Group has retained the servicing rights to these assets, ensuring future income streams. Substantially all the risks and rewards of the assets were transferred on sale. The assets have been derecognised from the Group statement of financial position.

An active lettings market during the year, along with the acquisition of a small lettings book, has resulted in a stronger performance in Peter Alan with overall income 16% ahead of the same period last year. The number of house sales has increased by 3%.

During the year, the Group undertook a property review and is pursuing a number of property-related development opportunities. This will support the delivery of increased rental income throughout the Group over the next 12-24 months.

Administrative expenses
The Group continues to invest in all distribution channels along with investment in core technology platforms and improvements to the new website created during 2011. The Society has opened a new branch in Cwmbran and a further two agency branches during the year. This investment strategy, including responding to the increased cost of regulation, has resulted in an increase in the ratio of operating expense as a percentage of total mean assets to 1.07% (2011: 1.04%). The cost to income ratio was 57.2% (2011: 52.7%).

During the year, the Group has implemented a continuous improvement programme which we expect to deliver customer, colleague and financial benefits in future years.

Impairment provisions for losses on loans and advances

The charge for impairment provisions of £16.3m (2011: £24.6m) for the Group was £8.3m lower than last year.

	2012	2011
	£m	£m
Retail financial services	1.8	4.3
Commercial lending	11.0	7.0
Secured personal lending	3.5	13.3
Total	**16.3**	**24.6**

The total charge for residential impairments in the retail financial services and secured personal lending divisions is £12.3m lower than last year. Positive movements in the House Price Index (HPI) and forced-sale discount assumptions, along with robust arrears management procedures, have contained arrears growth.

The impairment provisions charge in the commercial lending division was £11.0m (2011: £7.0m). The commercial lending market remains challenging and collective provisions of £5.3m have been charged in the year, reflecting the difficult environment. Accumulated impairment on loans secured on commercial property currently stands at 3.23% (2011: 2.11%) with 11 exposures greater than three months in arrears (2011: 11). Management keeps a very close focus on all loans experiencing difficulty, to ensure positions are tightly managed and the potential for losses arising is realistically and conservatively assessed. Joint action plans are implemented with borrowers wherever possible to minimise the likelihood and extent of defaults. There are no arrears in respect of lending to Registered Social Landlords.

Provisions for other liabilities and charges

A provision of £3.2m (2011: £1.5m) has been charged in the year in respect of the Financial Services Compensation Scheme (FSCS) levy. Capital shortfalls associated with the FSCS amount to just over £800m and will be levied in equal instalments between 2012 and 2014. The Group's share of the shortfall has been estimated to be £4.5m and will be charged in equal instalments between 2012 and 2014. £1.5m of this is included in the 2012 charge.

Other provisions of £9.7m (2011: £9.7m) have been made in respect of various customer claims, including claims in relation to previous sales of Payment Protection Insurance.

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

Derivatives and hedge accounting

All derivatives are recorded on the statement of financial position at fair value with any valuation movements being taken to the income statement. Derivatives are 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 gain (2011: £0.1m gain) relating to fair value adjustments on derivatives and hedge accounting represents the net fair value adjustments on derivative instruments that are matching risk exposures on an economic basis. Some income statement volatility arises on these items due to accounting ineffectiveness of designated hedges or because hedge accounting has not been adopted or is not achievable. The gain is primarily due to timing differences in cash flows and interest rate reset dates between the derivative instrument and the hedged assets and liabilities. The impact will trend to zero over time.

Taxation

The statutory rate of corporation tax was reduced to 24.0% from 1 April 2012. The Group was subject to corporation tax at a rate of 26.0% for the period 1 January to 31 March 2012, and 24.0% for the period 1 April to 31 December 2012, resulting in an effective statutory rate of corporation tax of 24.5% for the full year in 2012.

The actual effective tax rate for the Group was 25.9% (2011: 28.9%) compared with the statutory rate of tax of 24.5% (2011: 26.5%). The rate differential is mainly due to disallowable expenditure.

The reduction of the UK corporation tax rate to 23.0% from 1 April 2013 has resulted in a deferred tax adjustment of less than £0.1m arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the liability is expected to reverse.

The Group notes the recently announced reduction in the UK corporation tax rate to 21.0% from 1 April 2014 which has not yet been enacted. It is not considered that this change will have a material impact on the carrying value of the net deferred tax asset.

Statement of financial position

Loans and advances to customers including forbearance

The Group continues to focus on the quality of business written, concentrating on affordability and LTV ratios in underwriting loans and mortgages. Whilst lending criteria remain tight, residential first charge mortgage completions have increased by 24.7% on last year. Excluding fair value adjustments, loans and advances to customers were:

	2012		2011	
	£m	%	£m	%
Retail financial services	4,069.6	73.4	3,630.3	70.3
Commercial lending	897.7	16.2	913.0	17.7
Secured personal lending	576.9	10.4	621.6	12.0
Total	**5,544.2**	**100.0**	**5,164.9**	**100.0**

Buy-to-Let mortgages make up 24.0% of mortgages in the retail financial services division (2011: 20.6%). The average LTV for first and second charge residential lending is 63.7% (2011: 62.6%) with 75.1% under 80% LTV and 5.9% in negative equity.

The Board's focus remains the sustainability of the business so that it can deliver value to Members, and during the year has committed to a five year growth strategy in the first charge residential portfolio. We expect this to more than offset the risk reduction strategy implemented for the second charge and commercial lending portfolios which is reflected in the declining loan balances for these divisions.

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

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

Our approach to dealing with Members and customers in financial difficulties means that we will only take possession of a property as a last resort. The number of properties taken into possession during the year was 73 (2011: 91) with 35 remaining unsold at the end of the year (2011: 40).

Treasury and liquid assets

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

The liquid asset buffer, as defined by the FSA, includes highly liquid assets which typically comprise cash held with central banks and gilts. During the year, surplus liquidity was redeployed to support the Society's mortgage growth strategy, resulting in a small overall reduction in total liquidity. The proportion of liquid assets assigned to the buffer is 74.1% (2011: 88.1%); however, this still represents a surplus of 61.0% of our buffer liquidity requirement. Of the other liquid assets not assigned to the 'Liquid Assets Buffer', which typically comprise investments with other financial institutions, 3.85% (2011: 2.40%) are less than A rated under Fitch credit ratings. The Group's core liquidity ratio was 16.23% (2011: 16.88%).

In December 2010, the Basel Committee on Banking Supervision issued its proposals under the Basel III framework for liquidity risk management, standards and monitoring. These included a short-term liquidity stress metric, the Liquidity Coverage Ratio (LCR), and a longer-term stable funding metric, the Net Stable Funding Ratio (NSFR). These proposals have not yet been enacted into UK or European law and are subject to ongoing refinement. The Group monitors compliance against these metrics and as at 31 December 2012 the LCR was estimated at 227% and the NSFR at 122% against proposed regulatory requirements of 100%. Estimations are made using the Society's interpretation of the draft directive, which has yet to be incorporated into the European and UK regulatory framework and therefore remains subject to change.

Other than £107.4m of AAA rated Supranational Bonds issued by the European Investment Bank and the Council of Europe and effectively guaranteed by the European Union member states, the Group does not hold any direct bank exposures outside the UK. The Group has indirect exposures through bank counterparties that themselves have direct exposures to Greece, Italy, Portugal, Spain, Ireland and Cyprus. Based on available information, an assessment has been made of the Society's key counterparties regarding the potential levels of indirect exposure to distressed Eurozone economies. After such an assessment, the Board has concluded that no impairment provisions are required for indirect exposures to Eurozone sovereign debt.

During the year the Group continued to perform internal stress tests on its liquidity which consistently demonstrates a strong position after allowing for a range of extreme stress scenarios and mitigating actions. The results of these scenarios are brought together into the

Group's Individual Liquidity Adequacy Assessment (ILAA) document, which is reviewed at least annually by the Board.

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

Funding

The Society has a strong funding base, predominantly represented by retail savings. As a result, less reliance is placed on short-term wholesale markets. Savings balances represent 97.7% (2011: 96.1%) of all mortgage balances. The savings environment in the first half of the year has been highly competitive and the Board's focus has been to secure and retain funds at economic rates whilst providing value to Members and managing liquidity in line with evolving regulatory standards.

In October 2011, the Group became a member of the FLS which allows the Group the ability to pledge mortgage assets with the Bank of England in return for Treasury bills which are capable of repo financing either directly with the market or with central banks to which the Group has direct access. Based on the base stock of loans and mortgages as at 30 June 2012, the Group has an initial borrowing allowance of £270.4m, representing 5.0% of the core balance sheet. No assets have been pledged into the scheme at the end of the year and no funds have been drawn-down.

The amortised value of the mortgage assets held within the RMBS issued in 2011 is £657.0m (2011: £814.0m). These assets are encumbered. The Group holds £422.8m (2011: £514.0m) of the notes, £270.0m of which have been repo financed with central banks to which the Group has direct access. Assets subject to repurchase agreements (repos) are not recognised in the statement of financial position as the Group retains the risks and rewards of the mortgages.

Asset encumbrance is 10.6% (2011: 13.9%) of total assets. The Board has set an encumbrance limit of 30.0%.

Borrowings from wholesale sources, administered by the Group's treasury function, have reduced during the year. At 11.6% (2011: 13.9%) 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 largely inaccessible. 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 remain unchanged from last year.

	2012 & 2011	
	Short-term	**Long-term**
Moody's	NP	Ba1
Fitch	F2	BBB+

Defined benefit pension scheme

During the year, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the scheme with Legal and General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal and General assumed full responsibility for the benefits payable to the scheme's current pensioners. The buy-in took effect from September 2012. The pensioner liability and the matching annuity policy remain within the scheme. The premium paid for the annuity policy was £30.8m which the scheme settled with a combination of cash and assets including an additional Group contribution of £5.4m. This additional contribution is recognised in the statement of other comprehensive income. A further £0.4m is due to be paid in 2013.

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

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.

During the year £14.7m (2011: £3.0m) of subordinated debt has been repurchased.

The Group continues to manage its capital in accordance with the EU Capital Requirements Directive (Basel II), as required by the FSA. At 31 December 2012, regulatory capital stood at £458.3m (2011: £477.8m). A reconciliation of total capital to regulatory capital is presented below:

	2012	**2011**
	£m	**£m**
Total capital	509.0	509.1
Adjusted for:		
Other reserves not eligible for inclusion in regulatory capital	(3.4)	(2.0)
Intangibles	(2.6)	(2.5)
Fair value adjustments to subscribed capital	(17.0)	(16.1)
Amortisation adjustments to subordinated liabilities	(27.7)	(10.7)
Regulatory capital	**458.3**	**477.8**

The subordinated liabilities, as a lower Tier 2 instrument, will amortise out of regulatory capital over five years from July 2011. This will reduce the solvency ratio, over the five year period, to the same percentage as the Tier 1 ratio.

Peter Alan Managing Director, Andrew Barry, receives the award for Welsh Letting Agency of the Year with Olympic swimmer Rebecca Adlington

At the end of the year, risk weighted assets were £2,888.3m (2011: £2,828.8m) with key capital ratios standing at:

	2012	2011
	%	%
Core Tier 1	11.67	11.48
Tier 1	13.63	13.49
Solvency ratio	15.87	16.89
Leverage ratio (with PIBS)	5.52	5.52
Leverage ratio (without PIBS)	4.68	4.66

The decrease in the Group's solvency ratio is due to the repurchase of £14.7m of subordinated liabilities and the impact of reducing eligibility of subordinated liabilities within the solvency calculation. The solvency ratio, however, is well in excess of the minimum established by the FSA.

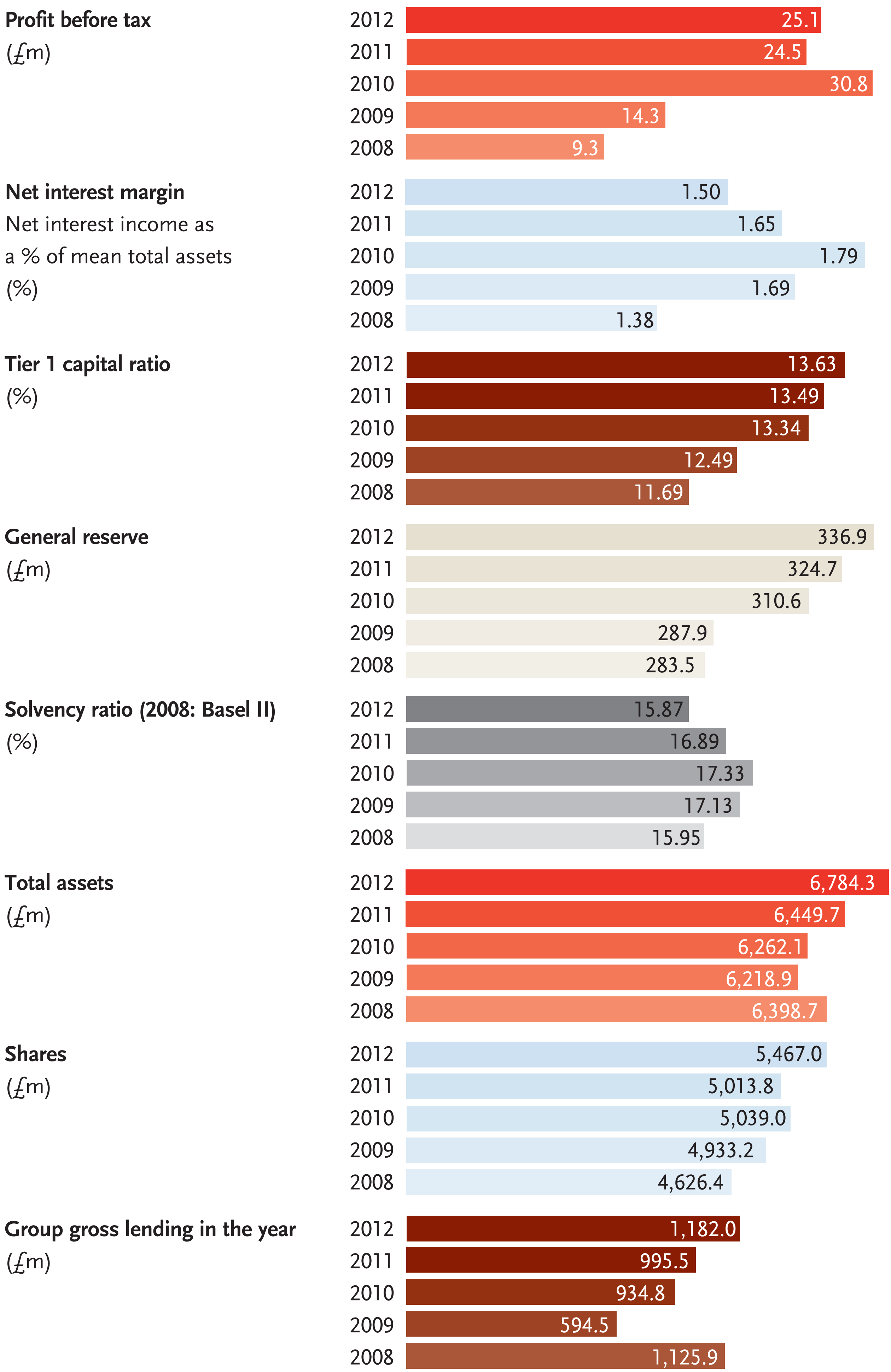
In 2011, the European Commission released its proposal for implementing Basel III in Europe along with a plan for a single European rulebook for regulation (the package is commonly referred to as CRD IV). The objective of CRD IV is to improve the banking sector's ability to absorb shocks arising from financial and/or economic stress and reduce the impact of any 'spill-over' affecting the global economy. CRD IV raises the requirement with respect to the quality and quantity of the regulatory capital base and enhances the risk coverage of the capital framework. CRD IV also introduces a number of macro-prudential elements into the capital framework to help contain systemic risks. CRD IV legislation was due to be finalised for an implementation on 1 January 2013; however, this has not been finalised. It is unlikely that implementation will be before 1 July 2013 at the earliest. The Group's Core Tier 1 and Tier 1 ratios are well in excess of the minimum established by CRD IV 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 applying a range of severe stress scenarios. The results of these scenarios are brought together into the Group's Internal Capital Adequacy Assessment Process (ICAAP) document which is reviewed at least annually by the Board.

The Group currently adopts the standardised approach and is in the process of applying to the FSA for permission to use an Internal Ratings Based (IRB) approach to retail credit risk and capital management. This will allow the Group to use its own estimates of risk, rather than values prescribed by the FSA, after certain conditions have been satisfied, and will further enhance the Group's risk management processes.

Key performance indicators

The following indicators illustrate Principality Group's performance during 2012 compared to the preceding four years:



Key performance indicators

The following indicators illustrate Principality Group's performance during 2012 compared to the preceding four years:

Year ended 31 December	2012	2011	2010	2009	2008
Capital and Profit					
Gross capital ratio	8.24%	8.75%	8.71%	8.52%	8.00%
Free capital ratio	8.53%	9.04%	8.93%	8.71%	7.94%
Profit after tax as a % of mean total assets	0.28%	0.27%	0.37%	0.17%	0.09%
Other income as a % of net operating income	19.63%	16.44%	13.25%	15.12%	20.18%
Operating expenses as a % of mean total assets	1.07%	1.04%	1.00%	0.95%	1.04%
Assets					
Growth	5.18%	2.99%	0.69%	(2.81%)	9.33%
Loans and advances to customers	£5,591.7m	£5,220.1m	£4,960.4m	£4,736.9m	£4,884.3m
Liquid assets	£1,074.3m	£1,114.7m	£1,194.8m	£1,380.3m	£1,382.0m
Liquid assets as a % of shares and borrowings	17.39%	19.14%	21.12%	24.49%	23.98%
Core liquidity ratio	16.23%	16.88%	12.53%	10.44%	4.36%
Funding					
Borrowings	£710.5m	£808.6m	£618.6m	£713.6m	£1,186.0m
Funding limit	11.57%	13.96%	11.03%	12.78%	20.60%
Employees					
Average number of people employed	1,242	1,173	1,126	1,049	997
Other measures					
Number of branches	53	52	51	51	50
Number of agency branches	16	14	13	5	5
Number of estate agency branches	23	23	23	23	23

W. Guy Thomas
Group Finance Director
29 January 2013

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 Group Management Committee, divisional management and risk specialists:

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

Group Credit Risk Committee (GCRC) is chaired by the Director of Group Risk 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. ALCO reports to the Group Management Committee and to the GRC. Weekly monitoring is conducted by the Society's Treasury Committee, which is a subsidiary of ALCO.

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, Group Finance and Group Business Conduct. The role of these functional specialists is to maintain and review policies, establish limits and qualitative standards which are consistent with the Group's risk appetite, monitor and report on compliance with those limits and standards, and generally to provide an oversight role in relation to the management of risk.

Principal risks

The key risks to which the Group is exposed include strategic risk (including reputational risk), credit risk, liquidity risk, market risk, conduct risk, operational risk and pension obligation risk. As a mutual, the Group maintains a relatively low risk appetite.

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

The key risks to the Group are linked to the overall performance of the economy and the resultant effect on unemployment, house price indices, commercial property market values and performance, and overall liquidity as the markets seek to refinance borrowings against a background of continuing volatility and the risk of sovereign default. The impact of emerging regulatory changes and any potential replacement funding scheme for the FSCS are also direct risks for the Group. Specific risks to the Group are reviewed as part of the ICAAP and ILAA and are detailed below.

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

Credit risk

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

Market background

The outlook remains uncertain, with economic pressures and political challenge placing additional strain on the sector. For that reason the Group's forecasts and plans continue to take account of scenarios that include the risk of decreases in house prices, impacts on commercial property market values, performance and the ability to re-finance at maturity, a sustained deterioration in the macro-economic environment, and consequential increases in unemployment. These forecasts have been prepared by management and stressed accordingly in line with 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 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 the Board. Credit risk portfolios are subject to regular stress testing to simulate outcomes and assess the potential impact on capital requirements.

First and second charge retail credit risk

The Group continues to focus on the underlying quality of business written, and lending criteria remain conservative. Applicant quality is monitored closely, defined in terms of 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 with regard to commercial lending which is undertaken on a prudent basis reflected in a decrease in the statement of financial position year-on-year, but where management continues to pursue a strategy geared towards reducing overall exposure to development finance and larger, single counterparty loans. Commercial lending is operated within a framework of conservative credit criteria, principally focusing on the underlying income stream and debt servicing cover as well as property value.

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

Responsibility for the overall quality of the lending book and the adequacy of credit procedures and controls rests with 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 Treasury Policy Statement.

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

Liquidity risk

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

Market background

Wholesale funding markets remain weak, with underlying confidence in the interbank market continuing to reflect broader concerns regarding the possibility of contagion risk arising from sovereign default or the second order impact of corporate failure across the Eurozone. The relative cost of funds remains substantially higher than at the onset of recession in 2007, and in that context the Bank of England's recent decision to provide medium-term support to the banking sector through the FLS is a welcome development.

The introduction of the new liquidity regime has, as anticipated, 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, although the impact may be mitigated to a certain extent, following the FSA's decision to defer the planned, phased implementation of new regulations in forthcoming years. Conditions in the wholesale market have led to greater competition and increased cost of retail savings, especially in the first half of the year, 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 the Group Treasury Department, which oversees the Group's portfolio of liquid assets and wholesale funding facilities.

ALCO exercises control over the Group's liquidity through the operation of strict liquidity policies and close monitoring, receiving regular reports on current and projected liquidity positions including the impact of stress testing. The Group conducts an ILAA at least annually. This is used to assess the Group's liquidity adequacy and determine the levels of liquid assets required to support the current and future liquidity risks in the Group. The most recent ILAA was approved by the Board in December 2012. The Group's ILAA includes stress tests that consider a range of severe scenarios and their impact on the Group, particularly with respect to retail saving outflows. The ILAA concludes that the Group's liquidity reserves are adequate to sustain the Group over an extended severe stress during which contingent actions aimed at stabilising the situation would be deployed.

Market risk

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

The Group Treasury Department is responsible for managing the Group's exposure to all aspects of market risk within the operational limits set out in the Group's Treasury Policies. Oversight is provided by ALCO, GMC 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.

The finance team get the opportunity to show off their creativity by repainting Trelai Youth Centre's sports hall

Interest rate risk

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

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

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

Market background

Over the last three years, customer preference has continued to move towards variable rate mortgages and fixed rate savings bonds. Along with other mortgage providers, the lower 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 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.

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
Equity linked investment products	Sensitivity to equity indices	Interest rate swaps and equity linked options

The table above 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.

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

Foreign currency risk

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

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

Conduct risk

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

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

Risk mitigation

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

The Group's newly established Customer and Conduct Committee forms part of the overall governance and control framework and is responsible for ensuring adherence to the risk strategy and the conduct appetite statement.

The Committee is responsible for the governance of conduct risk and structures this around the four pillars of the product lifecycle:

- Identification of target market, product design and governance
- Sales processes and sustainability
- Servicing and arrears management
- Complaint management

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 resilience and 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 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. The ICAAP

Only Boys Aloud singing outside our Queen Street branch for the launch of their CD with Tim Rhys Evans and Principality Group Chief Executive, Graeme Yorston

includes a series of hypothetical scenarios designed to assess the ability of the Group to mitigate or withstand the impact of a range of operational failures. The scope and relevance of this analysis is reviewed not less than annually by the GORC.

Pension obligation risk

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

To mitigate these risks, management, together with the Trustees of the Fund, regularly reviews 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. In September 2012 the Society concluded a 'buy-in' arrangement in order to mitigate future uncertainty regarding ongoing costs and liabilities associated with its closed defined benefit pension scheme.

Capital management

The Group conducts an Internal Capital Adequacy Assessment Process (ICAAP) 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 internal and regulatory requirements. The capital requirements are presented to the Board for approval with the most recent review being completed and approved by the Board in December 2012. The ICAAP is used by the 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 II Pillar 3 requirements, the Group publishes further information about its exposures and its risk management procedures and policies. It is anticipated that the 2012 version of the Pillar 3 report will be published on the Society's website (www.principality.co.uk) in April 2013.

R. Michael Jones
Director of Group Risk
29 January 2013

Board of directors

① Dyfrig D. J. John
CBE FCIB (Age 62)

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

President of the HSBC Bank UK Pension Association.

② Graeme H. Yorston
FCIB MBA (Age 55)

Group Chief Executive

Joined the Society as Chief Operating Officer on 3 July 2006. He was appointed as a director on 19 October 2007 and became Group Chief Executive on 1 October 2012. He is Chairman of Nemo Personal Finance Limited and Loan Link Limited and a director of Peter Alan 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 23 on page 65.

He is Chairman of the Group Management Committee, and a member of the Asset and Liability, Group Risk and the Commercial Liability and Asset Management Committee.

③ W. Guy Thomas
BSc (Hons) ACA FCT C.Dir (Age 57)
Group Finance Director

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

④ Gordon MacLean
BA FCA (Age 58)
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. He is also a director of Nemo Personal Finance Limited and Loan Link Limited.

Other Directorships and Appointments

Director of 9 Highcliffe Road Management Company Limited.

⑤ Christopher Jones
BA (Age 49)
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

Chairman of Dwr Cymru Customer Services Cyf and a Director of Dwr Cymru Cyf, Glas Cymru Cyf, Glas Cymru (Securities) Cfy, 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.

⑥ Langley Davies
BSc (Hons) ACA (Age 53)
Non-Executive Director

Appointed a non-executive director on 1 May 2007. He is Chairman of the Group Risk Committee and a member of the Audit, Nominations and Commercial Liability and Asset Management Committees.

Other Directorships and Appointments

Partner in Ruperra Properties LLP and Hensol Properties LLP. Director of Vansdirect Limited and St Lawrence Consultancy Limited.

⑦ Keith Brooks
(Age 64)
Non-Executive Director

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

Other Directorships and Appointments

Chairman of Vista Retail Support Group Limited and a partner in Airport Investments and Enterprises.

⑧ Joanne Kenrick
LLB (Age 46)
Non-Executive Director

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

Other Directorships and Appointments

Marketing director of Homebase Limited, a director of 53 Rosslyn Hill Residents Association Limited and a director of MLC Contracting Limited.

⑨ Menna Richards
BA OBE (AGE 59)
Non-Executive Director

Appointed a non-executive director on 1 June 2012. She is a member of the Customer and Conduct, and Nominations Committees.

Other Directorships and Appointments

Board member of the Welsh National Opera, Vice–President of Cardiff University and the Royal Welsh College of Music and Drama, non-executive director of Glas Cymru and a Trustee of the ALOUD charity.

⑩ Natalie Elphicke
LLB (AGE 42)
Non-Executive Director

Appointed a non-executive director on 23 July 2012. She is a member of the Group Risk Committee and Nominations Committee.

Directors' report
for the year ended 31 December 2012

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 2012.

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 2012 were outside the powers of the Society.

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

Directors
The names of the directors at the date of this report, together with brief biographical details, are listed on pages 19 and 20.

Peter L. Griffiths resigned from the Board with effect from 1 October 2012. During the year Menna Richards and Natalie Elphicke joined the Board on 1 June and 23 July respectively. To comply with the UK Corporate Governance Code, and as permitted by Rule 26(1), all of the directors retire and stand for annual election at the Annual General Meeting. With the exception of Christopher Jones, all are eligible and willing to continue serving on the Board and there have been no other nominations.

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

New activities
During the year, the Group has:

- Opened a further two new agencies in North Wales and a new branch in Cwmbran;
- Launched an innovative funding scheme designed to help improve the provision of social housing in Wales.

Profits and capital
Profit before tax was £25.1m (2011: £24.5m). The profit after tax transferred to the general reserve was £18.6m (2011: £17.4m).

Total Group general reserves at 31 December 2012 were £336.9m (2011: £324.7m).

Gross capital at 31 December 2012 was £509.0m (2011: £509.1m), including £92.3m of subordinated debt and £76.4m of permanent interest-bearing shares (PIBS).

The ratio of gross capital as a percentage of shares and borrowings at 31 December 2012 was 8.24% (2011: 8.75%) and the free capital ratio was 8.53% (2011: 9.04%). The Annual Business Statement on page 91 contains an explanation of these ratios.

Mortgage arrears
At 31 December 2012 there were 834 (2011: 824) 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 £37.6m (2011: £37.5m) and the total amount of arrears was £9.1m (2011: £8.0m), for which provision has been made where appropriate.

Material differences between market and book value of land and buildings
The Board considers that the 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 made charitable donations of £20k (2011: £20k). No contributions were made for political purposes in either year.

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

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

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

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 2013.

At 31 December 2012 the total amount owed to suppliers was equivalent to 27 days credit (2011: 27 days).

Auditor

At the Annual General Meeting on 21 April 2012 the Members passed a resolution that Deloitte LLP be re-appointed as auditors for the ensuing year.

The Group opened a further two new agencies during the year

Responsibilities of the directors

The following statement, which should be read in conjunction with the statement of the auditor's responsibilities on page 35, 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.

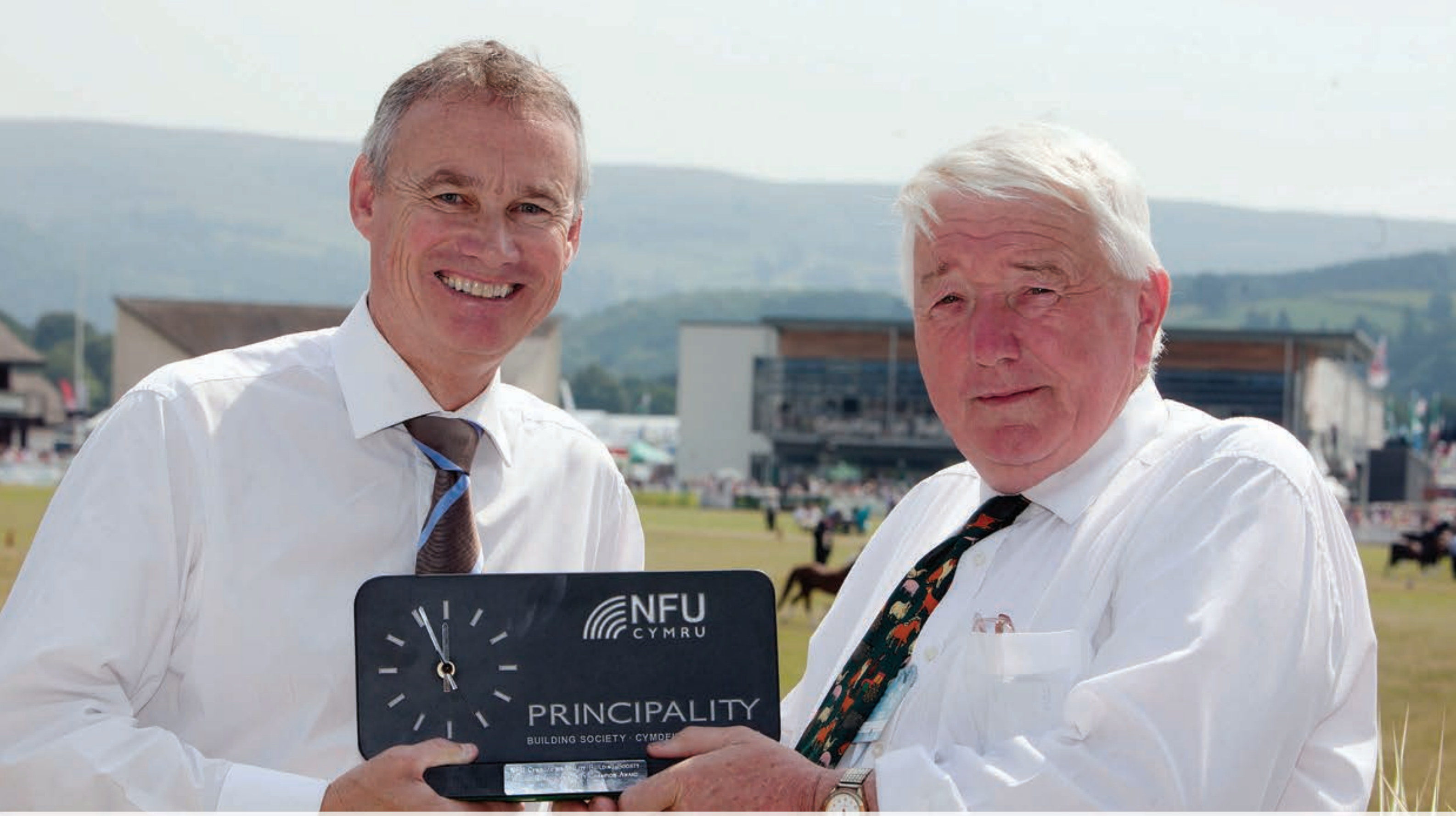
The directors are also responsible for the integrity of the Society's website www.principality.co.uk. The work carried out by the auditor does not involve consideration of these matters and, accordingly, the auditor accepts no responsibility for any changes that may have occurred to the financial statements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

Going concern

The Chairman's statement and Group Chief Executive's review on pages 1 to 5, together with the Business Review on pages 6 to 12, 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 75 to 89 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 13 to 18 and in Note 40 on pages 75 to 89.

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

The Group's forecasts and projections include scenario testing as carried out in accordance with the Internal Capital Adequacy Assessment Process (ICAAP) and Individual Liquidity Adequacy Assessment (ILAA), which are processes required by our regulator to demonstrate appropriate levels of capital and liquidity respectively under stressed scenarios reflecting the directors' views



Head of Member Services, Pete Owen, presents Hugh Richards of Llanelli with the NFU Cymru/Principality Rural Community Champion Award at the Royal Welsh Show.

of different risks that might arise under varying economic conditions. These scenarios take account of reasonably possible changes in trading performance, and show that the Group will be able to operate within the sources of funding currently available to it, even under stressed scenarios. In addition to these sources, contingency funding plans are in place.

The assets held for liquidity purposes are assessed and regularly reviewed for counterparty risks, and the directors consider that the Group is not exposed to losses on those assets that would affect the decision to adopt the basis of going concern. The directors consider that the overall level of capital, including Tier 1 capital of £393.7m (13.62% as a percentage of risk-weighted assets) and a solvency ratio of 15.85% are adequate.

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

The future

We fully expect the strained economic conditions to continue for some time, with increased pressures due to reductions in public spending, higher levels of unemployment and increased global pressures. There is no doubt that against that backdrop, and as the impact of the tighter regulatory environment within which the Society operates is felt, there will be further consolidation within the sector. Public and political interest in financial services will not diminish and we are working closely with the Financial Services Authority as it prepares to transfer its responsibilities to the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA).

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
29 January 2013

Corporate governance report

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

The Board

At 31 December 2012, the Board comprised two executive directors and eight non-executive directors. The offices of Chairman and Group Chief Executive are separate and held by different individuals. In accordance with the Code all directors stood for re-election in 2012 and were duly re-elected. All directors will again stand for re-election at the 2013 Annual General Meeting.

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. A framework of delegated authority is in place, which extends to the Society's officers, management and various subsidiary company boards and management committees. This is reviewed annually by the Board.

During the second half of the year Menna Richards and Natalie Elphicke joined the Board and will stand for election in accordance with the Society's Rules at the 2013 Annual General Meeting. Peter Griffiths left the Society after ten years in the role of Chief Executive at the end of September 2012.

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

Board and Committee membership and attendance record

	Board	Audit	Remuneration	Customer and Conduct	Group Risk	Nominations
Dyfrig John	15/15	-	9/9	-	-	4/4
Keith Brooks	15/15	-	9/9	1/1	8/8	4/4
Langley Davies	15/15	7/7	-	-	8/8	4/4
Peter Griffiths*	11/12	-	-	-	4/6	2/2
Christopher Jones	14/15	-	9/9	-	-	4/4
Jo Kenrick	12/15	6/7	-	0/1	-	4/4
Gordon MacLean	15/15	7/7	-	-	-	4/4
Guy Thomas	15/15	-		-	8/8	-
Graeme Yorston	15/15	-	-	-	8/8	1/1
Natalie Elphicke (from July 2012)	6/6	-	-	-	-	-
Menna Richards (appointed June 2012. Commenced Board activities in September 2012)	5/5	-	-	1/1	-	-

* Resigned from the Board with effect from 1 October 2012.

Nominations Committee

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

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

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

The Society has 10 Board members in total, 2 of which are executive and 8 independent (including the Chairman). Women directors constitute 30% of the Board.

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

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

Audit Committee

The Committee is chaired by Gordon MacLean. During the year the other members of the Committee have been Langley Davies and Jo Kenrick. All members are independent non-executive directors. Gordon MacLean and Langley Davies have recent and relevant financial experience. The Group Chief Executive, the Group Finance Director, the Group Secretary, the Head of Group Audit, the Head of Group Business Conduct and representatives of Deloitte, the external auditor, attend each meeting. The Committee acts as an Audit Committee for the Society and its subsidiary companies.

During the year the Committee met on seven occasions. It monitored the integrity of the financial statements and formal announcements relating to the Group's financial performance. As part of its regular agenda, the Audit Committee reviewed and challenged relevant accounting policies and significant financial judgements regarding the level of residential and commercial lending impairment provisions including forbearance, provisions for FSCS and PPI liabilities and the adoption of the Going Concern assumption. All significant financial judgements are outlined in Note 2. The Committee has reviewed the effectiveness of the Group's financial 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 reappointment as auditor to the Board and this resolution will be put to members at the 2013 Annual General Meeting.

The Committee has implemented the Group's policy which restricts the engagement of the external audit firm (presently 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 auditor's independence and objectivity. It identifies engagements that can only be undertaken with appropriate authority from the Committee Chairman or the Committee where non-audit fees will exceed pre-set thresholds. The Committee receives an annual report on the non-audit services being provided and the cumulative total of non-audit fees. The audit fee for the year in respect of the Group, excluding irrecoverable VAT, was £126k. Non-audit fees were £83k.

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 Business Conduct and Deloitte during the year.

The Committee has reviewed the whistleblowing 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.

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

The Committee reports on its activities to the Board.

Auditor independence

The appointment of external auditor is coordinated through the Audit Committee which recommends any appointment or re-appointment to the Board. This is normally

Marketing Director, James Wright, chats with Members at the Member Talkback

undertaken through a process of competitive tendering. The existing auditor have served for longer than five years and in accordance with the existing policy framework the Audit Committee considers annually whether to commence the competitive tender process for the audit. In 2012 the Committee concluded that the external auditor continued to meet the test for independence and agreed that it was not necessary to commence the competitive tender process in the current year.

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 Keith Brooks and Dyfrig John. It considers remuneration policy and the Board delegates to this Committee decisions on executives' remuneration and compensation packages. The Committee monitors changing trends in directors' remuneration in the marketplace including consideration of the FSA Code on Remuneration Practice. The Committee is responsible for maintaining the Group's Remuneration Policy. In performing its duties the Committee draws on the advice of independent consultants who have no other connection with the Society. No individual is present at a meeting when his or her own pay is decided. Fees payable to the Chairman and other non-executive directors are determined by the Board on recommendations from the executive directors. Details of directors' remuneration are set out on page 33.

The Committee reports on its activities to the Board.

Group Risk Committee

The Group Risk Committee is chaired by Langley Davies. During the year the other members of the Committee have been Keith Brooks, the Group Chief Executive, the Group Finance Director, the Director of Group Risk and the Group Secretary. A number of other senior managers from across the Group attend meetings of the Committee regularly. 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. A fuller report on risk management can be found on page 13.

Customer and Conduct Committee

The Customer and Conduct Committee is chaired by Keith Brooks and its other members are Jo Kenrick and Menna Richards. Established in December 2012, the Committee held one meeting during the year. The Group Chief Executive, Customer Director, Director of Group Risk, Group Human Resources Director, Group Secretary and a number of other senior managers from across the Group will also attend meetings of the Committee regularly. The Committee is responsible for maintaining an appropriate Business Conduct Strategy and setting standards leading to fair outcomes for customers across the Group.

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 2012 the Board comprised a non-executive Chairman and seven other non-executive directors and two 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 Chairman and Group 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 Group Chief Executive's responsibilities are set out in a role profile approved by the Board.

Information and training

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

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

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

Performance evaluation

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

During 2012 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 three meetings were held by the Members' Forum as well as two 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.

Risk management and internal control

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

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

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

- Formal identification by management across the Group through a self-assessment process of the key risks to achieving its business objectives and the controls in place to manage them. The likelihood and potential impact of each risk is evaluated;
- Independent review by 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
29 January 2013

Principality Chairman, Dyfrig John with Ceri Thomas and Andrew Jenkins at the opening of the new Principality and Peter Alan branch in Cwmbran.

Corporate and social responsibility report

As the building society of Wales, at the heart of our community ethos is our passionate commitment to supporting as many aspects of Welsh life as we can, from funding and participating in events celebrating our heritage to sport and the arts, to giving our time to local schools and ensuring that we reduce our impact on the environment as much as possible.

Helping in your community

Our wide-ranging community involvement is testament to the dedication of our staff, who not only get involved, but often drive the projects themselves. Over the past year, as well as voting for and raising money to support our Welsh charity, Cancer Research Wales, staff have also given their time to community projects - from painting and decorating to lending their individual skills in fields like marketing and design to causes that need them. In our annual staff survey, a massive 85% of our staff said they were confident their manager would support them in becoming involved in community projects.

We encourage each of our 53 branches across Wales to support their local community in the way they judge best. Twenty members of the Finance team, based at Principality's head office, recently donned their overalls to repaint Trelai Youth Centre's Sports hall in Cardiff to encourage future athletes to make use of the facilities.

Principality has been a key supporter of the Only Boys Aloud initiative since 2010, where they joined Only Men Aloud founder Tim Rhys Evans to search for the next generation of male choral singers in the Valleys, an area that often attracts negative press for lack of opportunities for young people. After just a year, over 175 teenage boys had joined Only Boys Aloud, and the Society signed a three-year deal as principal sponsors and title sponsors of the Principality Only Boys Aloud Academi.

This project provided the perfect opportunity to demonstrate our commitment to contributing to our local communities, helping young people to develop life skills and celebrating our Welsh heritage and culture. It was through this partnership that the Only Kids Aloud scheme was pioneered, involving the choir taking its unique workshops to schools across Wales to boost children's concentration and energy levels.

The Society raised over £70k for the Charity of the Year

Our support of Welsh heritage extends to our attendance at events like the National Eisteddfod and the Royal Welsh Show. Not only do we offer a financial boost to these important Welsh traditions and events, we also have the opportunity to meet our customers face to face, at events that are important to them.

Of course, Welsh culture and community support would not be complete without a mention of rugby - Wales' national sport. We are proud to sponsor grassroots rugby in Wales through the Principality Rugby Premiership, part of the Welsh Rugby Union, which has proven to be the training ground of some of Wales' best international players.

Our staff tell us that they enjoy being at the centre of our community action, which is why every year we ask staff to vote to select the official Welsh charity of the year which was Cancer Research Wales in 2012. It is here that our staff really demonstrated their versatility in the pursuit of a good cause, doing everything from scaling the three highest peaks in Britain, to charity bake sales to raise vital funds. We even introduced a Cancer Research Wales Savings bond, to allow our savers to help us raise money by giving part of their interest in donation. In total, Principality raised over £70k and we look forward to doing even better in 2013 with our newly elected charity, British Heart Foundation.

We are proud to be able to say we are truly at the heart of the community here in Wales; with the suppport of both our staff and Members.

Helping you manage your finances

We want our Members and customers to feel empowered to make the right financial decisions and, as a result, we are committed to creating and maintaining products that are easy to understand and making sure that all our literature is easy to follow and clear.

In the interests of being there for our customers, we are absolutely committed to being exactly where they need us most, on their doorstep. We now have 53 branches across Wales, as well as 16 agency counters. We have also made the decision to continue offering expert financial advice via our branch network. While some providers have chosen to withdraw this service in response to the shift in the way advice is given brought on by the FSA's Retail Distribution Review (RDR) that came into force in January, we recognise that people need support making large financial decisions and will ensure that this support is available in branches.

Only Kids Aloud sing at the 2012 Eisteddfod opening ceremony

Helping Welsh people into their first home

We know that home ownership is an aspiration for many and we are doing all we can to make sure that as many Welsh people as possible can be in a position to own their own home. We were one of the first building societies to sign up to the Funding For Lending scheme, a scheme designed to give financial services providers access to cheaper funds to facilitate lending.

In December, we announced a 95% mortgage designed to help those with a smaller deposit get into their first home. As with all decisions, our Members were at the heart of our decision to provide this, and we have developed this product with a long-term view. It has been designed to meet the needs of those with lower deposits and less funds available, so there are no fees and there will be no tightening of the lending criteria. The product also has a five year fixed rate, which gives buyers the security of a guaranteed payment for the significant future, allowing them to realistically budget.

Supporting sustainable and affordable housing

Our Commercial lending division has played a strong role supporting the Welsh housing agenda through its work with Wales-based housing associations, where the lending book has now exceeded £165m. The division was one of the funding partners of the first Welsh stock transfer at Bridgend of some 6,500 homes for Valleys To Coast Housing Association and has funded two subsequent transfers at Torfaen and Merthyr.

Most recently, Principality worked with The Welsh Government to create a social enterprise to realise the potential of the 53 acre former Paper Mill site at Ely Bridge with a view to creating a sustainable financial model for delivering affordable and open market housing in the area. The project is set to bring new jobs, homes, community facilities and a host of environmental benefits to Cardiff, and has the potential to be emulated successfully all over Wales, to deliver high quality housing in areas that need it most.

Supporting Welsh schools to reach their full potential

The Society has recently partnered with two Cardiff high schools Llanishen and Glyn Derw. The partnerships mean that we will be able to support the schools in a number of areas including financial education, leadership and employability. Initiatives like a reading support scheme involving 20 staff will be taking place all year, as we work with the schools to help them reach their full potential.

Controlling our impact on the environment

Principality has introduced a series of measures to help reduce its environmental impact, ranging from recycling general waste to introducing procurement conditions to ensure that all companies we retain act in accordance with our approach.

During 2012, over 45,438 kilograms of paper have been recycled, equivalent to 851 trees. 183,470 Kw -hours of electricity were also saved and landfill reduced by 103m^3. 98 (1100ltr) recycling bins of waste were taken out of Principality House during 2012 that prior to 2009 would have gone to landfill. We have also saved 1,185,605 litres of water.

Report of the Remuneration Committee

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

Unaudited information

Executive summary

Key features of 2012

- The Remuneration Committee reviewed its principles for executive remuneration, taking account of the recent publication of new FSA guidance. It has decided to simplify executive remuneration going forward by significantly reducing the level of potential bonus earnings whilst ensuring base salaries are in line with the market. The Committee believes that lower variable pay combined with overall lower total remuneration aligns more closely with current market conditions and with our mutual values.
- The simplification of remuneration policy has led to the adoption of a single, annual, executive bonus scheme, with deferral.
- The executives' salaries were reviewed in 2012, and awards made which were proportionately less than those granted to customer facing and lower paid staff.
- Peter Griffiths resigned and left the Group in September 2012. The balance of his contract was honoured.
- Following a review by the Board of fees for the Chairman and non-executive directors using independent data, increases were made to bring fees into line with the lower level of market benchmarks.
- The Committee sought to reduce future costs and liabilities for the Society in relation to its closed defined benefit pension scheme by purchasing a 'buy-in' annuity policy for defined benefit pensioner scheme liabilities with a reputable insurance company, Legal & General.

The work of the Remuneration Committee

The Remuneration Committee comprises Christopher Jones (Chairman), Keith Brooks and Dyfrig John, all of whom are independent non-executive directors. The Committee is responsible for determining, on behalf of the Board, the overall remuneration practices and policies for all staff and, in particular, the level of remuneration of the three executive directors and nine other senior Code Staff, who have been identified by the Committee as having a potential material impact on the Society's risk profile. Full Terms of Reference for the Committee can be found on the Society's website.

The Committee met on nine occasions during the year (2011: seven). Activities during the year included:

- A wide-ranging review resulting in a significant rebalancing of executive remuneration from variable to fixed remuneration with an overall reduction in expected earnings of some 10%;
- Reviewed and agreed a new set of design principles for executive remuneration;
- Agreed the performance targets for awards to be made under the annual schemes and reviewed the outcomes which were paid in respect of the year and;
- Ongoing work in relation to the FSA Remuneration Code and how it applies to the Society.

The Committee draws on the advice of independent external advisors if it considers this beneficial when performing its duties. This year New Bridge Street provided benchmarking of the Group Chief Executive Officer package and also the Directors of Nemo. This consultancy has no other connection with the Society. KPMG and Eversheds provided advice on the purchase of the pensioner annuity.

Elaine Morris, Group Secretary, acts as secretary to the Committee. The Group HR Director and the Director of Group Risk attend most Committee meetings and provide specialist advice. The Group Chief Executive and the Group Finance Director are also asked to attend the Committee's meetings when their input is required on specific issues, for example the purchasing of an annuity policy in respect of part of the pension scheme liabilities. They are not involved in discussions concerning their own pay.

Executive remuneration policy and principles

Principality is proud to be a mutually owned business, run to make sufficient profits to enable us to give our Members great value products and excellent service. This principle underpins our remuneration policy and principles which are designed 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. Our remuneration policy and framework helps us:

- Attract, motivate and retain high quality people who can ensure that Principality continues to deliver value to our Members and be profitable in a highly competitive and uncertain marketplace; and
- Pay for performance and operate bonus schemes which further the interests of Members but do not encourage risk-taking that is excessive. Our executive bonus schemes reward the achievement of key performance indicators, which include financial and non-financial measures, together with individual personal and leadership performance.

Principality seeks to maintain high standards of corporate governance at all times and follow the provisions and requirements of the Financial Services Authority's (FSA) 'Remuneration Code'.

Executive remuneration

Total Remuneration	
Fixed Pay	Performance Pay
Base salary and benefits Car allowance, pension, medical cover	Rewards the achievement of challenging corporate and individual targets for the year

Base salary

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

In 2012, a 2.5% increase was made to executive directors' salaries, less than the average increase for all Society staff (3.5%) and that for customer facing and lower paid staff (4.0%).

The base salary and total remuneration for the new Group Chief Executive Officer (CEO), Graeme Yorston, was benchmarked by New Bridge Street prior to his appointment on 1 October 2012. The Committee adopted new principles for executive remuneration with the objective of setting total remuneration around the market median. Meanwhile the maximum bonus potential has been simultaneously scaled back with 'On Target' earnings at 20% and the maximum potential variable bonus being 40% of base salary (as compared to a potential maximum payment of 100% under the previous scheme). In the event of an 'On Target' bonus being paid, the total remuneration for the new CEO would be some 22% less than that for his predecessor.

Executive annual bonus scheme

In 2012, the Remuneration Committee reviewed the approach for setting executive bonuses and, following advice from New Bridge Street, consolidated the existing two bonus schemes (the Executive Annual Bonus Scheme and the Executive Group Performance Bonus Scheme) into one Executive Annual Bonus Scheme for 2012 with the overall quantum remaining the same at a maximum of 100% of base salary. With effect from 1 January 2013, however, the maximum award under this annual scheme will be 40%. The Executive Annual Bonus Scheme for 2012 provides an opportunity to reward executive directors for achieving stretching targets for the financial year.

Basket of Financial & Non-Financial Measures	Weighting
Return on assets: external comparison with peers	20.0%
Group profit before tax	30.0%
Staff satisfaction	10.0%
Customer satisfaction	12.5%
Customers' net promoter score	12.5%
Individual personal objectives	15.0%

The scheme specifies capital and liquidity hurdles, in excess of the regulatory levels, which the Society must meet before any award can be made. Assessing performance against a broad range of measures means that participants are not incentivised to focus on performance in a single area at the expense of other priorities.

The Society met its hurdles and so the awards have been calculated. Guy Thomas is eligible for an Executive Annual Bonus award of 59% in respect of performance during 2012. In accordance with the Remuneration Code, 60% of the scheme's award for 2012 will be calculated and paid in June 2013, under the scheme rules, the remainder of the deferred award (40%) will be paid in equal instalments over the first, second and third anniversaries of the February payroll date, subject to annual review, and may be reduced or withdrawn at the discretion of the Committee in line with the requirements set out in the FSA's Remuneration Code.

Graeme Yorston is eligible for an Executive Annual Bonus award of 50% in respect of performance during 2012 based on a maximum participation of 100% for nine months and a maximum participation of 40% for the later three months in the CEO post. The award will be paid in line with the deferral arrangements as set out above.

Peter Griffiths resigned as Chief Executive Officer in May 2012, leaving the Society on 30 September 2012, and was paid in lieu of the balance of his 12 months' notice period. The Committee agreed that Mr Griffiths should receive a pro rata payment equivalent to 75% of the annual bonus award under the 2012 Executive Annual Bonus Scheme, as he was in post as CEO for nine months of the bonus year. This award was approved by the Committee and (subject to the relevant provisions of the scheme) an award will be paid in line with the deferral arrangements of the scheme as set out above.

The deferred bonus payments for all executives will be subject to review by the Remuneration Committee and may be reduced or cancelled at the Committee's discretion if it emerges that the original assessment of performance was misleading or if performance declines substantially (as determined by the rules and provisions of the relevant bonus scheme).

Service contracts

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

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

Pension arrangements

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

Non-executive directors' remuneration

The Chairman, senior independent director and non-executive directors do not have service contracts and are subject to re-election at each year's Annual General Meeting.

Non-executive directors are paid a basic fee for participation on the 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, based on recommendations from the executive directors and external benchmarking from time to time.

At the beginning of 2012, benchmarking data was sourced from New Bridge Street for the Chairman and non-executive directors. The benchmarking data showed that the Society's fees for the Board roles were well below the market median for our comparator group of the largest building societies as well as companies locally. Therefore, to align fees more closely with the market, the Chairman and non-executive director basic fees were increased by around 30%. There was no change to fees for serving on the Board Committees. Recent data shows even after these increases in fees, the Chairman is still the lowest paid among the top eight building societies; similarly the non-executives are ranked seventh in the top eight.

Details of non-executive directors' remuneration are set out below. 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 2012

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

	Salary & fees	Benefits	Annual bonus	Group performance bonus	Sub-total	Pension	Total
	£000	£000	£000	£000	£000	£000	£000
Executive 2012							
Peter Griffiths (to 30 September 2012)	232	10	137	-	379	35	414
Guy Thomas	216	13	128	-	357	32	389
Graeme Yorston	231	11	109	-	351	35	386
Total	**679**	**34**	**374**	-	**1,087**	**102**	**1,189**
Executive 2011							
Peter Griffiths	302	13	60	148	523	45	568
Guy Thomas	211	13	42	103	369	32	401
Graeme Yorston	200	11	40	98	349	30	379
Total	**713**	**37**	**142**	**349**	**1,241**	**107**	**1,348**

	Salary and fees	
	2012	2011
	£000	£000
Non-executive directors		
Dyfrig John	87	68
Christopher Jones	43	35
Gordon MacLean	58	45
Langley Davies	68	63
Keith Brooks	65	54
Jo Kenrick	44	34
Chris Rowlands (to 1 October 2011)	-	34
Menna Richards (from 1 June 2012)	21	-
Natalie Elphicke (from 23 July 2012)	18	-
Sub-total	**404**	**333**
Executive remuneration total	**1,189**	**1,348**
Total	**1,593**	**1,681**

1. The 2011 Group Performance Bonus (GPB) was calculated in June 2012 once the full set of results for the comparator group was available. This resulted in an additional bonus entitlement of £99k earned by executive directors in relation to the final outcome of the scheme. This sum is payable over three years.
2. The 2012 Annual Bonus Scheme contains a Return on Assets measure against the average performance of a comparator group of mutual building societies. Since all the results of other societies are not available until May 2013 an assumption has been made of on-target performance relative to the comparator group. This figure will be adjusted upwards or downwards to reflect actual performance once the other 2012 results are known.
3. Peter Griffiths was also paid the gross sum of £232.9k, together with pension contributions of £28.7k, as pay in lieu of the balance of his contractual notice period.
4. The figures under benefits include cars, fuel, and personal medical insurance.
5. Awards under the bonus schemes are non-pensionable.

Executive directors' pension arrangements

In addition to the current pension arrangements noted above, Peter Griffiths and Guy Thomas are 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, indexed linked to the Retail Prices Index, up to retirement age.

The scheme closed to accrual of future benefits on 31 July 2010. As a result there was no further accrual of benefits (in excess of inflation) during the year to 31 December 2012 and no further contributions were paid.

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

	Accrued pension entitlement at 31/12/12	Increase in accrued pension during the year	Transfer value of accrued pension at 31/12/11	Transfer value of accrued pension at 31/12/12	Director's contributions during the year	Increase in transfer value over the year, net of director's contributions
	£000 pa	£000	£000	£000	£000	£000
Executive						
Peter Griffiths	22	1	350	388	-	38
Guy Thomas	21	1	376	417	-	41

Conclusion

The Group has performed well, considering the challenging and uncertain market in 2012. Sound management and the benefits of strategies put in place in previous years have meant that the Group has a secure financial position, ensuring that our Members' savings are safe and our products and services are competitive. Our trading performance has been good bearing in mind the non-trading items which have hit us in 2012. The Committee believes that having appropriate remuneration policies in place, as set out in this report, has contributed to this result. From 2013, the Committee has put in place a new overarching policy of executive remuneration with a significantly lower bonus element. The new bonus scheme will continue to ensure that executives are rewarded for good performance that promotes the benefits of Members, ensuring executives' incentives are closely aligned with those of our Members.

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

Christopher Jones
Chairman
29 January 2013

Independent Auditor's 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 2012 which comprise the Consolidated and Society income Statements, the Consolidated and Society Total Statements of Other Comprehensive Income, the Consolidated and Society Statements of Financial Position, the Consolidated and Society Statements of Cash Flows and the related Notes 1 to 41. 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. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

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 2012 and of the Group's and the Society's income and expenditure for the year then ended; and
- Have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

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.

Matthew Perkins
Senior Statutory Auditor
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Cardiff, United Kingdom
29 January 2013

Staff at The Royal Welsh Show are always on hand to help

Consolidated income statement
for the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Interest receivable and similar income	4	253.3	235.4
Interest payable and similar charges	5	(154.2)	(130.4)
Net interest income		99.1	105.0
Fees and commission receivable	6	24.5	20.6
Fees and commission payable	7	(1.2)	(1.4)
Net fee and commission income		23.3	19.2
Other operating income		1.0	1.4
Other fair value gains/(losses)	8	0.2	(0.1)
Net operating income		123.6	125.5
Administrative expenses	9	(64.4)	(60.0)
Depreciation and amortisation	24 & 25	(6.4)	(6.2)
Operating expenses		(70.8)	(66.2)
Impairment provision for losses on loans and advances	21	(16.3)	(24.6)
Provision for other liabilities and charges	22	(12.9)	(11.2)
Operating profit		23.6	23.5
Other gains	35	1.5	1.0
Profit before taxation		25.1	24.5
Taxation expense	13	(6.5)	(7.1)
Profit for the year		**18.6**	**17.4**

Consolidated statement of other comprehensive income

	Notes	2012 £m	2011 £m
Profit for the year		18.6	17.4
Actuarial loss on retirement benefit obligations	12	(8.0)	(4.2)
Gains on available-for-sale assets		1.8	2.1
Taxation expense	13	1.3	0.4
Total comprehensive income	**37 & 38**	**13.7**	**15.7**

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

The accounting policies and notes on pages 43 to 90 form part of these accounts.

Income statement of the Society
for the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Interest receivable and similar income	4	216.3	192.5
Interest payable and similar charges	5	(153.8)	(130.1)
Net interest income		62.5	62.4
Fees and commission receivable	6	11.8	9.9
Fees and commission payable	7	(0.6)	(0.5)
Net fee and commission income		11.2	9.4
Other operating income		1.2	1.5
Other fair value gains /(losses)	8	0.2	(0.1)
Net operating income		75.1	73.2
Administrative expenses	9	(48.0)	(45.0)
Depreciation and amortisation	24 & 25	(5.1)	(5.0)
Operating expenses		(53.1)	(50.0)
Impairment provision for losses on loans and advances	21	(12.8)	(11.3)
Provision for other liabilities and charges	22	(3.6)	(1.9)
Operating profit		5.6	10.0
Other gains	35	1.5	1.0
Profit before taxation		7.1	11.0
Taxation expense	13	(1.9)	(2.7)
Profit for the year		**5.2**	**8.3**

Statement of other comprehensive income of the Society

	Notes	2012 £m	2011 £m
Profit for the year		5.2	8.3
Actuarial loss on retirement benefit obligations	12	(8.0)	(4.2)
Gains on available-for-sale assets		1.8	2.1
Taxation expense	13	1.3	0.4
Total recognised income for the year	**37 & 38**	**0.3**	**6.6**

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 43 to 90 form part of these accounts.

Consolidated statement of financial position

at 31 December 2012

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

Liabilities			
Shares	28	5,467.0	5,013.8
Deposits and debt securities:			
Amounts owed to credit institutions	29	95.8	115.4
Amounts owed to other customers	30	345.7	306.9
Debt securities in issue	31	269.0	386.3
		710.5	808.6
Derivative financial instruments	16	49.4	57.4
Current tax liabilities		3.1	3.1
Other liabilities	32	8.5	8.6
Provisions for liabilities	22	13.0	26.7
Accruals and deferred income	33	9.8	9.9
Deferred tax liabilities	34	0.8	1.0
Retirement benefit obligations	12	13.2	11.5
Subordinated liabilities	35	92.3	107.0
Subscribed capital	36	76.4	75.4
Total liabilities		6,444.0	6,123.0
General reserve	37	336.9	324.7
Other reserves	38	3.4	2.0
Total equity and liabilities		**6,784.3**	**6,449.7**

The accounting policies and notes on pages 43 to 90 form part of these accounts.

These accounts were approved by the Board on 29 January 2013.

Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Graeme H. Yorston Group Chief Executive

W. Guy Thomas Group Finance Director

Statement of financial position of the Society

at 31 December 2012

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

Liabilities			
Shares	28	5,467.0	5,013.8
Deposits and debt securities:			
Amounts owed to credit institutions	29	252.1	317.5
Amounts owed to other customers	30	345.7	306.9
Debt securities in issue	31	34.4	83.8
		632.2	708.2
Derivative financial instruments	16	49.4	57.4
Current tax liabilities		0.9	0.6
Other liabilities	32	6.0	6.4
Provisions for liabilities	22	6.6	5.1
Accruals and deferred income	33	8.8	8.9
Deferred tax liabilities	34	0.9	1.1
Retirement benefit obligations	12	13.2	11.5
Subordinated liabilities	35	92.3	107.0
Subscribed capital	36	76.4	75.4
Total liabilities		6,353.7	5,995.4
General reserve	37	309.2	310.3
Other reserves	38	3.4	2.0
Total equity and liabilities		**6,666.3**	**6,307.7**

The accounting policies and notes on pages 43 to 90 form part of these accounts.

These accounts were approved by the Board on 29 January 2013.

Signed on behalf of the Board:

Dyfrig D. J. John Chairman

Graeme H. Yorston Group Chief Executive

W. Guy Thomas Group Finance Director

Consolidated statement of cash flows
for the year ended 31 December 2012

	2012 £m	2011 £m
Net cash inflow/(outflow) from operating activities (see below)	10.3	(120.5)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(9.1)	(9.9)
Purchase of investment securities	(694.8)	(1,342.9)
Proceeds from sale and maturity of investment securities	658.7	1,736.1
Cash flows from financing activities		
Subordinated debt repurchase	(13.2)	(2.0)
(Decrease)/increase in cash and cash equivalents	(48.1)	260.8
Cash and cash equivalents at beginning of year	651.7	390.9
Cash and cash equivalents at end of year	**603.6**	**651.7**
Represented by:		
Cash and balances with the Bank of England	498.2	532.9
Loans and advances to credit institutions repayable on demand	105.4	118.8
	603.6	**651.7**
Net cash inflow from operating activities		
Profit before taxation	25.1	24.5
Adjusted for:		
Depreciation and amortisation	6.4	6.2
Loss on sale of property, plant and equipment	-	0.4
Increase in impairment losses on loans and advances to customers	16.3	24.6
Change in fair values	9.5	9.4
Other non-cash movements	(1.6)	(0.9)
Changes in net operating assets		
Decrease/(increase) in loans and advances to credit institutions	30.2	(50.1)
(Increase) in loans and advances to customers	(395.6)	(280.8)
(Increase) in other assets	(1.2)	(1.1)
(Increase)/decrease in prepayments and accrued income	(0.3)	3.1
(Decrease) in derivative financial instruments	(6.1)	(5.1)
Increase/(decrease) in shares	455.3	(34.2)
(Decrease)/increase in deposits and debt securities	(100.9)	189.9
(Decrease)/increase in other liabilities	(0.1)	1.9
(Decrease)/increase in provisions for liabilities	(13.7)	1.9
(Decrease) in accruals and deferred income	(0.1)	(2.8)
(Decrease) in pension fund obligations	(6.4)	(2.0)
Taxation	(6.5)	(5.4)
	10.3	**(120.5)**

The Group is required to maintain interest-free balances with the Bank of England which at 31 December 2012 amounted to £6.1m (2011: £5.5m).

Statement of cash flows of the Society

for the year ended 31 December 2012

	2012 £m	2011 £m
Net cash outflow from operating activities (see below)	(9.1)	(170.2)
Cash flows from investing activities		
Purchase of intangible assets and property, plant and equipment	(8.0)	(8.5)
Purchase of investment securities	(694.8)	(1,342.9)
Proceeds from sale and maturity of investment securities	658.7	1,736.1
Cash flows from financing activities		
Subordinated debt repurchase	(13.2)	(2.0)
(Decrease)/increase in cash and cash equivalents	(66.4)	212.5
Cash and cash equivalents at beginning of year	601.9	389.4
Cash and cash equivalents at end of year	**535.5**	**601.9**
Represented by:		
Cash and balances with the Bank of England	498.2	532.9
Loans and advances to credit institutions repayable on demand	37.3	69.0
	535.5	601.9
Net cash inflow from operating activities		
Profit before taxation	7.1	11.0
Adjusted for:		
Depreciation and amortisation	5.1	5.0
Loss on sale of property, plant and equipment	-	0.4
Increase in impairment losses on loans and advances to customers	12.8	11.3
Change in fair values	9.5	9.4
Other non-cash movements	(1.2)	(1.1)
Changes in net operating assets		
(Increase) in loans and advances to credit institutions	(9.8)	(0.1)
(Increase) in loans and advances to customers	(436.7)	(323.5)
Decrease in loans to subsidiary companies	41.9	66.2
(Increase)/decrease in other assets	(0.7)	0.8
(Increase)/decrease in prepayments and accrued income	(0.4)	3.3
(Decrease) in derivative financial instruments	(6.1)	(5.1)
Increase/(decrease) in shares	455.3	(34.2)
(Decrease)/increase in deposits and debt securities	(79.0)	92.3
(Decrease)/increase in other liabilities	(0.4)	1.5
Increase in provisions for liabilities	1.5	0.2
(Decrease) in accruals and deferred income	(0.1)	(2.5)
(Decrease) in pension fund obligations	(6.4)	(2.0)
Taxation	(1.5)	(3.1)
	(9.1)	**(170.2)**

Notes to the accounts
for the year ended 31 December 2012

1. Accounting policies

Basis of preparation

The Group and Society's financial statements for the year ended 31 December 2012 have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) as adopted by the European Union (EU) and those parts of the Building Societies (Accounts and Related Provisions) Regulations 1998 applicable to Societies reporting under IFRS.

The financial statements have been prepared on a going concern basis. This is discussed in the Directors' Report on page 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 7 Disclosures – Transfers of Financial Assets	The amendment requires additional disclosures about offsetting financial assets and financial liabilities. The amendment is not expected to have a significant impact for the Group.	Accounting periods beginning on or after 1 January 2013
IFRS 10 Consolidated Financial Statements	The new standard replaces *IAS 27 Consolidated and Separate Financial Statements* and *SIC-12 Consolidation – Special Purpose Entities* by introducing a single consolidation model for all entities based on control. The new standard is currently being reviewed by the Group but is not expected to have a significant impact.	Accounting periods beginning on or after 1 January 2013
IFRS 11 Joint Arrangements	The new standard introduces new accounting requirements for joint arrangements, replacing *IAS 31 Interests in Joint Ventures*. The Group currently has no joint arrangements in place. The new standard, therefore, is not expected to impact the Group.	Accounting periods beginning on or after 1 January 2013
IFRS 12 Disclosure of Involvement with Other Entities	The new standard requires enhanced disclosures regarding both consolidated and unconsolidated entities in which an entity has involvement. The new standard is currently being reviewed by the Group but is not expected to have a significant impact.	Accounting periods beginning on or after 1 January 2013
IFRS 13 Fair Value Measurement	The new standard replaces guidance on fair value measurement in existing IFRS accounting literature with a single standard. The standard does not change the requirements regarding which items should be measured or disclosed at fair value but does require enhanced disclosures. The new standard is currently being reviewed by the Group and, with the exception of enhanced disclosures, is not expected to have a significant impact.	Accounting periods beginning on or after 1 January 2013
IAS 19 Employee Benefits	IAS 19 has been amended resulting from the Post-Employment Benefits and Termination Benefit projects. The standard makes improvements by eliminating an option to defer the recognition of gains and losses, known as the 'corridor method', streamlining the presentation of changes in assets and liabilities arising from defined benefit plans, changes to the rate of return on assets, and enhancing the disclosure requirements for defined benefit plans, providing better information about the characteristics of defined benefit plans and the risks that entities are exposed to through participation in those plans. The changes to the rate of return on assets will increase the charge to the income statement by £0.5m in 2013.	Accounting periods beginning on or after 1 January 2013

Notes to the accounts
for the year ended 31 December 2012

1. Accounting policies (continued)

Basis of preparation (continued)

Pronouncement	Nature of Change	Effective Date
IAS 27 Separate Financial Statements	IAS 27 has been amended to remove the consolidation requirements previously forming part of the standard. Consolidation requirements now contained in IFRS 10. The amendment is currently being reviewed by the Group but is not expected to have a significant impact.	Accounting periods beginning on or after 1 January 2013
IAS 28 Investment in Associates and Joint Ventures	IAS 28 has been amended to conform to the changes arising from the issuance of IFRS 10, IFRS 11 and IFRS 12. The amendment is currently being reviewed by the Group but is not expected to have a significant impact.	Accounting periods beginning on or after 1 January 2013
Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance	Amends IFRS 10, IFRS 11 and IFRS 12 to provide additional transition relief by limiting the requirement to provide adjusted comparative information to only the preceding comparative period. Also, amendments to IFRS 11 and IFRS 12 eliminate the requirement to provide comparative information for periods prior to the immediately preceding period. The amendment is not expected to have a significant impact for the Group.	Accounting periods beginning on or after 1 January 2013
IAS 32 Financial Instruments: Presentation	IAS 32 has been amended to conform to the changes arising from the issuance of IFRS 7. The amendment is not expected to have a significant impact for the Group.	Accounting periods beginning on or after 1 January 2014
Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)	Amends IFRS 10, IFRS 12 and IAS 27 to provide 'investment entities' an exemption from the consolidation of particular subsidiaries and instead requires that an investment entity measures the investment in each eligible subsidiary at fair value through profit or loss and requires additional disclosure about why the entity is considered an investment entity, details of the entity's unconsolidated subsidiaries, and the nature of relationship and certain transactions between the investment entity and its subsidiaries. The amendment is not expected to have a significant impact for the Group.	Accounting periods beginning on or after 1 January 2014
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 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 IFRS 9 on the Group is currently being considered.	Accounting periods beginning on or after 1 January 2015
IFRS 7 Disclosures – Transfers of Financial Assets	IFRS 7 has been amended to require disclosures about the first-time adoption of IFRS 9. The amendment is not expected to have a significant impact for the Group.	Accounting periods beginning on or after 1 January 2015

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

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

Notes to the accounts
for the year ended 31 December 2012

1. Accounting policies (continued)

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

Basis of consolidation
The Group financial statements consist of the financial statements of the ultimate parent (Principality Building Society) and all entities controlled by the Society (its subsidiaries and special purpose entities).

Subsidiaries
A subsidiary is an entity whose 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. Intra-group balances and transactions are eliminated in preparing the consolidated financial statements.

Securitisation transactions
The Group has securitised certain mortgage loans by the transfer of the loans to a special purpose entity (SPE) controlled by the Group. The securitisation enables a subsequent issuance of debt by the SPE to investors who gain the security of the underlying assets as collateral. The SPE is fully consolidated into the Group's accounts under Standing Interpretations Committee 12 *Consolidation – Special Purpose Entities*. The transfer of the mortgage loans to the SPE is not treated as a sale by the Society. The Society continues to recognise the mortgage loans on its own statement of financial position after the transfer because it retains their risks and rewards through the receipt of substantially all of the profits or losses of the SPE. In the accounts of the Society, the proceeds received from the transfer are accounted for as a deemed loan repayable to the SPE. To manage interest rate risk, the Society enters into derivative transactions with the SPE, receiving a rate of interest based on the securitised mortgages and paying a rate inherent in the debt issuance. In accordance with IAS 39, these internal derivatives are treated as part of the deemed loan and not separately fair valued because the relevant mortgage loans are not derecognised. Cash flows arising from these internal derivatives are accounted for on an accruals basis.

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

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

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

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

Fees and commissions
Loan origination fees are reflected in the calculation of the effective interest rate on the loan.

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

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

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

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

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

1. Accounting policies (continued)

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

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

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

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

Financial liabilities
Financial liabilities are measured at:

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

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

Permanent interest-bearing shares (subscribed capital) which are redeemable at specific dates at the option of the Society are classified as liabilities.

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

A financial liability may be designated as at FVTPL upon initial recognition if:

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

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

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

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

1. Accounting policies (continued)

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.

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

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

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

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

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

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

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

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

Derivative financial instruments and hedge accounting

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

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

Where cash collateral is received, to mitigate the risk inherent in amounts due to the Group, it is included as a liability within 'amounts owed to credit institutions'. Where

1. Accounting policies (continued)

collateral is given, to mitigate the risk inherent in amounts due from the Group, it is included as an asset in 'loans and advances to credit institutions'.

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

iii) Hedge accounting
When transactions meet the criteria specified in 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 income statement to offset the fair value movement of the related derivative.

To qualify for hedge accounting at inception the hedge relationship must be clearly documented. At inception the derivative must be expected to be highly effective in offsetting the hedged risk, and effectiveness must be tested throughout the life of the hedge relationship.

The Group discontinues hedge accounting when:
i) it is evident from testing that a derivative is not, or has ceased to be, highly effective as a hedge;
ii) the derivative expires, or is sold, terminated or exercised; or
iii) the underlying item matures or is sold or repaid.

The Group may also decide to cease hedge accounting even though the hedge relationship continues to be highly effective by ceasing to designate the financial instrument as a hedge. If the derivative no longer meets the criteria for hedge accounting, the cumulative fair value hedging adjustment is amortised over the period to maturity of the previously designated hedge relationship. If the underlying item is sold or repaid, the unamortised fair value adjustment is immediately reflected in the income statement.

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

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

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

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

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

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

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

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

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

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

Notes to the accounts
for the year ended 31 December 2012

1. Accounting policies (continued)

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

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

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

Property, plant and equipment

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

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

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

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

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

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

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

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

Pension costs

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

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

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

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

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

Qualifying insurance policies are reflected in plan assets at their fair value, which is defined as the present value of the related defined benefit obligations. The difference between the fair value of plan assets and the cost of the policy is

Notes to the accounts
for the year ended 31 December 2012

1. Accounting policies (continued)

treated as an actuarial loss which is recognised in full in the statement of other comprehensive income.

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

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

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

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

Segmental reporting
A business segment is defined as a group of assets and operations providing products and services that are subject to different risks and returns from 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.

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

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

Government grants are recognised as income in the income statement over the periods necessary to match them with the related costs 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.

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

Notes to the accounts
for the year ended 31 December 2012

2. Judgements in applying accounting policies and critical accounting estimates

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

Impairment provision on loans and advances

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

Key assumptions included in the measurement of the incurred loss include data regarding the probability of any account going into default, the probability of defaulted accounts progressing to possession and the eventual loss incurred in the event of forced sale or write-off. The House Price Index (HPI) and the discount applied on forced sale are key assumptions on the residential mortgage books. To the extent the HPI movements were to differ from current observations by 1%, the impact on provisions would be £0.9m. The impact of a 1% change in the forced sale discounts currently being experienced would impact provisions by £0.9m.

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

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

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

Impairment provision on investment securities

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

Fair value of derivatives and available-for-sale assets

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

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

Retirement benefit obligations

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

The impact of a 0.1% increase in the inflation assumptions would be to increase the carrying value of the pension obligations by approximately £1.1m. The impact of a 0.1% increase in the discount rate would be to reduce the value of pension obligations by approximately £1.1m.

The asset value of the annuity policy would also be affected by a change in either of these assumptions. A 0.1% increase in the inflation assumptions would increase the value of the assets by approximately £0.3m whereas a 0.1% increase in the discount rate would reduce the value of the assets by approximately £0.3m.

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

Other provisions for liabilities and charges

i) Payment Protection Insurance (PPI)

Provisions have been made in respect of claims in relation to previous sales of PPI which, in the Group's case, relate to secured personal lending PPI products. In August 2010, the FSA released its Policy Statement PS10/12 on *The Assessment and Redress of Payment Protection Complaints*.

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

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 provision 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.

At 31 December 2012, the Group holds a provision of £6.3m (2011: £21.6m), which it expects to be sufficient to meet obligations in relation to previous sales of PPI. The level of provision is calculated based upon estimates of complaint volumes, the rate at which these claims are upheld and the level of redress paid on each complaint. A 1% increase in the expected level of complaints would increase the value of the required provision by £0.1m.

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

ii) Financial Services Compensation Scheme (FSCS) levy
Along with other deposit-taking institutions, the Group has a provision for liabilities under the FSCS. As at 31 December 2012, the Group holds a provision of £5.2m in respect of levies payable in September 2013 and 2014.

The principal assumption underlying the provision relates to the interest charged on the loans funding the scheme by HM Treasury. A 1% increase in the expected level of interest would increase the value of the required provision by £0.8m.

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

- Future interest rates;
- Capital shortfalls from insufficient recoveries to fully repay loans from HM Treasury;
- The Group's share of industry protected deposits as at 31 December 2012; and
- The future structure of the replacement scheme.

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

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

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

The impact of a 10% change in the expected lives of financial instruments would result in an increase/decrease in the value of the loans in the statement of financial position by £0.5m/(£0.5m) respectively. The impact of a 10% change in the anticipated level of early redemption would result in an increase/decrease in the value of the loans in the statement of financial position by £0.4m/(£0.3m) respectively.

Notes to the accounts
for the year ended 31 December 2012

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.

	2012					
	Retail financial services	Commercial lending	Secured personal lending	Property services	Adjustment for Group transactions	Total
	£m	£m	£m	£m	£m	£m
Net interest income	53.7	8.8	36.6	-	-	99.1
Other income and charges	9.5	2.0	3.8	11.8	(2.6)	24.5
Net operating income	63.2	10.8	40.4	11.8	(2.6)	123.6
Administrative expenses	(46.6)	(2.0)	(9.8)	(10.4)	(2.0)	(70.8)
Impairment provision for losses on loans and advances	(1.8)	(11.0)	(3.5)	-	-	(16.3)
Provision for other liabilities and charges	(3.2)	-	(9.3)	(0.4)	-	(12.9)
Operating profit/(loss)	**11.6**	**(2.2)**	**17.8**	**1.0**	**(4.6)**	**23.6**
Other gains	1.5	-	-	-	-	1.5
Profit before taxation	**13.1**	**(2.2)**	**17.8**	**1.0**	**(4.6)**	**25.1**

	2011					
	Retail financial services	Commercial lending	Secured personal lending	Property services	Adjustment for Group transactions	Total
	£m	£m	£m	£m	£m	£m
Net interest income	53.1	9.3	42.6	-	-	105.0
Other income and charges	8.3	1.1	2.6	11.0	(2.5)	20.5
Net operating income	61.4	10.4	45.2	11.0	(2.5)	125.5
Administrative expenses	(43.2)	(2.0)	(9.3)	(9.7)	(2.0)	(66.2)
Impairment provision for losses on loans and advances	(4.3)	(7.0)	(13.3)	-	-	(24.6)
Provision for other liabilities and charges	(1.5)	-	(9.3)	(0.4)	-	(11.2)
Operating profit/(loss)	**12.4**	**1.4**	**13.3**	**0.9**	**(4.5)**	**23.5**
Other gains	1.0	-	-	-	-	1.0
Profit before taxation	**13.4**	**1.4**	**13.3**	**0.9**	**(4.5)**	**24.5**

Notes to the accounts
for the year ended 31 December 2012

3. Business segments (continued)

	Group	
	2012	2011
	£m	£m
Total assets by business segment		
Retail financial services	5,298.1	4,904.9
Secured personal lending	582.9	627.0
Commercial lending	897.8	913.0
Property services	5.5	4.8
Total assets	**6,784.3**	**6,449.7**
Total liabilities by business segment		
Retail financial services	6,197.6	5,819.3
Secured personal lending	581.2	625.6
Commercial lending	-	-
Property services	5.5	4.8
Total liabilities	**6,784.3**	**6,449.7**

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

4. Interest receivable and similar income

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
On loans fully secured on residential property	243.2	237.6	190.9	179.0
On other loans fully secured on land	23.1	21.7	23.1	21.7
On other loans to subsidiaries	-	-	15.7	15.9
On debt securities	6.2	7.7	5.8	7.5
Profit on realisation of investments	3.2	0.8	3.2	0.8
On other liquid assets	2.3	2.9	2.3	2.9
On derivative financial instruments	(24.7)	(35.3)	(24.7)	(35.3)
	253.3	**235.4**	**216.3**	**192.5**

5. Interest payable and similar charges

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
On shares held by individuals	142.4	132.8	142.4	132.8
On deposits and debt securities	16.2	12.4	15.8	12.1
On subscribed capital	4.2	4.2	4.2	4.2
On subordinated liabilities	2.0	4.1	2.0	4.1
On derivative financial instruments	(10.6)	(23.1)	(10.6)	(23.1)
	154.2	**130.4**	**153.8**	**130.1**

6. Fees and commission receivable

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Insurance and related financial service products	7.8	7.2	5.5	5.5
Estate agency	5.2	4.8	-	-
Mortgage related fees	5.1	3.3	5.1	3.3
Other fees and commission	6.4	5.3	1.2	1.1
	24.5	**20.6**	**11.8**	**9.9**

7. Fees and commission payable

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Mortgage related fees	0.8	1.0	0.2	0.1
Bank charges	0.4	0.4	0.4	0.4
	1.2	**1.4**	**0.6**	**0.5**

8. Other fair value gains and losses

	Group and Society	
	2012	2011
	£m	£m
Gains on derivatives	6.0	5.2
Losses on hedged items attributable to the hedged risk	(5.8)	(5.3)
	0.2	**(0.1)**

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

Notes to the accounts
for the year ended 31 December 2012

9. Administrative expenses

		Group		Society	
		2012	2011	2012	2011
		£m	£m	£m	£m
Wages and salaries		35.0	31.0	25.4	22.7
Social security costs		3.4	3.2	2.5	2.4
Other pension costs		1.3	1.1	1.2	1.0
		39.7	35.3	29.1	26.1
Other administrative expenses		24.7	24.7	18.9	18.9
		64.4	**60.0**	**48.0**	**45.0**
Other administrative expenses include:		**£000**	**£000**	**£000**	**£000**
Auditor's remuneration:					
For audit of the Society's Annual Accounts		118	115	118	115
For audit of the Society's subsidiaries		8	8	-	-
Total		**126**	**123**	**118**	**115**
For other services:					
Tax advisory		56	57	53	57
Specialist consultancy		-	307	-	307
Further assurance services		-	90	-	90
All other services		27	12	23	12
Operating lease charges	- motor vehicles	262	252	227	228
	- land and buildings	1,715	1,727	921	1,019

10. Employees

The average number employed including executive directors was:

	Full-time		Part-time	
	2012	2011	2012	2011
	Number	Number	Number	Number
Society's Customer Support Centre	508	467	70	67
Society branch offices	200	192	137	131
Employed by the Society	708	659	207	198
Subsidiaries	268	258	59	58
Employed by the Group	**976**	**917**	**266**	**256**

11. Emoluments of the Society's directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on page 33 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 (2011: £1.7m).

In addition, ex-gratia pensions amounting to £24k (2011: £24k) were paid to former directors.

Notes to the accounts
for the year ended 31 December 2012

12. Retirement benefit obligations

The Group operates two pension schemes, a defined benefit scheme 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 of the pension fund. Membership of the Scheme is, however, available at the discretion of the Society and a small number of new members have been admitted to the scheme on this basis subsequent to 1 January 2001.

The defined benefit scheme 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 injected a further £2.0m during 2011 to help reduce the current deficit.

During the year, the Trustees of the defined benefit scheme agreed a buy-in of the pensioner element of the scheme with Legal and General Assurance Society Limited. The buy-in involved the purchase of a bulk annuity policy by the scheme under which Legal and General assumed full responsibility for the benefits payable to the scheme's current pensioners. The buy-in took effect from September 2012. The pensioner liability and the matching annuity policy remain within the scheme. The premium paid for the annuity policy was £30.8m which the scheme settled with a combination of cash and assets including an additional Group contribution of £5.4m. This additional contribution is recognised in the statement of other comprehensive income. A further £0.4m is due to be paid in 2013.

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

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 2012 was £1.0m (2011: £0.9m). 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. In addition the Trustees may hold cash from time to time. The assets managed by Standard Life Investments 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 2012, including the unfunded liability referred to above, reflected a deficit amounting to £13.2m (2011: £11.5m). The use of the RPI and CPI in valuing the scheme will be reviewed in 2014.

The major assumptions used by the actuary were:

	At 31 December				
	2012	**2011**	**2010**	**2009**	**2008**
	%	%	%	%	%
Rate of increase in pensionable salaries	3.00	3.05	3.55	3.60	2.70
Rate of increase of pensions in payment and deferred pensions	3.00	3.05	3.55	3.60	2.70
Discount rate	4.60	4.70	5.40	5.65	6.25
Inflation assumption (RPI)	3.00	3.05	3.55	3.60	2.70
Inflation assumption (CPI)	2.60	2.25	3.05	n/a	n/a

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12. Retirement benefit obligations (continued)

The assumptions on mortality are determined by the following tables:

	2012	2011
Retired and non-retired members	SAPS LC1%B	SAPS LC1%B
The assumptions are illustrated by the following year of life expectancy at age 65:		
Retired members		
Males currently aged 65	23.0	22.9
Females currently aged 65	25.8	25.7
Non-retired members		
Males currently aged 45	25.0	24.9
Females currently aged 45	27.8	27.7

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

	At 31 December				
	2012	2011	2010	2009	2008
	£m	£m	£m	£m	£m
Target return funds	24.2	22.6	22.4	18.6	17.8
Debt securities	-	22.6	20.4	21.4	17.7
Annuities	22.7	-	-	-	-
Bonds and cash	0.5	0.9	0.4	0.4	-
Total fair value of plan assets	47.4	46.1	43.2	40.4	35.5
Present value of funded obligations	(60.1)	(57.1)	(52.0)	(49.8)	(36.3)
Present value of unfunded obligations	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net deficit recognised in the statement of financial position	**(13.2)**	**(11.5)**	**(9.3)**	**(9.9)**	**(1.3)**

The amounts recognised in the income statement are as follows:

	Group and Society	
	2012	2011
	£m	£m
Analysis of finance credit (included in other operating income)		
Expected return on pension scheme assets	(2.6)	(2.8)
Interest on pension scheme liabilities	2.7	2.8
Net credit to other financial income	**0.1**	**-**
Analysis of amount recognised in statement of other comprehensive income		
Actuarial loss	(8.0)	(4.2)
Analysis of the movement in the statement of financial position deficit		
Deficit in scheme at beginning of year	(11.5)	(9.3)
Movement in year:		
Other finance credit	(0.1)	-
Actuarial loss	(8.0)	(4.2)
Contributions paid and accrued	6.4	2.0
Deficit in scheme at end of year	**(13.2)**	**(11.5)**

12. Retirement benefit obligations (continued)

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

	Group and Society	
	2012	2011
	£m	£m
At 1 January	46.1	43.2
Expected return on scheme assets	2.6	2.7
Society contributions	6.4	2.1
Scheme member contributions	-	-
Benefits paid	(1.5)	(1.3)
Actuarial losses	(6.2)	(0.6)
At 31 December	**47.4**	**46.1**

Details of experience gains and losses

	Group and Society				
	2012	2011	2010	2009	2008
Difference between the expected and actual return on scheme assets:					
(Loss)/gain amount	(£6.2m)	(£0.6m)	(£0.2m)	£2.8m	(£6.2m)
Percentage of scheme assets	13.1%	1.3%	0.4%	6.9%	17.5%
Experience gains and losses on scheme liabilities:					
(Loss)/gain amount	(£1.8m)	(£3.6m)	(£0.3m)	(£11.6m)	£6.9m
Percentage of the present value of scheme liabilities	3.0%	6.2%	0.6%	23.0%	18.8%
Total amount recognised in statement of total recognised income and expense:					
(Loss)/gain amount	(£8.0m)	(£4.2m)	(£0.5m)	(£8.8m)	£0.7m
Percentage of the present value of scheme liabilities	13.2%	7.2%	1.0%	17.5%	1.8%

The cumulative amount of actuarial losses recognised in other comprehensive income since the date of transition to IFRSs is £15.8m (2011: £7.8m).

The actual return on plan assets was £4.2m (2011: £2.7m).

13. Taxation

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Current tax				
UK corporation tax charge for the year	6.9	6.7	2.2	2.8
Adjustments in respect of prior years	(0.1)	-	-	(0.4)
	6.8	6.7	2.2	2.4
Deferred tax				
Deferred tax charge for year	(0.5)	0.2	(0.5)	0.2
Adjustments in respect of prior years	0.2	0.2	0.2	0.1
	(0.3)	0.4	(0.3)	0.3
Taxation on profit on ordinary activities	**6.5**	**7.1**	**1.9**	**2.7**

13. Taxation (continued)

The statutory rate of corporation tax was reduced to 24.0% from 1 April 2012. The Group was subject to corporation tax at a rate of 26.0% for the period 1 January to 31 March 2012, and 24.0% for the period 1 April to 31 December 2012, resulting in an effective rate of corporation tax of 24.5% for the full year in 2012.

The actual tax charge for the year differs from that calculated using the standard rate of corporation tax in the UK. The differences are explained below.

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Profit before taxation	25.1	24.5	7.1	11.0
Profit multiplied by the standard rate of corporation tax at 24.5% (2011: 26.5%)	6.1	6.5	1.7	2.9
Effects of:				
Expenses not deductible for tax purposes	0.3	0.3	0.2	0.3
Adjustments to prior years	0.1	0.2	0.2	(0.2)
Other	-	0.1	(0.2)	(0.3)
Total taxation for the year	**6.5**	**7.1**	**1.9**	**2.7**

In addition to the amount charged to the income statement, the following amounts relating to tax have been recognised in other comprehensive income:

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Current tax				
Relating to retirement benefit obligations	(0.8)	-	(0.8)	-
Revaluations of available-for-sale financial assets	0.4	0.5	0.4	0.5
	(0.4)	0.5	(0.4)	0.5
Deferred tax				
Relating to retirement benefit obligations	(0.9)	(0.9)	(0.9)	(0.9)
	(0.9)	(0.9)	(0.9)	(0.9)
Total charged to other comprehensive income	**(1.3)**	**(0.4)**	**(1.3)**	**(0.4)**

14. Loans and advances to credit institutions

Repayable from the date of the statement of financial position in the ordinary course of business:

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Accrued interest	0.1	0.2	0.1	0.2
On demand	79.4	67.9	11.2	18.1
Less than three months	18.0	53.0	8.0	3.0
Between three months and one year	5.0	-	5.0	-
Credit Support Annex (CSA) assets	26.0	51.0	26.0	51.0
	128.5	**172.1**	**50.3**	**72.3**

The International Swaps and Derivatives Association (ISDA) Master Agreement is Principality's preferred agreement for documenting derivative activity. For certain counterparties a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions. £26.0m has been pledged at the statement of financial position date (2011: £51.0m).

15. Debt securities

	Group and Society	
	2012	2011
	£m	£m
Issued by UK Government	195.0	242.8
Issued by Supranational entities	107.4	25.9
Issued by other borrowers and unlisted	145.2	141.0
	447.6	**409.7**

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

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

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

	Group and Society	
	2012	2011
	£m	£m
Accrued interest	2.7	2.3
Less than three months	90.0	132.9
Between three months and one year	22.5	166.4
Between one year and five years	303.2	56.7
Greater than five years	29.2	51.4
	447.6	**409.7**

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

	Group and Society	
	2012	2011
	£m	£m
At 1 January	409.7	800.8
Additions	694.8	1,342.9
Disposals and maturities	(659.1)	(1,735.3)
Gains from changes in fair value	1.8	2.1
Increase/(decrease) in accrued interest	0.4	(0.8)
At 31 December	**447.6**	**409.7**

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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	
	2012	2011	2012	2011
	£m	£m	£m	£m
Derivative assets held for hedging purposes and designated fair value hedges:				
Interest rate swaps	1,463.4	1,686.8	37.5	38.6
Cross currency interest rate swaps	16.2	33.4	2.7	6.3
Equity and RPI index-linked interest rate swaps	48.7	30.1	3.4	0.6
Total recognised derivative assets	**1,528.3**	**1,750.3**	**43.6**	**45.5**
Derivative liabilities held for hedging purposes and designated fair value hedges:				
Interest rate swaps	1,301.8	1,678.1	(49.1)	(57.0)
Equity and RPI index linked interest rate swaps	7.9	12.4	(0.3)	(0.4)
Total recognised derivative assets/(liabilities)	**1,309.7**	**1,690.5**	**(49.4)**	**(57.4)**

17. Assets measured at fair value

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

	Group and Society		
	2011	Level 1	Level 2
	£m	£m	£m
Financial assets at fair value through profit or loss:			
Derivative financial instruments	45.5	-	45.5
Available-for-sale financial assets:			
Debt securities	409.7	409.7	-
Total	**455.2**	**409.7**	**45.5**

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

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 2012 (2011: none).

18. Loans fully secured on residential property

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Gross balances	5,081.4	4,669.9	4,496.5	4,042.5
Provision for impairment losses	(67.1)	(63.2)	(36.1)	(27.4)
Unamortised loan origination fees	22.6	28.2	(0.4)	(1.8)
Fair value adjustment for hedged risk	47.5	55.2	47.5	55.2
	5,084.4	**4,690.1**	**4,507.5**	**4,068.5**

Within the Group totals above there was £45.2m partially secured against residential property (2011: £45.2m).

19. Other loans fully secured on land

	Group and Society	
	2012	2011
	£m	£m
Other loans	507.3	530.0

20. Loans and advances to customers

Maturity analysis of loans and advances to customers from the date of the statement of financial position:

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Less than three months	163.4	143.4	153.6	130.4
Between three months and one year	316.2	299.4	287.9	271.7
Between one year and five years	952.2	958.0	788.2	795.6
More than five years	4,157.0	3,799.1	3,774.1	3,374.8
	5,588.8	5,199.9	5,003.8	4,572.5
Provision for impairment losses	(67.1)	(63.2)	(36.1)	(27.4)
Unamortised loan origination fees	22.5	28.2	(0.4)	(1.8)
Fair value adjustment for hedged risk	47.5	55.2	47.5	55.2
	5,591.7	**5,220.1**	**5,014.8**	**4,598.5**

The amortised value of the residential mortgage backed security issued in 2011 is £657.0m (2011: £814.0m). The Group holds £422.8m of the notes (2011: £514.0m).

In October 2012, the Group became a member of the FLS which allows the Group the ability to pledge mortgage assets with the Bank of England in return for Treasury bills which are capable of repo financing either directly with the market or with central banks to which the Group has direct access. No assets have been pledged into the scheme at the end of the year and no funds have been drawn-down.

Asset encumbrance is 10.6% (2011: 13.9%) of total assets. The Board has set an encumbrance limit of 30.0%.

21. Provision for impairment losses

	Fully secured on residential property		Fully secured on land	
	Specific	Collective	Specific	Collective
	£m	£m	£m	£m
2012				
Group				
At 1 January 2012	44.1	15.1	4.0	-
Amounts written off during the year	(12.4)	-	-	-
Provision for loan impairment	7.0	5.8	3.5	-
At 31 December 2012	**38.7**	**20.9**	**7.5**	**-**
Society				
At 1 January 2012	8.3	15.1	4.0	-
Amounts written off during the year	(4.1)	-	-	-
Provision for loan impairment	4.0	5.3	3.5	-
At 31 December 2012	**8.2**	**20.4**	**7.5**	**-**
2011				
Group				
At 1 January 2011	43.6	11.9	-	-
Amounts written off during the year	(16.9)	-	-	-
Provision for loan impairment	17.4	3.2	4.0	-
At 31 December 2011	**44.1**	**15.1**	**4.0**	**-**
Society				
At 1 January 2011	8.1	11.9	-	-
Amounts written off during the year	(3.9)	-	-	-
Provision for loan impairment	4.1	3.2	4.0	-
At 31 December 2011	**8.3**	**15.1**	**4.0**	**-**

22. Provisions for liabilities

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
At 1 January	26.7	24.8	5.1	4.9
Additions	12.9	11.2	3.6	1.9
Utilisation	(26.6)	(9.3)	(2.1)	(1.7)
At 31 December	**13.0**	**26.7**	**6.6**	**5.1**

Included in provisions is the Financial Services Compensation Scheme levy of £5.2m 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 £7.8m are held 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 months. The contingent aspect of this provision is described in Note 39.

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23. Investments in subsidiary undertakings

	Society	
	2012	2011
	£m	£m
Shares in subsidiary undertakings:		
At cost	1.1	1.1
Loans to subsidiary undertakings	544.5	586.4
	545.6	**587.5**

	Subsidiary undertakings	
	Shares	Loans
	£m	£m
Movement in investments in subsidiary undertakings:		
At 1 January 2012	1.1	586.4
Loan repayment	-	(41.9)
At 31 December 2012	**1.1**	**544.5**

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

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

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

During the year, the Society participated in designing a scheme to assist the housing agenda in Wales. The scheme aims to deliver a 700 house development on a brownfield site in Cardiff being a mix of affordable, social and private dwellings ultimately funded by the capital markets. This resulted in the creation of Ely Bridge Development Company Limited which was incorporated on 28 March 2012. The company is not for profit and limited by guarantee. The Society holds no beneficial interest in the company but has agreed to contribute £1 to the assets of the company in the event of it being wound up.

The Society also holds 100% of the ordinary share capital of the following subsidiary undertakings which have not carried on business during the year. These were all incorporated in the United Kingdom.

Brokerpoint Limited
Energy Assess Wales Limited
Home Information Pack Wales Limited
Nemo Loans Limited
Nemo Financial Limited
Nemo Financial Services Limited
Nemo Home Loans Limited
Nemo Secured Loans Limited
Nemo Insurance Services Limited
Peter Alan Black Limited
Peter Alan Property Services Limited

Peter Alan Surveyors Limited
Peter Alan Property Development Services Limited
Principality Limited
Principality Asset Management Limited
Principality Bank Limited
Principality Direct Limited
Principality Estate Agency Limited
Principality Financial Management Limited
Principality Homes Limited
Principality (IFA Services) Limited
Principality Independent Financial Advisers Limited

Principality Life Assurance Services Limited
Principality (Life and Pensions) Limited
Principality Mortgage Corporation Limited
Principality Personal Loans Limited
Principality Property Development Services Limited
Principality Property Sales Limited
Principality Property Services Limited
Principality Property Solutions Limited
Principality Surveyors Home Condition Report Limited
Principality Syndicated Loans Limited
The Principality Home Information Pack Limited

24. Intangible assets

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

	Goodwill		Computer software		Total	
	Group	Society	Group	Society	Group	Society
	£m	£m	£m	£m	£m	£m
2011						
Cost:						
At 1 January 2011	0.7	-	4.8	4.8	5.5	4.8
Additions	-	-	1.1	1.1	1.1	1.1
Disposals	-	-	-	-	-	-
At 31 December 2011	**0.7**	**-**	**5.9**	**5.9**	**6.6**	**5.9**
Amortisation:						
At 1 January 2011	-	-	3.4	3.4	3.4	3.4
Charge for the year	-	-	0.7	0.7	0.7	0.7
Disposals	-	-	-	-	-	-
At 31 December 2011	**-**	**-**	**4.1**	**4.1**	**4.1**	**4.1**
Net book value:						
At 31 December 2011	**0.7**	**-**	**1.8**	**1.8**	**2.5**	**1.8**
At 31 December 2010	0.7	-	1.4	1.4	2.1	1.4

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

In accordance with the requirements of IAS 36, the Group completed an impairment review of the carrying value for goodwill as at 31 December 2012 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.

25. Property, plant and equipment

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

Included within land and buildings additions is £0.3m (2011: £0.9m) on account of assets in the course of construction.

The value of assets subject to operating leases where the Group acts as lessor is £21.9m (2011: £21.9m).

	2012		2011	
	Group	Society	Group	Society
	£m	£m	£m	£m
Land and buildings:				
Freehold	21.0	20.0	29.9	28.4
Long leasehold	0.4	0.2	0.5	0.3
Short leasehold	1.9	1.7	2.6	2.3
	23.3	**21.9**	**33.0**	**31.0**
Occupied by the Society and subsidiary undertakings	25.5	24.6	22.5	20.5

25. Property, plant and equipment (continued)

	Land and buildings		Equipment, fixtures, fittings & vehicles		Total	
	Group	Society	Group	Society	Group	Society
	£m	£m	£m	£m	£m	£m
Cost:						
At 1 January 2011	51.6	47.8	29.3	20.1	80.9	67.9
Additions	2.7	2.6	6.1	4.8	8.8	7.4
Disposals	(0.2)	(0.2)	(3.5)	(3.2)	(3.7)	(3.4)
At 31 December 2011	**54.1**	**50.2**	**31.9**	**21.7**	**86.0**	**71.9**
Depreciation:						
At 1 January 2011	19.5	17.7	20.5	13.5	40.0	31.2
Charge for the year	1.6	1.5	3.9	2.8	5.5	4.3
Disposals	-	-	(3.2)	(2.9)	(3.2)	(2.9)
At 31 December 2011	**21.1**	**19.2**	**21.2**	**13.4**	**42.3**	**32.6**
Net book value:						
At 31 December 2011	**33.0**	**31.0**	**10.7**	**8.3**	**43.7**	**39.3**
At 31 December 2010	32.1	30.1	8.8	6.6	40.9	36.7

26. Other assets

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Due within one year:				
Other	6.2	4.9	3.7	2.9

27. Prepayments and accrued income

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Accrued interest on derivative financial instruments	10.9	11.5	10.9	11.5
Other	4.4	3.5	3.5	2.5
	15.3	**15.0**	**14.4**	**14.0**

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28. Shares

	Group and Society	
	2012	2011
	£m	£m
Held by individuals	5,442.3	4,987.1
Other shares	4.3	4.2
Fair value adjustment for hedged risk	20.4	22.5
	5,467.0	**5,013.8**

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	
	2012	2011
	£m	£m
Fair value adjustment for hedged risk	20.4	22.5
Accrued interest	73.9	63.6
On demand	1,633.2	1,092.7
Less than three months	1,197.0	1,229.6
Between three months and one year	1,080.7	1,230.9
Between one year and five years	1,461.8	1,374.5
	5,467.0	**5,013.8**

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	
	2012	2011	2012	2011
	£m	£m	£m	£m
Accrued interest	-	0.1	-	0.1
Credit Support Annex (CSA) liabilities	13.3	9.1	13.3	9.1
On demand	2.5	2.4	-	-
Less than three months	18.5	56.3	36.8	81.2
Between three months and one year	5.0	3.0	57.1	47.0
Between one year and five years	42.0	2.3	130.4	137.9
Greater than five years	14.5	42.2	14.5	42.2
	95.8	**115.4**	**252.1**	**317.5**

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	
	2012	2011	2012	2011
	£m	£m	£m	£m
Accrued interest	4.3	2.9	4.3	2.9
On demand and less than three months	125.8	162.0	125.8	162.0
Between three months and one year	170.9	112.4	170.9	112.4
Between one year and five years	44.7	29.6	44.7	29.6
	345.7	**306.9**	**345.7**	**306.9**

Notes to the accounts
for the year ended 31 December 2012

31. Debt securities in issue

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Certificates of deposit	14.8	40.0	14.8	40.0
Fixed and floating rate notes	16.3	43.5	16.3	43.5
Other debt securities	234.6	302.5	-	-
Fair value adjustment for hedged risk	3.3	0.3	3.3	0.3
	269.0	**386.3**	**34.4**	**83.8**

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

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Fair value adjustment for hedged risk	3.3	0.3	3.3	0.3
Accrued interest	0.1	3.3	0.1	0.2
Less than three months	17.1	58.8	4.0	32.0
Between three months and one year	47.9	83.0	10.7	17.9
Between one year and five years	200.6	240.9	16.3	33.4
	269.0	**386.3**	**34.4**	**83.8**

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

Certificates of deposit	1.75%	1.51%
Fixed and floating rate notes	0.71%	1.18%

32. Other liabilities

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Due within one year:				
Income tax	0.9	1.0	0.9	1.0
Other taxation and social security	1.2	1.0	0.9	0.7
Other creditors	6.4	6.6	4.2	4.7
	8.5	**8.6**	**6.0**	**6.4**

33. Accruals and deferred income

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Interest accrued on subordinated liabilities	0.4	0.5	0.4	0.5
Interest accrued on subscribed capital	0.4	0.4	0.4	0.4
Other	9.0	9.0	8.0	8.0
	9.8	**9.9**	**8.8**	**8.9**

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34. Deferred tax

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
At 1 January	(2.3)	(1.8)	(2.2)	(1.6)
(Credited)/charged to the statement of other comprehensive income	(0.3)	0.4	(0.2)	0.3
Credited to statement of other comprehensive income on actuarial losses	(0.9)	(0.9)	(0.9)	(0.9)
At 31 December	**(3.5)**	**(2.3)**	**(3.3)**	**(2.2)**

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

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Deferred tax liabilities				
Accelerated tax depreciation	-	-	0.2	0.3
Other	0.8	1.0	0.7	0.8
	0.8	**1.0**	**0.9**	**1.1**
Deferred tax assets				
Accelerated tax depreciation	(0.1)	-	-	-
Retirement benefit obligation	(3.8)	(2.9)	(3.8)	(2.9)
Other	(0.4)	(0.4)	(0.4)	(0.4)
	(4.3)	**(3.3)**	**(4.2)**	**(3.3)**

The reduction of the UK Corporation tax rate to 23% from 1 April 2013 has resulted in a deferred tax charge arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the asset is expected to reverse. The statement of other comprehensive income includes a charge of £0.3m arising from the actuarial loss on retirement benefit obligations. The charge reflected in the income statement is not material.

The deferred tax asset relating to retirement benefit obligations is expected to be recovered within 13 years. More information on the triennial valuation can be found in note 12.

35. Subordinated liabilities

	Group and Society	
	2012	2011
	£m	£m
5 3/8% Subordinated Notes due 2016	92.3	107.0

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

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

With the permission of the Financial Services Authority, in 2012, the Society repurchased £14.7m of subordinated liabilities at a discount. The Group has benefited from a one-off gain of £1.5m (2011: repurchase of £3.0m of subordinated liabilities with a gain of £1.0m).

Repaying the subordinated liabilities requires the prior consent of the Financial Services Authority.

36. Subscribed capital

	Group and Society	
	2012	2011
	£m	£m
7.00% Permanent Interest-Bearing Shares	60.0	60.0
Unamortised issue costs	(0.7)	(0.7)
Fair value adjustment for hedged risk	17.1	16.1
	76.4	**75.4**

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

The PIBS are repayable, at the option of the Society, in whole on 1 June 2020 or any fifth anniversary thereafter. Repaying the PIBS requires the prior consent of the 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	
	2012	2011	2012	2011
	£m	£m	£m	£m
Balance at 1 January	324.7	310.6	310.3	305 .3
Profit for the financial year	18.6	17.4	5.2	8.3
Actuarial loss on retirement benefit obligations	(8.0)	(4.2)	(8.0)	(4.2)
Movement in deferred tax relating to retirement benefit obligations	1.7	0.9	1.7	0.9
Total recognised income for the year	12.3	14.1	(1.1)	5.0
Balance at 31 December	**336.9**	**324.7**	**309.2**	**310.3**
Reserves excluding pension liability	350.1	336.2	322.4	321.8
Pension liability	(13.2)	(11.5)	(13.2)	(11.5)
	336.9	**324.7**	**309.2**	**310.3**

38. Other reserves

	Group and Society	
	2012	2011
	£m	£m
Other reserves comprise		
Revaluation reserve – available-for-sale investments	3.4	2.0
Movement in other reserves		
Balance at 1 January	2.0	0.4
Net gains from changes in fair value, net of taxation	1.4	1.6
Balance at 31 December	**3.4**	**2.0**
Balance at 1 January	2.0	0.4
Gains transferred to equity	5.0	2.9
Gains recycled to profit and loss on sale	(3.2)	(0.8)
Taxation	(0.4)	(0.5)
Balance at 31 December	**3.4**	**2.0**

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39. Financial commitments and contingent liabilities

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

While it is anticipated that the majority of the borrowings will be repaid wholly from recoveries from the institutions concerned, the FSCS has advised of an expected loan repayment shortfall in the region of £800m. At current rates and based on latest information which is subject to change, the Group's share of the expected shortfall would be £4.5m. This will be levied in equal instalments between 2012 and 2014 and £1.5m of this is included in the 2012 charge.

A provision of £5.2m (31 December 2011: £3.8m) is held in respect of these levies and represents the Society's best estimate of levies due.

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

b) Payment Protection Insurance (PPI)
Provisions have been made in respect of claims in relation to previous sales of Payment Protection Insurance (PPI) which, in the Group's case, relate to secured personal lending PPI products. In August 2010, the FSA released its Policy Statement PS10/12 on *The Assessment and Redress of Payment Protection Complaints*.

A further provision of £9.3m has been recognised in the year. At 31 December 2012, provisions of £6.2m are held which represents the best estimate of expected redress obligations, where the Group had responsibility for the original sale of the product. It is expected that this liability will crystallise over the next 12 months as work is undertaken to finalise the remediation process.

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

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

39. Financial commitments and contingent liabilities (continued)

d) Commitments under non-cancellable operating leases

	2012		2011	
	Property	Vehicles, plant and equipment	Property	Vehicles, plant and equipment
	£m	£m	£m	£m
Group commitments in respect of operating lease rentals:				
Due within one year	1.8	0.3	1.8	0.2
Due between two and five years	7.1	0.3	6.4	0.3
Due after five years	6.5	-	6.4	-
	15.4	**0.6**	**14.6**	**0.5**
Society commitments in respect of operating lease rentals:				
Due within one year	1.0	0.3	1.0	0.2
Due between two and five years	3.9	0.2	3.6	0.3
Due after five years	4.0	-	3.9	-
	8.9	**0.5**	**8.5**	**0.5**

e) Income receivable under non-cancellable operating leases

Property rental income earned during the year was £0.8m (2011:£0.8m).

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

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Receivable within one year	0.8	0.8	1.0	1.0
Receivable between two and five years	2.8	2.9	3.3	3.4
Receivable after five years	8.6	10.6	10.6	12.7
	12.2	**14.3**	**14.9**	**17.1**

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

f) Capital commitments

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
Capital expenditure contracted for but not provided for	1.3	1.0	1.3	1.0

40. Financial instruments

a) Categories of financial instruments

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

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

Group As at 31 December 2012	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivatives designated as fair value hedging instruments	Total
	£m	£m	£m	£m	£m	£m
Group assets						
Cash in hand and balances with Bank of England	498.2	-	-	-	-	498.2
Loans and advances to credit institutions	-	128.5	-	-	-	128.5
Debt securities	-	-	447.6	-	-	447.6
Derivative financial instruments	-	-	-	2.7	40.9	43.6
Loans and advances to customers	-	5,591.7	-	-	-	5,591.7
Total financial assets	**498.2**	**5,720.2**	**447.6**	**2.7**	**40.9**	**6,709.6**
Total non-financial assets						74.7
Total Group assets						**6,784.3**
Group liabilities						
Shares	5,467.0	-	-	-	-	5,467.0
Amounts owed to credit institutions	39.3	-	-	56.5	-	95.8
Amounts owed to other customers	345.7	-	-	-	-	345.7
Debt securities in issue	269.0	-	-	-	-	269.0
Derivative financial instruments	-	-	-	0.5	48.9	49.4
Subordinated liabilities	92.3	-	-	-	-	92.3
Subscribed capital	76.4	-	-	-	-	76.4
Total financial liabilities	**6,289.7**	**-**	**-**	**57.0**	**48.9**	**6,395.6**
Total non-financial liabilities						48.4
General reserve and other reserves						340.3
Total Group reserves and liabilities						**6,784.3**

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Society As at 31 December 2012	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivatives designated as fair value hedging instruments	Total
	£m	£m	£m	£m	£m	£m
Society assets						
Cash in hand and balances with Bank of England	498.2	-	-	-	-	498.2
Loans and advances to credit institutions	-	50.3	-	-	-	50.3
Debt securities	-	-	447.6	-	-	447.6
Derivative financial instruments	-	-	-	2.7	40.9	43.6
Loans and advances to customers	-	5,014.8	-	-	-	5,014.8
Loans to and investments in subsidiaries	1.1	544.5	-	-	-	545.6
Total financial assets	**499.3**	**5,609.6**	**447.6**	**2.7**	**40.9**	**6,600.1**
Total non-financial assets						66.2
Total Society assets						**6,666.3**
Society liabilities						
Shares	5,467.0	-	-	-	-	5,467.0
Amounts owed to credit institutions	195.6	-	-	56.5	-	252.1
Amounts owed to other customers	345.7	-	-	-	-	345.7
Debt securities in issue	34.4	-	-	-	-	34.4
Derivative financial instruments	-	-	-	0.5	48.9	49.4
Subordinated liabilities	92.3	-	-	-	-	92.3
Subscribed capital	76.4	-	-	-	-	76.4
Total financial liabilities	**6,211.4**	**-**	**-**	**57.0**	**48.9**	**6,317.3**
Total non-financial liabilities						36.4
General reserve and other reserves						312.6
Total Society reserves and liabilities						**6,666.3**

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Group As at 31 December 2011	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivatives designated as fair value hedging instruments	Total
	£m	£m	£m	£m	£m	£m
Group assets						
Cash in hand and balances with Bank of England	532.9	-	-	-	-	532.9
Loans and advances to credit institutions	-	172.1	-	-	-	172.1
Debt securities	-	-	409.7	-	-	409.7
Derivative financial instruments	-	-	-	6.5	39.0	45.5
Loans and advances to customers	-	5,220.1	-	-	-	5,220.1
Total financial assets	**532.9**	**5,392.2**	**409.7**	**6.5**	**39.0**	**6,380.3**
Total non-financial assets						69.4
Total Group assets						**6,449.7**
Group liabilities						
Shares	5,013.8	-	-	-	-	5,013.8
Amounts owed to credit institutions	72.7	-	-	42.7	-	115.4
Amounts owed to other customers	306.9	-	-	-	-	306.9
Debt securities in issue	386.3	-	-	-	-	386.3
Derivative financial instruments	-	-	-	0.5	56.9	57.4
Subordinated liabilities	107.0	-	-	-	-	107.0
Subscribed capital	75.4	-	-	-	-	75.4
Total financial liabilities	**5,962.1**	**-**	**-**	**43.2**	**56.9**	**6,062.2**
Total non-financial liabilities						60.8
General reserve and other reserves						326.7
Total Group reserves and liabilities						**6,449.7**

40. Financial instruments (continued)

a) Categories of financial instruments (continued)

Society As at 31 December 2011	Financial assets and liabilities at amortised cost	Loans and receivables	Financial assets available-for-sale	Financial assets and liabilities designated at fair value	Derivatives designated as fair value hedging instruments	Total
	£m	£m	£m	£m	£m	£m
Society assets						
Cash in hand and balances with Bank of England	532.9	-	-	-	-	532.9
Loans and advances to credit institutions	-	72.3	-	-	-	72.3
Debt securities	-	-	409.7	-	-	409.7
Derivative financial instruments	-	-	-	6.5	39.0	45.5
Loans and advances to customers	-	4,598.5	-	-	-	4,598.5
Loans to and investments in subsidiaries	1.1	586.4	-	-	-	587.5
Total financial assets	**534.0**	**5,257.2**	**409.7**	**6.5**	**39.0**	**6,246.4**
Total non-financial assets						61.3
Total Society assets						**6,307.7**
Society liabilities						
Shares	5,013.8	-	-	-	-	5,013.8
Amounts owed to credit institutions	274.8	-	-	42.7	-	317.5
Amounts owed to other customers	306.9	-	-	-	-	306.9
Debt securities in issue	83.8	-	-	-	-	83.8
Derivative financial instruments	-	-	-	0.5	56.9	57.4
Subordinated liabilities	107.0	-	-	-	-	107.0
Subscribed capital	75.4	-	-	-	-	75.4
Total financial liabilities	**5,861.7**	**-**	**-**	**43.2**	**56.9**	**5,961.8**
Total non-financial liabilities						33.6
General reserve and other reserves						312.3
Total Society reserves and liabilities						**6,307.7**

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40. Financial instruments (continued)

b) Carrying values and fair values

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

	Note	Group		Society	
		2012		2012	
		Carrying value	Fair value	Carrying value	Fair value
		£m	£m	£m	£m
Financial assets					
Cash in hand and balances with Bank of England		498.2	498.2	498.2	498.2
Loans and advances to credit institutions (excluding CSA deposits)	i.	102.5	102.5	24.3	24.3
CSA deposits		26.0	26.0	26.0	26.0
Debt securities – available-for-sale	ii.	447.6	447.6	447.6	447.6
Derivative financial instruments	iii.				
Interest rate swaps		37.5	37.5	37.5	37.5
Cross currency interest rate swaps		2.7	2.7	2.7	2.7
Equity and RPI index-linked interest rate swaps		3.4	3.4	3.4	3.4
Loans and advances to customers	iv.	5,591.7	5,569.2	5,014.8	5,014.4
Loans and advances to subsidiaries	v.	-	-	545.6	545.6
		6,709.6	**6,687.1**	**6,600.1**	**6,599.7**
Financial liabilities					
Shares	vi.	5,467.0	5,467.0	5,467.0	5,467.0
Amounts owed to credit institutions	vii.	82.5	82.5	238.8	238.8
CSA liabilities	vii.	13.3	13.3	13.3	13.3
Amounts owed to other customers	vii.	345.7	345.7	345.7	345.7
Debt securities in issue		269.0	271.2	34.4	34.4
Derivative financial instruments	iii.				
Interest rate swaps		49.1	49.1	49.1	49.1
Equity and RPI index-linked interest rate swaps		0.3	0.3	0.3	0.3
Subordinated liabilities	viii.	92.3	75.9	92.3	75.9
Subscribed capital	viii.	76.4	48.5	76.4	48.5
		6,395.6	**6,353.5**	**6,317.3**	**6,273.0**

The credit risk of the Group's liabilities and interest accrued thereon is considered to be immaterial and as such no adjustment has been made.

40. Financial instruments (continued)

b) Carrying values and fair values (continued)

	Note	Group		Society	
		2011		2011	
		Carrying value	Fair value	Carrying value	Fair value
		£m	£m	£m	£m
Financial assets					
Cash in hand and balances with Bank of England		532.9	532.9	532.9	532.9
Loans and advances to credit institutions (excluding CSA deposits)	i.	121.1	121.1	21.3	21.3
CSA deposits		51.0	51.0	51.0	51.0
Debt securities – available-for-sale	ii.	409.7	409.7	409.7	409.7
Derivative financial instruments	iii.				
Interest rate swaps		38.6	38.6	38.6	38.6
Cross currency interest rate swaps		6.3	6.3	6.3	6.3
Equity and RPI index-linked interest rate swaps		0.6	0.6	0.6	0.6
Loans and advances to customers	iv.	5,220.1	5,191.8	4,598.5	4,600.2
Loans and advances to subsidiaries	v.	-	-	587.5	587.5
		6,380.3	**6,352.0**	**6,246.4**	**6,248.1**
Financial liabilities					
Shares	vi.	5,013.8	5,013.8	5,013.8	5,013.8
Amounts owed to credit institutions	vii.	106.3	106.3	308.4	308.4
CSA liabilities	vii.	9.1	9.1	9.1	9.1
Amounts owed to other customers	vii.	306.9	306.9	306.9	306.9
Debt securities in issue		386.3	370.3	83.8	83.1
Derivative financial instruments	iii.				
Interest rate swaps		57.0	57.0	57.0	57.0
Equity and RPI index-linked interest rate swaps		0.4	0.4	0.4	0.4
Subordinated liabilities	viii.	107.0	76.5	107.0	76.5
Subscribed capital	viii.	75.4	42.6	75.4	42.6
		6,062.2	**5,982.9**	**5,961.8**	**5,897.8**

The gross amount of foreign currency swaps held was €20.0m (2011: €40.0m).

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

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

40. Financial instruments (continued)

c) Credit risk

The classes of financial instruments to 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	
	2012	2011	2012	2011
	£m	£m	£m	£m
Financial assets				
Loans and advances to credit institutions	128.5	172.1	50.3	72.3
Debt securities	447.6	409.7	447.6	409.7
Loans and advances to customers	5,591.7	5,220.1	5,014.8	4,598.5
Loans and advances to subsidiaries	-	-	545.6	587.5
Derivative financial instruments				
Interest rate swaps and other derivatives	43.6	45.5	43.6	45.5
	6,211.4	**5,847.4**	**6,101.9**	**5,713.5**

In respect of loans and advances to credit institutions, debt securities and derivative instruments:

	Group		Society	
	2012	2011	2012	2011
	£m	£m	£m	£m
UK Government securities and amounts held with central banks	195.0	207.7	195.0	207.7
Supranational securities	107.4	25.9	107.4	25.9
UK financial institutions	317.3	393.7	239.1	293.9
	619.7	**627.3**	**541.5**	**527.5**

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

40. Financial instruments (continued)

c) Credit risk (continued)

The percentage of these exposures that are rated between A and AAA under Fitch ratings for 2012 is 98.8% (2011: 97.1%).

Collateral is not held over loans and advances to credit institutions and debt securities. Collateral of £13.3m (2011: £9.1m) is held over derivative financial instruments.

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

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		Society	
	2012		2012	
	£m	%	£m	%
In respect of loans and advances to customers:				
Fully secured by a first charge on residential property	4,488.9	80.3	4,488.9	89.6
Fully secured by a first charge on land	478.4	8.6	478.4	9.5
Fully secured by a second charge on residential property	531.7	9.5	-	-
Partially secured by a second charge on residential property	45.2	0.8	-	-
Fair value adjustments	47.5	0.8	47.5	0.9
	5,591.7	**100.0**	**5,014.8**	**100.0**
Retail financial services	4,069.6	72.8	4,069.6	81.2
Commercial loans	897.7	16.1	897.7	17.9
Secured personal loans	576.9	10.3	-	-
Fair value adjustments	47.5	0.8	47.5	0.9
	5,591.7	**100.0**	**5,014.8**	**100.0**

	Group		Society	
	2011		2011	
	£m	%	£m	%
In respect of loans and advances to customers:				
Fully secured by a first charge on residential property	4,032.6	77.2	4,032.6	87.7
Fully secured by a first charge on land	510.7	9.8	510.7	11.1
Fully secured by a second charge on residential property	576.4	10.9	-	-
Partially secured by a second charge on residential property	45.2	1.0	-	-
Fair value adjustments	55.2	1.1	55.2	1.2
	5,220.1	**100.0**	**4,598.5**	**100.0**
Retail financial services	3,630.3	69.5	3,630.3	78.9
Commercial loans	913.0	17.5	913.0	19.9
Secured personal loans	621.6	11.9	-	-
Fair value adjustments	55.2	1.1	55.2	1.2
	5,220.1	**100.0**	**4,598.5**	**100.0**

40. Financial instruments (continued)

c) Credit risk (continued)

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property. The average index linked LTV in respect of the Group's loans secured on residential property including mortgages under offer is estimated to be 63.7% (2011: 62.6%). Index-linked LTV banding is shown below:

	Group		Society	
	2012	**2011**	**2012**	**2011**
	%	%	%	%
Less than 70%	58.4	58.5	62.7	64.1
More than 70% but less than 80%	16.7	17.2	16.3	16.3
More than 80% but less than 90%	13.1	10.9	12.5	10.0
More than 90% but less than 100%	5.9	6.6	4.8	5.2
More than 100%	5.9	6.8	3.7	4.4
	100.0	**100.0**	**100.0**	**100.0**

Collateral values are updated at the date of each statement of financial position based on the best information publicly available. Land Registry data is used in the Retail Financial Services sector with Hometrack being used in the Secured Personal Lending sector. Both indices take account of the geographical location of the collateral. External valuations are used to estimate commercial security values and future cash flows.

The Group provides loans secured on residential property across England, Scotland and Wales and the Society, as a regional building society, has a geographical concentration in Wales. As at 31 December 2012, approximately 31.6% (2011: 34.2%) of retail and secured personal loans exposures by account and 33.5% (2011: 34.9%) by value were concentrated in Wales.

The percentage of retail lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.75% (2011: 0.98%) which compares favourably with the industry average of 1.4% (CML arrears and possession data at 30 September 2012).

Total arrears balances on residential lending fully secured by a first charge were £1.5m (2011: £1.4m) and there are 143 (2011: 140) residential cases six months or more in arrears.

The percentage of secured personal loans currently in arrears by number is 9.25% (2011: 9.38%), which by value is 12.38% (2011: 12.19%).

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		Group	
	2012		2011	
	£m	%	£m	%
Current	4,469.3	96.1	4,072.0	95.9
Past due up to 3 months	116.3	2.5	99.2	2.3
Past due 3 months up to 6 months	23.2	0.5	34.4	0.8
Past due 6 months up to 12 months	16.5	0.4	22.8	0.5
Past due over 12 months	17.3	0.4	17.3	0.4
Possessions	3.9	0.1	6.3	0.1
	4,646.5	**100.0**	**4,252.0**	**100.0**

	Society		Society	
	2012		2011	
	£m	%	£m	%
Current	3,949.9	97.1	3,507.3	96.6
Past due up to 3 months	88.8	2.2	71.8	2.0
Past due 3 months up to 6 months	16.5	0.4	26.7	0.7
Past due 6 months up to 12 months	9.5	0.2	14.9	0.4
Past due over 12 months	0.9	-	3.2	0.1
Possessions	3.9	0.1	6.3	0.2
	4,069.5	**100.0**	**3,630.2**	**100.0**

Based on indexed valuations the total collateral held against lending secured against residential property is estimated to be £10,401.3m (2011: £10,067.6m). Any collateral surplus on the sale of repossessed properties, after a deduction for costs incurred in relation to the sale, would be returned to the borrower. The percentage of the book with a collateral shortfall is reflected in the table on page 82.

The Group holds collateral against loans and advances to residential customers in the form of mortgage interests over property. £5.2m (2011: £7.9m) of collateral is held against possession cases. Repossessed properties are made available-for-sale in accordance with statutory guidelines with proceeds used to reduce or repay the outstanding loan. The Group has a statutory duty to obtain the best reasonable price and to sell as soon as it reasonably can.

Provisions on loans fully secured on residential property is split as follows:

	Group and Society	
	2012	2011
	£m	£m
Retail financial services	7.1	8.1
Secured personal loans	31.0	35.7
	38.1	**43.8**

40. Financial instruments (continued)

c) Credit risk (continued)

Difficult economic conditions have continued throughout 2012. We continue to uphold our mutual values, exploring all reasonable and appropriate account management and forbearance options for borrowers experiencing financial difficulty.

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

Longer-term forbearance options include capitalisation of arrears, interest-only concessions, arrangements to underpay and term extensions. During the year 36 accounts (2011: 204) have been capitalised with balances of £1.5m (2011: £9.0m). Capitalisation of arrears requires a qualifying period, typically six months, or a number of qualifying payments being met prior to the restructure. Any restructure will result in cases being classified and reported as up to date. We extended the term of 485 mortgages (2011: 101) and loans during the year with balances of £26.9m (2011: £4.5m).

Where suitable, the secured personal lending division will agree to release the legal charge on properties which fall into negative equity, thereby facilitating a vendor controlled sale and the achievement of their most advantageous selling price. We may subsequently seek to reach agreement for payment of the unsecured shortfall with the borrowers. There have been 23 (2011: 25) successful cases during the year with balances of £0.9m (2011: £0.8m). Reduced settlement figures have been accepted on six (2011: five) secured accounts with balances of £0.2m (2011: £0.2m).

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

Repossession of a property is the last resort and will only take place once all alternatives have been reviewed and there are no other solutions available. 62 properties were taken into possession during 2012 (2011: 73) with balances of £6.2m (2011: £9.6m). Law of Property Act (LPA) receivers were appointed for 11 (2011: 18) Buy-to-Let properties with balances of £0.9m (2011: £1.6m).

13 (2011: 37) borrowers with balances of £0.4m (2011: £1.4m) were able to remain in their homes under a Mortgage Rescue Scheme and we continue to work with the Welsh Assembly Government, Local Authorities and debt advice agencies in Wales and England to ensure all options are available.

The underlying performance of previous capitalisations, interest-only concessions and arrangements to underpay are reflected in the provisioning methodology and are not individually or collectively material. Provisions of £0.6m (2011: £0.5m) are held in relation to accounts subject to previous forbearance.

	Group and Society			
	2012		2011	
	£m	%	£m	%
Commercial loans – Registered Social Landlords secured on residential property	173.9	19.4	150.9	16.5
Commercial loans – other	723.8	80.6	762.1	83.5
	897.7	**100.0**	**913.0**	**100.0**

Loans secured on commercial property are well diversified by industry type with the largest exposure to one counterparty amounting to £31.5m (2011: £36.9m) or 3.4% (2011: 4.0%) of gross balances. Total arrears balances are £0.4m and there are only 11 commercial cases three months or more in arrears (2011: £0.5m and 11 respectively).

Interest has been suspended on 8 commercial accounts (2011: 9) and amounts to £0.3m (2011: £0.4m) with balances of £7.6m (2011: £15.6m).

The average index-linked loan to value (LTV) in respect of the Group's commercial loans is estimated to be 78.7% (2011: 78.6%). LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/counterparty as well as geographical location.

40. Financial instruments (continued)

c) Credit risk (continued)

The total collateral held against commercial loans is estimated to be £1,419.8m (2011: £1,415.6m). 89.9% (2011: 88.7%) of collateral is categorised as primary or secondary. These internal categorisations of collateral take account of the quality of the property, the quality of the tenant (if tenanted), the terms of the lease and the demand or alternative use for properties of that type. These categorisations are not intended necessarily to reflect whether the property itself is primary, secondary or tertiary.

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

	Group and Society			
	2012		2011	
	£m	%	£m	%
Current	889.2	99.1	898.2	98.4
Past due up to 3 months	1.5	0.2	2.4	0.3
Past due 3 months up to 6 months	0.3	-	1.3	0.1
Past due 6 months up to 12 months	1.3	0.1	5.5	0.6
Past due over 12 months	0.3	-	-	-
LPA Receivers Appointed	5.1	0.6	5.6	0.6
	897.7	**100.0**	**913.0**	**100.0**

Using the commercial credit risk grading system, commercial lending can be distributed as follows:

	Group and Society 2012		Group and Society 2011	
	£m	%	£m	%
Satisfactory	733.1	81.7	822.3	90.1
Watch list	164.6	18.3	90.7	9.9
	897.7	**100.0**	**913.0**	**100.0**

Accounts in the Watch List would typically have persistent arrears, a material covenant breach or other concerns about the likelihood of eventual repayment. For development projects, this would also include the absence of development prospects or a planned exit within an acceptable tolerance of the original timescale.

During the year, the Watch List was expanded to include a 'raised awareness' category. Whilst these accounts are not in default, they are subject to close monitoring and management. For accounts in this category, an action plan has been deemed not necessary to minimise the likelihood and extent of any potential default arising in the future.

In some cases of default, action plans are implemented which may require the granting of a concession involving amendments to the contractual terms of a loan, such as an extension of a maturity, reduction in interest rate or non-enforcement of covenants, recognising that providing such forbearance can often be the best way to avoid default and minimise losses, giving the customer time to take action to improve their situation. Such forbearance activity is always carefully considered with the aim of maximising the benefit and optimising the outcome for both the Group and the borrower. In 2012, 14 (2011: 17) accounts with balances totalling £68.6m (2011: £58.3m) in value were granted forbearance concessions. The potential for losses on these accounts is assessed and considered in the level of overall provisions held against the Commercial Lending portfolio. Provisions of £29.0m are held in respect of commercial loans (2011: £19.3m).

Loans to subsidiaries

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

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40. Financial instruments (continued)

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 principal cash flows payable under financial liabilities, excluding accrued interest and fair value adjustments:

	Total	Undefined maturity	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 2012						
Non-derivative liabilities						
Shares	5,372.8	-	2,830.3	1,080.7	1,461.8	-
Amounts owed to credit institutions, other customers and debt securities in issue	702.8	13.3	163.9	223.8	287.3	14.5
Subordinated liabilities	92.3	-	-	-	92.3	-
Subscribed capital	60.0	-	-	-	-	60.0
	6,227.9	**13.3**	**2,994.2**	**1,304.5**	**1,841.4**	**74.5**
Society						
As at 31 December 2012						
Non-derivative liabilities						
Shares	5,372.8	-	2,830.3	1,080.7	1,461.8	-
Amounts owed to credit institutions, other customers and debt securities in issue	624.5	13.3	166.6	238.7	191.4	14.5
Subordinated liabilities	92.3	-	-	-	92.3	-
Subscribed capital	60.0	-	-	-	-	60.0
	6,149.6	**13.3**	**2,996.9**	**1,319.4**	**1,745.5**	**74.5**
Group and Society						
As at 31 December 2012						
Derivative liabilities						
Interest rate swaps	49.1	-	0.6	3.8	17.2	27.5
Cross currency interest rate swaps	-	-	-	-	-	-
Equity and RPI index-linked interest rate swaps	0.3	-	-	-	-	0.3
	49.4	**-**	**0.6**	**3.8**	**17.2**	**27.8**

The Group's liquidity risk management strategy is outlined in the Risk Management Report on pages 13 to 18.

40. Financial instruments (continued)

d) Liquidity risk (continued)

The balances in the previous 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.

	Total	Undefined maturity	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 2011						
Non-derivative liabilities						
Shares	4,927.8	-	2,322.3	1,230.9	1,374.6	-
Amounts owed to credit institutions, other customers and debt securities in issue	805.0	9.1	289.5	198.4	265.9	42.1
Subordinated liabilities	107.0	-	-	-	107.0	-
Subscribed capital	60.0	-	-	-	-	60.0
	5,899.8	**9.1**	**2,611.8**	**1,429.3**	**1,747.5**	**102.1**
Society						
As at 31 December 2011						
Non-derivative liabilities						
Shares	4,927.8	-	2,322.3	1,230.9	1,374.6	-
Amounts owed to credit institutions, other customers and debt securities in issue	704.6	9.1	275.2	177.3	200.9	42.1
Subordinated liabilities	107.0	-	-	-	107.0	-
Subscribed capital	60.0	-	-	-	-	60.0
	5,799.4	**9.1**	**2,597.5**	**1,408.2**	**1,682.5**	**102.1**
Group and Society						
As at 31 December 2011						
Derivative liabilities						
Interest rate swaps	57.0	-	0.4	4.7	21.9	30.0
Cross currency interest rate swaps	-	-	-	-	-	-
Equity and RPI index-linked interest rate swaps	0.4	-	-	-	-	0.4
	57.4	**-**	**0.4**	**4.7**	**21.9**	**30.4**

40. Financial instruments (continued)

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 £3.4m (2011: £4.5m).

Currency risk

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

41. Related party transactions

The remuneration of the directors (including non-executive directors), who are the key management personnel of the Group, is set out in the Report of the Remuneration Committee on page 31.

Loans to and shares held by directors

There was an aggregate of £0.2m (2011: £0.4m) outstanding at the end of the financial year in respect of secured advances made prior to or during the year to directors.

In so far as it is required under Section 68(1) and Section 68(3) of the Building Societies Act 1986, details of such loans are maintained in a register kept at Principality Buildings, Queen Street, Cardiff, and a statement containing requisite particulars will be available for inspection by Members at the same address for the period of 15 days prior to the Annual General Meeting to be held on 19 April 2013.

As required by the Society's Rules, each director has a share account. The Society's duty of confidentiality to its Members precludes individual disclosure of these details; the aggregate total of deposits held by directors was £0.1m (2011: £0.2m).

Directors' transactions

There were no other transactions with directors during the year.

Transactions with Group companies

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

	Interest received from Society	Interest paid to Society	Fees received from Society	Fees paid to Society	Rent received from Society	Rent paid to Society
	£m	£m	£m	£m	£m	£m
Year ended 31 December 2012						
Nemo Personal Finance Limited	-	15.7	-	0.2	-	-
Peter Alan Limited	-	-	-	-	-	0.2
	-	**15.7**	**-**	**0.2**	**-**	**0.2**
Year ended 31 December 2011						
Nemo Personal Finance Limited	-	16.0	-	0.2	-	-
Peter Alan Limited	-	-	-	-	-	0.2
	-	**16.0**	**-**	**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
	2012	2012	2011	2011
	£m	£m	£m	£m
Nemo Personal Finance Limited	542.8	-	584.8	-
Peter Alan Limited	1.7	-	1.6	-
	544.5	**-**	**586.4**	**-**

Annual Business Statement
for the year ended 31 December 2012

1. Statutory percentages

	At 31 December 2012	At 31 December 2011	Statutory limit
	%	%	%
The lending limit	10.3	11.6	25.0
The funding limit	11.6	14.0	50.0

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

	2012	2011
	%	%
As a percentage of shares and borrowings:		
Gross capital	8.2	8.7
Free capital	8.5	9.0
Liquid assets	17.4	19.1
As a percentage of mean total assets:		
Profit after taxation	0.28	0.27
Management expenses	1.07	1.04

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

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

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

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

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

Annual Business Statement
for the year ended 31 December 2012

3. Directors

Details of directors are contained on pages 19 and 20.

Details of directors' service contracts are included in the Report of the Remuneration Committee on page 31.

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
Julie-Ann Haines
Peter Hughes
Stephen Hughes
Michael Jones
Susan Lane
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:
Andrew Barry

Nemo Personal Finance Limited
Managing Director:
Phillip E. Jones

Glossary

ALCO
Asset and Liability Committee.

Arrears
A customer is in arrears when they are behind in fulfilling their obligations with the result that an outstanding loan payment is overdue. Such a customer can also be said to be in a state of delinquency.

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

Basel III
In December 2010, the Basel Committee on Banking Supervision issued the Basel III rules text, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity. The standards will be phased in gradually from 2013.

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

Buffer eligible liquid assets
Includes high quality debt securities issued by a government or central bank, securities issued by a designated multilateral development bank or reserves in the form of sight deposits with a central bank in an EEA State or Canada, the Commonwealth of Australia, Japan, Switzerland or the United States of America.

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

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

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

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

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

Core Tier 1 capital
Tier 1 capital (see definition below) less permanent interest-bearing shares (PIBS).

Core Tier 1 capital ratio
Core Tier 1 capital as a proportion of risk-weighted assets.

Cost income ratio
A ratio that represents the proportion of management expenses (i.e. administrative expenses, depreciation and amortisation) to total income.

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

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

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

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

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

Credit Valuation Adjustment (CVA)
An adjustment that represents an estimate of the change to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures.

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

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

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

Defined benefit pension scheme
A scheme that defines the benefit an employee will receive on retirement, depending on such factors as age, length of service and salary.

Defined contribution pension scheme
A scheme into which the Group and the employee pay fixed contributions without any further obligation to pay further contributions.

Delinquency
See Arrears.

Glossary (continued)

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

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

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

Euro Medium Term Notes (EMTN)
Euro notes issued by corporates across a range of maturities. EMTNs are frequently issued by corporates under EMTN programmes whereby notes are offered on a regular and continuous basis to investors.

Expected Loss (EL)
A Basel II calculation to estimate the potential losses on current exposures due to potential defaults over a one-year time horizon. It is the product of PD, LGD and EAD.

Exposure
The maximum loss that a financial institution might suffer if a borrower, counterparty or group fails to meet their obligations or if assets and off-statement of financial positions have to be realised.

Exposure At Default (EAD)
A Basel II parameter used to estimate the amount outstanding at the time of default.

FSA
Financial Services Authority. The financial services industry regulator in the UK.

Final salary pension arrangements
A defined benefit pension arrangement where the pension payable to the employee is based on final pensionable salary prior to retirement.

Financial Services Compensation Scheme (FSCS)
The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the FSA is obliged to pay an annual levy, which goes towards its running costs and compensation payments.

Forbearance strategies
Strategies to assist borrowers in financial difficulty, such as extending loan terms, temporarily converting loans to an interest-only basis and agreeing a temporary reduction in payments. Forbearance strategies aim, if possible, to avoid foreclosure or repossession.

Free capital
The aggregate of gross capital and provisions for collective impairment losses on loans and advances to customers less property, plant and equipment and intangible assets.

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

GORC
Group Operational Risk Committee.

GRC
Group Risk Committee.

Gross capital
The aggregate of general reserve, revaluation reserve, available-for-sale reserve, subscribed capital and subordinated liabilities.

Guarantee
An agreement by a third party to cover the potential loss to a credit institution should a specified counterparty default on their obligations.

Individual Liquidity Adequacy Assessment (ILAA)
The Group's own assessment of the levels of liquidity that it needs to meet its current and expected financial obligations. These are assessed under normal and stressed conditions.

Impaired loans
A loan is impaired if there is objective evidence that an impairment event has occurred, and that the event has an impact on the estimated future cash flows of the loan which can be reliably estimated. Impairment may be caused by a single event, or a combination of events. Impairment events include redundancy or marital breakdown.

Impairment allowances
Provisions held against assets on the statement of financial position. The provisions represent management's best estimate of losses incurred in the loan portfolio at the statement of financial position date.

Indexed LTV (Loan to Value)
A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

Individually/collectively assessed impairment allowances
Impairment is measured individually for assets that are individually significant to the Group, and collectively where a portfolio comprises homogenous assets and where appropriate statistical techniques are available. Collective assessment also covers losses that have occurred but are not yet individually identified on loans subject to individual assessment.

Individual Liquidity Guidance (ILG)
Guidance from the FSA on the quantity of a firm's liquidity resources and the firm's funding profile.

Internal Capital Adequacy Assessment Process (ICAAP)
The Group's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements (for credit, market and operational risks) and for other risks including stress events.

International Swaps and Derivatives Association (ISDA) master agreement
A standardised contract developed by ISDA and used to enter into bilateral derivative transactions. The contracts grant legal rights of set-off for derivative transactions with the same counterparty. This reduces the credit risk of the derivatives to the extent that negative values offset positive values.

Glossary (continued)

IPD index
Measures the returns on property investments in the UK.

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

Level 1 fair values
Fair value derived from unadjusted quoted prices in active markets for identical assets or liabilities, e.g. G10 government securities.

Level 2 fair values
Fair value derived from inputs other than quoted prices that are observable for the asset or liability, either directly (i.e. a price) or indirectly (i.e. derived from prices), e.g. most investment grade and liquid bonds, asset backed securities, certain collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and OTC derivatives.

Level 3 fair values
Fair value derived from inputs for the asset or liability that are not based on observable market data (unobservable inputs), e.g. private equity investments, derivatives including an equity element, deposits including an equity element, some CDOs and certain asset backed securities and bonds.

Leverage ratio
As currently proposed under Basel III rules, it is a supplementary measure of risk-adjusted capital requirements, defined as the ratio of Tier 1 capital to total exposures. Total exposures include on and off statement of financial position items (after netting derivatives).

LIBOR
London Inter Bank Offered Rate.

Liquid assets
Cash or other assets that can be readily converted to cash without loss of value.

Liquidity Coverage Ratio (LCR)
As currently proposed under Basel III rules, this is a liquidity metric which aims to ensure that a firm maintains an adequate level of liquidity to meet its needs for a 30-calendar day time horizon under a severe stress scenario.

Liquidity and funding risk
The risk that the Group is not able to meet its financial obligations as they fall due or can secure them only at excessive cost.

Loan to deposit ratio
Represents loans and advances to customers divided by the aggregate of shares, other deposits and amounts due to customers.

Loan To Value ratio (LTV)
A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates residential mortgage LTV on an indexed basis (the value of the property is updated on a regular basis to reflect changes in the house price index (HPI)).

Loans past due/past due loans
Loans are past due when a counterparty has failed to make a payment when contractually due.

Loss Given Default (LGD)
A Basel II parameter used to estimate the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.

Management expenses
The aggregate of administrative expenses, depreciation and amortisation.

Management expense ratio
Management expenses as a proportion of total average assets.

Market risk
The potential losses or decrease in value of the Group statement of financial position as a result of adverse market movements. Specific types of market risk include interest rate risk (banking book), swap spread risk and currency risk.

Maturity
The remaining time in years that a borrower is permitted to take to fully discharge their contractual obligation (principal, interest and fees) under the terms of a loan agreement.

Member
A person aged 18 or over who has a share investment or a mortgage loan with the Society over £100 during the year.

Negative equity mortgages
Negative equity occurs when the value of the property purchased using the mortgage is less than the balance outstanding on the loan. Negative equity is the difference between the current value of the property and the outstanding balance on the loan.

Net interest income
The sum of the amount earned on assets (a combination of retail lending, commercial lending and liquid assets) less liabilities (savings products and borrowings).

Net interest margin
Net interest income as a proportion of total average assets.

Net Stable Funding Ratio (NSFR)
A liquidity ratio, currently proposed under Basel III, to calculate the proportion of long-term assets that are funded by stable, long-term funding sources (customer deposits and long-term wholesale funding).

Non-standard lending
Consists of Buy-to-Let and other non standard mortgages.

Operational risk
The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.

Overnight Indexed Swap rate (OIS)
A rate reflecting the overnight interest typically earned or paid in respect of collateral exchanged. OIS rates are also used to discount collateralised derivative future cash flows to calculate the fair value of collateralised swaps.

Over-The-Counter (OTC)
A bilateral transaction (e.g. derivatives) that is not exchange traded and valued using valuation models.

Own credit adjustment
Adjustment for the effect of the Group's credit standing on the fair value of its financial liabilities. This is sometimes referred to as a debit valuation adjustment.

Permanent Interest-Bearing Shares (PIBS)
Unsecured, deferred shares of the Society that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, creditors and investing members of the Group. Also known as subscribed capital.

Prime residential mortgages
Prime mortgages are mainstream residential loans, which typically have a higher credit quality and fit standard underwriting processes. As such, they are likely to have a good credit history, and pass a standard affordability assessment at the point of origination.

Glossary (continued)

Probability of Default (PD)
A Basel II parameter used to estimate the probability that a borrower will default on their credit obligations in the next 12 months.

Regulatory capital
The capital held by the Group, determined in accordance with rules established by the FSA. The regulatory capital base comprises Tier 1 and Tier 2 capital (see below).

Renegotiated loans
Loans and advances may be renegotiated either as part of an ongoing customer relationship with a creditworthy customer or in response to a borrower's financial difficulties. In the latter case, the renegotiated loan may no longer be treated as past due or impaired if there is no change to the estimated future flows. Individually significant loans whose terms have been renegotiated are subject to ongoing review to determine if they remain past due or impaired.

Repurchase agreement (repo)/Reverse repurchase agreement (reverse repo)
A repurchase agreement that allows a borrower to use a financial security as collateral for a cash loan. In a repo, the borrower agrees to sell a security to the lender subject to a commitment to repurchase the asset at a specified price on a given date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the counterparty to the transaction (buying the security and agreeing to sell in the future) it is a reverse repurchase agreement or reverse repo.

Residential Mortgage Backed Securities (RMBS)
A category of asset backed security that represents interests in a group of residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and/or principal).

Retail loans
Loans to individuals rather than institutions, including residential mortgage lending and consumer banking.

Risk appetite
The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's Members whilst achieving business objectives.

Risk-Weighted Assets (RWA)
The value of assets, after adjustment, under the Basel II capital rules to reflect the degree of risk they represent.

Return On Capital (ROC)
Profit after tax as a percentage of average gross capital (general reserve, revaluation reserve, available-for-sale reserve, PIBS and subordinated liabilities). Profit after tax excludes the interest cost of PIBS and subordinated liabilities.

Securitisation
A process by which a group of assets, usually loans, are aggregated into a pool, which is used to back the issuance of new securities. A company transfers assets to a special purpose entity (SPE) which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities. These securitisation structures use retail mortgages as the asset pool.

Shares
Funds deposited by a person in a retail savings or current account with the Society. Such funds are recorded as liabilities for the Society.

Shares and borrowings
The total of shares, deposits from banks, other deposits, amounts due to customers and debt securities in issue.

Solvency ratio
A component of regulatory capital measuring of the Group's total capital as a proportion of the Group's risk-weighted assets.

Special Purpose Entities (SPE)
Entities that are created to accomplish a narrow and well defined objective. There are often specific restrictions or limits around their ongoing activities. The Group uses SPEs set up under securitisation activities. Where the Group has control of these entities or retains the risks and rewards relating to them they are consolidated within the Group's results. This term is used interchangeably with SPV (Special Purpose Vehicle).

Standardised approach
The basic method used to calculate credit risk capital requirements under Basel II. In this approach the risk weights used in the capital calculation are determined by FSA supervisory parameters. The standardised approach is less risk-sensitive than IRB.

Stress testing
Various techniques that are used by the Group to gauge the potential vulnerability to exceptional but plausible events.

Subscribed capital
See Permanent Interest-Bearing Shares (PIBS).

Subordinated debt/liabilities
A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors and investing Members but before the claims of holders of Permanent Interest-Bearing Shares (PIBS).

Sub prime
Loans to borrowers that typically have weakened credit histories that include payment delinquencies and potentially more severe problems such as court judgements and discharged bankruptcies. They may also display higher risk characteristics as measured by credit scores, or other criteria indicating heightened risk of default.

Standard Variable Rate (SVR)
The rate of interest on which mortgage pricing is based.

Tier 1 capital
A component of regulatory capital comprising general reserves from retained profits, Permanent Interest-Bearing Shares (PIBS), less goodwill, intangible assets and other regulatory adjustments.

Tier 1 capital ratio
Tier 1 capital as a proportion of risk-weighted assets.

Tier 2 capital
A further component of regulatory capital comprising subordinated debt and the collective impairment allowance (for exposures treated on a Basel II standardised basis), less certain regulatory deductions.

Value At Risk (VAR)
A technique that estimates the potential loss that could occur on risk positions as a result of future movements in market rates and prices over a specified time horizon and to a given level of statistical confidence.

Branch Addresses

Principality Building Society
Customer Contact Centre, PO Box 89, Principality Buildings, Queen Street, Cardiff CF10 1UA
Telephone 0330 333 4000 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 (Albany Road)	105/107 Albany Road CF24 3LP	029 2048 7030
CARDIFF (Birchgrove)	95 Caerphilly Road, Birchgrove CF14 4AE	029 2061 5928
CARDIFF (Canton)	174 Cowbridge Road East, Canton CF11 9NE	029 2037 3153
CARDIFF (Llandaff)	36/38 High Street, Llandaff CF5 2DZ	029 2056 3094
CARDIFF (Llanishen)	18 Station Road, Llanishen CF14 5LT	029 2076 4151
CARDIFF (Queen Street)	Principality Buildings, Queen Street CF10 1UA	0845 045 0007
CARDIFF (Rumney)	796 Newport Road, Rumney CF3 4FH	029 2079 4721
CARDIFF (St David's)	39 Town Wall, St David's Centre CF10 2EW	029 2022 7788
CARDIFF (Whitchurch)	21 Merthyr Road, Whitchurch CF14 1DA	029 2062 4537
CARMARTHEN	13 Guildhall Square SA31 1PR	01267 235403
CHESTER	14 Bridge Street CH1 1NQ	01244 323039
COWBRIDGE	28 High Street CF71 7AG	01446 773954
CWMBRAN	Cwmbran Shopping Centre, Cwmbran NP41 1AH	01633 835000
DENBIGH	11 Vale Street LL16 3AD	01745 814549
EBBW VALE	2A The Walk NP23 6AY	01495 305569
FISHGUARD	29 West Street SA65 9AL	01348 873473
GORSEINON	86 High Street SA4 4BL	01792 896389
HAVERFORDWEST	5 Victoria Place SA61 2JX	01437 762147
HEREFORD	2 St. Peter's Square HR1 2PG	01432 273039
LAMPETER	Yr Heol Arad, High Street SA48 7BB	01570 422844
LLANDEILO	40 Rhosmaen Street SA19 6HD	01558 822638
LLANDRINDOD WELLS	Carlton House, Middleton Street LD1 5ET	01597 823511
LLANDUDNO	85 Mostyn Street, Llandudno LL30 2PD	01492 876326
LLANELLI	Unit 13, St Elli Square SA15 1SH	01554 746950
LLANTWIT MAJOR	1 The Precinct CF61 1XA	01446 794238
MAESTEG	139 Commercial Street CF34 9DW	01656 737111
MERTHYR TYDFIL	Beacons Place CF47 8ED	01685 385421
MOLD	39 High Street CH7 1BQ	01352 756345
MONMOUTH	1 Monnow Street NP25 3EF	01600 717038
NEATH	1-3 Green Street SA11 1DR	01639 635316
NEWPORT	33 High Street NP20 1RU	01633 258206
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 (Kingsway)	64-65 The Kingsway SA1 5HW	01792 655791
SWANSEA (Mumbles)	53 Newton Road, Mumbles SA3 4BD	01792 360223
SWANSEA (Morriston)	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 Office Addresses

ABERTILLERY	11 Market Street, NP13 1AH	01495 213958
AMMANFORD	6 High Street, Dyfed SA18 2LY	01269 591884
BALA	87 High Street, Gwynedd LL23 7AG	01678 520495
BARGOED	65 Hanbury Road CF81 8QX	01443 831100
CAERNARFON	17 Y Maes LL55 2NE	01286 674500
CARDIGAN	3 Heathfield, Pendre SA43 1JT	01239 615040
COLWYN BAY	14 Penrhyn Road LL29 8LG	01492 878299
HOLYHEAD	2 Market Buildings LL65 1HH	01407 760500
LLANGEFNI	21 Church Street LL77 7DU	01248 724040
MACHYNLLETH	Maldwyn House, Penrallt Street SY20 8AG	01654 703110
NEWCASTLE EMLYN	College Street SA38 9AJ	01239 710481
PORTHMADOG	103 High Street, Gwynedd LL49 9EY	01766 512011
ROSS ON WYE	8 Broad Street HR9 7EA	01989 763553
TALBOT GREEN	38 Talbot Road CF72 8AF	01443 224000
TREHARRIS	12 Fox Street CF46 5HE	01443 412097
YSTRADGYNLAIS	18 Station Road, Pant Glas SA9 1NT	01639 842013

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