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# THE PRINCIPALITY

CYMDEITHAS ADEILADU • BUILDING SOCIETY

## Principality Building Society

*(incorporated in England and Wales under the Building Societies Act 1986 under no. 455B)*

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**£60,000,000**

**7 per cent. Permanent Interest Bearing Shares**

**Issue Price: 99.232 per cent.**

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Principality Building Society (the “Society”) will issue £60,000,000 7 per cent. Permanent Interest Bearing Shares (the “PIBS”) at an issue price of 99.232 per cent. of their principal amount, comprising 60,000 PIBS of £1,000 each. Application has been made to list the PIBS on the Luxembourg Stock Exchange.

Attention is drawn to the description in “Certain Provisions of the Building Societies Act” on pages 7 to 9 of this document of the ways in which a building society can, without the consent of holders of permanent interest bearing shares, amalgamate with or transfer its rights and obligations to another building society or a company pursuant to the relevant legislation.

It is anticipated that the PIBS will be issued in registered form in the denomination of £1,000. The PIBS will be settled through the CREST System operated by CREST Co Limited (“CRESTCo.”). The PIBS are also eligible for settlement through Clearstream Banking, société anonyme (“Clearstream, Luxembourg”) and Euroclear Bank S.A./N.V., as operator of the Euroclear System (“Euroclear”) (each a “Clearing System” and together the “Clearing Systems”).

The PIBS will be deferred shares in the Society for the purposes of section 119 of the Building Societies Act 1986, as amended, and will not be an investment in respect of which a claim may be entertained by the Financial Services Compensation Scheme established under the Financial Services and Markets Act 2000 (“FSMA”). Attention is drawn to certain characteristics of the PIBS as described in “Risk Factors” on pages 4 to 6 of this document.

The PIBS will not be withdrawable at the option of the PIBS investors and will be repayable only in certain limited circumstances as described in “Special Conditions of Issue of the PIBS – 6 Repayment” on page 14 of this document.

The PIBS are rated Baa1 by Moody’s Investors Services, Inc. and BBB+ by Fitch Ratings Ltd.

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**Barclays Capital**

28 May 2004

*The Society accepts responsibility for the information contained in this document. To the best of the knowledge and belief of the Society (which has taken all reasonable care to ensure that such is the case), the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information.*

*No person is authorised to give any information or to make any representation not contained in this document and any information or representation not contained in this document must not be relied upon as having been authorised by the Society or Barclays Bank PLC (the “**Manager**”). Neither the delivery of this document nor any subscription, sale or purchase made in connection herewith shall, under any circumstances, constitute a representation or create any implication that there has been no change in the affairs of the Society and the Society and its subsidiary undertakings (together, the “**Group**”) since the date of this document.*

*The PIBS have not been and will not be registered under the U.S. Securities Act of 1933 (the “**Securities Act**”), and may not be offered or sold within the United States.*

*This document does not constitute an offer of, or an invitation by or on behalf of the Society or the Manager to subscribe for or purchase, any of the PIBS. The distribution of this document and the offering of the PIBS in certain jurisdictions may be restricted by law. Persons into whose possession this document comes are required by the Society and the Manager to inform themselves about and to observe any such restrictions. For a further description of certain restrictions on offering and sales of the PIBS and on distribution of this document, see “Marketing Arrangements” on page 63 of this document.*

**The information contained in this document is intended for sophisticated investors capable of understanding the nature of the PIBS and the risks attaching to them. There are fundamental differences between the PIBS and ordinary share accounts and deposit products of building societies. A number of these differences significantly increase the risk element involved in investing in the PIBS. Accordingly, attention is drawn to certain characteristics of the PIBS as described in “Risk Factors” set out on pages 4 to 6 of this document.**

*In connection with this issue, the Manager and any person acting for it may each over-allot or effect transactions with a view to supporting the market price of the PIBS at a level higher than that which might otherwise prevail for a limited period. However, there is no obligation on the Manager or any agent of it to do this. Such stabilising, if commenced, may be discontinued at any time, and must be brought to an end after a limited period.*

*In this document, unless otherwise specified or the context otherwise requires, references to “**pounds**”, “**pence**”, “**sterling**”, “**£**” and “**p**” are to the currency of Great Britain and Northern Ireland (the “**United Kingdom**”) and to the “**Building Societies Act**” are to the Building Societies Act 1986 of the United Kingdom, which expression shall include, where applicable, any statutory modification or re-enactment thereof and any statutory instrument, order or regulation made thereunder or under any such statutory modification or re-enactment.*

*Terms used in this document shall, unless otherwise defined in this document, or as the context otherwise requires, have the same meanings as are given to them in the Building Societies Act or, as the case may be, the Rules of the Society (the “**Rules**”) or the Memorandum of the Society (the “**Memorandum**”).*

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## RISK FACTORS

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Investors should be aware that the PIBS are undated and subordinated and that the terms of the PIBS vary considerably from the terms of ordinary share accounts and deposit products of building societies in the United Kingdom. They should particularly note the following characteristics of the PIBS:

### 1. Permanence

The PIBS will be repayable only at the option of the Society on 1 June 2020 and every fifth successive year thereafter, or in certain limited circumstances as described in “Special Conditions of Issue of the PIBS – 6 Repayment” on page 14 of this document, in each case subject to the permission of the statutory authority responsible for regulating building societies in the United Kingdom, which is currently the Financial Services Authority (the “FSA”), which expression shall in this document (except where the context otherwise requires) include any successor body performing for the time being the same or similar functions in relation to building societies (or, in the event that the Society transfers its business to a company under section 97 of the Building Societies Act, companies of that nature) in the United Kingdom. The Society is under no obligation to seek any such permission to repay the PIBS.

### 2. Liquidity

In order to realise its capital investment in the PIBS, an investor must either go to an established secondary market or look to make a private sale. **There is no guarantee that the investor will be able to liquidate its investment in the PIBS** for cash either because the future liquidity of the secondary market is not guaranteed or because the investor may be unable to find any potential private purchasers. Therefore, there is a risk that an investor cannot realise its investment in the PIBS when it wishes to do so.

### 3. Capital value of investment

As the capital value of the PIBS will vary with market interest rates, the market perception of the value of the Society and the availability of purchasers, **there is a real chance that the investor will make a capital loss** when it comes to sell its PIBS.

### 4. Subordination

The PIBS are subordinated to all other liabilities of the Society other than liabilities in respect of other deferred shares. In a winding up or dissolution of the Society, the claims of the PIBS holders will rank behind all other creditors of the Society and the claims of Members holding shares (other than deferred shares) as to principal and interest. Investors should be aware that this subordination is a primary factor behind the higher interest rate that is paid on the PIBS when compared to other investment products of the Society i.e. that there is a direct link between higher interest and higher risk.

### 5. Investor protection

Unlike normal building society investment products, the PIBS are not an investment in respect of which a claim may be entertained by the United Kingdom Financial Services Compensation Scheme.

### 6. Payments of interest may be missed

Interest in respect of the PIBS will not be payable where the directors of the Society resolve that to make payment would result in the Society’s capital falling below prescribed minimum levels and that accordingly such interest should not be paid or where the Society has not paid interest in respect of deposits or shares (other than deferred shares).

### 7. Interest is not cumulative

If the Society does not make an interest payment in respect of the PIBS in accordance with paragraph 6 above, such interest will be cancelled.

## 8. Rights

The rights of the PIBS holders are markedly different from those of shareholders in a United Kingdom company, including in particular, as to voting rights and protection of minorities. For example, as indicated in “Summary of Certain Provisions of the Rules of the Society and the Building Societies Act relating to the PIBS – 6 Meetings” on page 8 of this document, each PIBS holder only has one vote at general meetings of the Society, irrespective of the number of PIBS it holds, whereas shareholders, on a poll at a general meeting of a company, would normally have one vote for each share held.

## 9. Membership rights whilst the PIBS are held through Euroclear and/or Clearstream, Luxembourg Accounts

Any investor may elect that its holding of PIBS be held and transferred through accounts with Euroclear and/or Clearstream, Luxembourg, and not through an account with CRESTCo. Any investors which elect to hold their PIBS through a Euroclear or Clearstream, Luxembourg account will not themselves be entered on the PIBS Register as holder of the relevant PIBS. Instead, the holder entered on the PIBS Register for such PIBS shall be Euroclear and/or Clearstream, Luxembourg’s nominee accountholder with CRESTCo. and the relevant investor’s holding of PIBS will be registered in the internal records of Euroclear and/or Clearstream, Luxembourg.

This means that investors in the PIBS who hold through Euroclear and/or Clearstream, Luxembourg will not themselves be members of the Society and, accordingly, will not be entitled to vote at any general meeting of the Society or in a postal ballot or to any other similar membership rights. Instead the members’ rights attaching to those PIBS which are held through Euroclear and/or Clearstream, Luxembourg will be held by their nominee accountholder with CRESTCo. Such nominee accountholder will be entered in the PIBS Register as the holder of PIBS held in this manner, and will be entitled to exercise the vote attributable to all those PIBS so held.

Given the difficulty of casting that vote in a manner which reflects the views of all the relevant investors and the relative insignificance of that vote in the context of all the votes which may be cast by members of the Society, the nominee accountholder will not exercise that vote.

As investors in the PIBS holding through Euroclear and/or Clearstream, Luxembourg accounts will not be members of the Society they will also not be entitled to any windfall rights (including any rights to windfall payments) arising on a demutualisation of the Society. Any windfall rights arising on a demutualisation of the Society will be passed instead to the Euroclear and/or Clearstream, Luxembourg nominee accountholder with CRESTCo., as the registered holder of the relevant PIBS in the PIBS Register. Any windfall payment made to the Euroclear and/or Clearstream, Luxembourg nominee accountholder arising in respect of a demutualisation of the Society shall be divided equally between such number of investors holding their PIBS through Euroclear and/or Clearstream, Luxembourg accounts and passed through to each investor in accordance with the procedures of the relevant Clearing System. Such amount will therefore vary significantly depending on the number of investors holding their PIBS through Euroclear and/or Clearstream, Luxembourg accounts at the time of the demutualisation and will almost certainly be significantly less than an investor would have received had it been holding its PIBS through an account with CRESTCo.

**For the avoidance of doubt, PIBS held through CRESTCo. confer on their holders full membership rights in the Society, in accordance with the terms of the PIBS.**

## 10. Amalgamation of the Society and transfer of its engagements

If the Society amalgamates with, or transfers all or part of its engagements to, another building society, the PIBS will not become repayable as a consequence thereof, but will become deferred shares in that society. If the Society transfers the whole of its engagements to any other body, the transfer will incorporate arrangements to secure that the PIBS are effectively converted into undated subordinated debt of that body, and do not become repayable other than at the option of that body on 1 June 2020 and every fifth successive year thereafter or in the limited circumstances as described in “Special Conditions of Issue of the PIBS – 6 Repayment”, in each case subject to the permission of the FSA.

## **11. Taxation of Interest**

Because the PIBS will be listed on a recognised stock exchange, interest will be paid without withholding or deduction for tax under current law. Nevertheless, tax may be withheld or deducted if there is a change of law or if the PIBS cease to be listed on a recognised stock exchange.

## **12. The EU Transparency Obligations Directive**

Application has been made to list the PIBS on the Luxembourg Stock Exchange. However, the Society may seek to list the PIBS on an alternative stock exchange outside the European Union in the event that, in the opinion of the directors of the Society, after consultation with the Manager, the proposed EU Transparency Obligations Directive, at such time as it comes into force, and/or application of Regulation (EC) No 1606/2002 on the application of international accounting standards, imposes excessively onerous obligations on the Society.

Investors' attention is also drawn to the information in respect of the Society appearing on pages 21 to 26 of this document.

## SUMMARY OF CERTAIN PROVISIONS OF THE RULES OF THE SOCIETY AND THE BUILDING SOCIETIES ACT RELATING TO THE PIBS

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The rights and restrictions attaching to the PIBS will be governed by the Rules, certain provisions of the Building Societies Act and the “Special Conditions of Issue of the PIBS” (the “**Conditions**”) set out on pages 10 to 18 of this document. Set out below is a summary of the key provisions of the Rules and certain provisions of the Building Societies Act insofar as they might affect the rights of the PIBS holders, together with certain explanatory notes which are italicised. Terms defined in the Rules will, unless the context otherwise requires, have the same meanings when used in this summary.

*For those investors which hold their PIBS through an account with Euroclear and/or Clearstream, Luxembourg, instead of through an account with CRESTCo., such PIBS will be registered in the name of Euroclear and/or Clearstream, Luxembourg’s nominee account holder with CRESTCo., who shall be the PIBS holder for those PIBS for the purpose of the Rules and the Conditions and not the investors holding the beneficial interests in the PIBS through Euroclear and/or Clearstream, Luxembourg. Except to the extent that an investor holding PIBS through Euroclear and/or Clearstream, Luxembourg is a member of the Society in some other capacity, such investors in the PIBS will not directly be bound by the Rules and the Memorandum or by the Act. Investors holding the beneficial interests in the PIBS through Euroclear and/or Clearstream, Luxembourg shall, save in respect of voting rights and demutualisation rights as described in “Risk Factors — 9 Membership Rights whilst the PIBS are held through Euroclear and/or Clearstream, Luxembourg Accounts” on page 5 of this document, be entitled to the same rights as the registered PIBS holder in respect of their beneficial interests, in accordance with the rules of the relevant Clearing System.*

### 1. General

The person whose name is entered in the PIBS Register (as defined in the Conditions) as the holder of PIBS is a Shareholding Member of the Society (as defined in the Rules).

Each PIBS holder (as defined in the Conditions), and all Persons (as defined in the Rules) claiming through him or on his behalf or under the Rules, shall be bound by the Rules and by the Memorandum and, where applicable, the Additional Rules (which are set out in the Rules).

### 2. Register

The Society shall maintain a PIBS Register for the purposes of the PIBS, in which shall be entered the name and address of each PIBS holder. Each PIBS holder shall notify the Society immediately of any change of name or address and shall produce such evidence of such change as the Society may require.

Transfers and other documents or instructions relating to or affecting the title to any PIBS shall also be recorded in the PIBS Register. No charge shall be made in respect of any entry in the PIBS Register. The PIBS Register shall be maintained at the Principal Office, or at such other place as the board of directors of the Society (the “**Board**”) thinks fit.

*The Society has appointed Lloyds TSB Registrars as its registrar for the PIBS issue.*

### 3. PIBS Certificates

Each PIBS holder, within one month after becoming entered in the PIBS Register as the holder of PIBS, shall, if he shall make a written request to the Society at the time of applying to be so entered, be supplied by the Society with a duly executed PIBS Certificate (which shall not be the property of the Society).

Every Person entered into the records of the Society as the holder of PIBS who has not previously requested to be supplied by the Society with a PIBS Certificate shall within one month after making a written request to the Society be supplied by the Society with a PIBS Certificate.

Save as aforesaid, nothing in the Rules requires PIBS to be evidenced by a duly executed PIBS Certificate or other written instrument. PIBS Certificates shall be made available at the offices of the Transfer Agent or Registrar, as the case may be.

#### 4. Replacement of a PIBS Certificate

A PIBS holder losing his PIBS Certificate shall immediately give notice in writing of such loss to the Society at its Principal Office. If a PIBS Certificate is damaged or alleged to have been lost, stolen or destroyed, a new PIBS Certificate representing the same PIBS shall be issued to that PIBS holder upon request, subject to delivery of the old PIBS Certificate or (if alleged to have been lost, stolen or destroyed) subject to compliance with such conditions as to evidence and indemnity as the Board may think fit and to payment of any exceptional expenses of the Society incidental to its investigation of the evidence of such alleged loss, theft or destruction. The new PIBS Certificate will be made available at the offices of the Transfer Agent or the Registrar (as the case may be). Where a holder of a certificated PIBS has sold part of his holding he will be entitled to a PIBS Certificate for the balance without charge.

#### 5. Transfers

A PIBS holder may transfer his PIBS to any Person and no fee shall be charged in respect of a transfer of PIBS. No transfer of PIBS shall be valid unless made in a form approved by the Board and until registered in the PIBS Register. A transferee of a fully paid PIBS shall be entitled to have his name entered in the PIBS Register following notice by him to the Society or Transfer Agent of such a transfer, such notice to be made or given in writing or in such other manner as the Society in its absolute discretion may permit.

The registration of transfers of a PIBS may be suspended at such times and for such periods as the Board may determine, but not for more than thirty days in the year, and notice of such suspension shall be given by advertisement in at least one national daily newspaper.

A fully paid PIBS shall be free from all liens in respect of liabilities to the Society.

Two or more Persons may jointly hold a PIBS. No PIBS shall be issued to the holders, or be held by them at any time, as tenants in common.

The Society may decline to issue any PIBS, or register any transfer of PIBS, to more than four Persons jointly. Joint PIBS holders shall be entitled to choose the order in which they are named in the records of the Society.

#### 6. Meetings

As Members of the Society, the PIBS holders will, subject to the provisions of the Rules, be entitled to receive notice of, to propose resolutions at, to attend, to be counted in a quorum and to vote or appoint a proxy at general meetings of the Society.

A PIBS holder is entitled to vote on a resolution (whether an Ordinary Resolution or Special Resolution or a Shareholding Members' Resolution, but not a Borrowing Members' Resolution) if:

- (a) being an Individual, he is not a minor on the voting date or, where he is voting by proxy, on the date of the meeting at which the resolution is moved; and
- (b) in the case of a joint Shareholding, he is the Representative Joint Shareholder; and
- (c) he was entered in the PIBS Register as the holder of PIBS:
  - (i) at the end of the last Financial Year before the voting date; or
  - (ii) if the voting falls during that part of the Financial Year which follows the conclusion of the Annual General Meeting commenced in that year, at the beginning of the period of 56 days immediately preceding the voting date for Members voting in person at a special general meeting or a postal ballot,  
as the case may be; and
- (d) he has not ceased to be a PIBS holder at any time between the time referred to in (c)(i) and (ii) above (as applicable) and the voting date.

At a general meeting of the Society, each PIBS holder will have one vote regardless of the principal amount of PIBS held by that PIBS holder or whether the PIBS holder is otherwise a Member of the Society.

## 7. Winding up and dissolution

Upon the winding up of the Society, or upon it being dissolved by consent, if there are insufficient assets to repay all Members the amounts paid up on their Shares, no repayments shall be made in respect of any deferred share (including the PIBS) until after all other Members have been repaid in full.

Upon the winding up of the Society, or upon it being dissolved by consent, any surplus remaining after payment in full of the Society's creditors and repayment to Members (including holders of the PIBS) of the amount of their Shares (together with any interest due thereon) according to their priority under their terms and conditions of issue, shall be applied as follows:

- (a) up to 20 per cent. to holders of all or some of the deferred shares in the Society (including the PIBS). The proportion (if any) of such 20 per cent. to which any particular issue of deferred shares (including the PIBS) is entitled shall be set forth in the terms and conditions of issue of that issue of deferred shares (*see note below which describes the way in which the Society has determined the exercise of this discretion*); and
- (b) the remainder among qualifying Members (other than holders of deferred shares (including the PIBS)) in proportion to the value of their Shareholdings.

For the purposes of these provisions of the Rules, “**qualifying Members**” means Persons who hold Shares on the date of commencement of the dissolution or winding-up.

*The Society has determined that, in exercising its discretion regarding the distribution of any surplus on a winding up or dissolution of the Society referred to in sub-paragraph 7(a) above, no proportion of any final surplus will be paid to the holders of PIBS.*

## 8. Disputes and legal proceedings

Subject to the provisions of section 1 of the Courts and Legal Services Building Societies Act 1990, section 85 of and Schedule 14 to the Building Societies Act provide that no court other than the High Court of Justice in England shall have jurisdiction to hear and determine disputes between a building society and a member or a representative of a member in that capacity in respect of any rights or obligations arising from the rules of a building society or the Building Societies Act. Pursuant to section 1 of the Courts and Legal Services Building Societies Act 1990, the High Court and County Courts Jurisdiction Order 1991 No. 724 has been made which empowers the High Court to transfer cases over which it has jurisdiction to the County Court.

## 9. Unclaimed interest

In certain circumstances set out in the Rules, the Society shall be entitled to sell for the best price reasonably obtainable any PIBS in respect of which no interest has been claimed during a period of 12 years. The Society shall be obliged to account (as debtor and not as trustee) to the PIBS holder or any other Person entitled to the PIBS for the net proceeds of sale of the PIBS.

## SPECIAL CONDITIONS OF ISSUE OF THE PIBS

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*The following, save for the paragraphs in italics, are the special conditions of the issue of the PIBS in the form in which they will appear on the reverse of each PIBS Certificate issued in respect of each holding of PIBS (a “PIBS Certificate”):*

The PIBS holders (as defined below) are entitled to the benefit of, are bound by and are deemed to have notice of the Rules (as defined below) of the Society (as defined below). The PIBS (as defined below) are also issued subject to, and with the benefit of, these special conditions of issue (the “**Conditions**”). In the event of inconsistency between the Rules and these Conditions, the Rules will prevail.

*For those investors which hold their PIBS through an account with Euroclear and/or Clearstream, Luxembourg instead of through an account with CRESTCo., such PIBS will be registered in the name of Euroclear and/or Clearstream, Luxembourg’s nominee account holder with CRESTCo., who shall be the PIBS holder for those PIBS for the purposes of the Conditions, and not the investors holding the beneficial interests in the PIBS through Euroclear and/or Clearstream, Luxembourg. Those investors holding the beneficial interests in the PIBS through Euroclear and/or Clearstream, Luxembourg accounts shall, save in respect of voting rights and demutualisation rights as described in “Risk Factors – 9 Membership rights whilst the PIBS are held through Euroclear and/or Clearstream, Luxembourg Accounts” on page 5 of this document, be entitled to the same rights as the registered PIBS holder in respect of their beneficial interests, in accordance with the rules of the relevant Clearing System.*

*For the avoidance of doubt, PIBS held through CRESTCo. confer on their holders full membership rights in the Society, in accordance with the terms of the PIBS.*

### 1. General

- (1) The “**Society**” means Principality Building Society.
- (2) The “**PIBS**” means £60,000,000 7 per cent. Permanent Interest Bearing Shares of the Society and, unless the context otherwise requires, includes any further permanent interest bearing shares issued pursuant to Condition 12 and forming a single series with the PIBS.
- (3) “**PIBS holder**” means a Person whose name and address is entered in the PIBS Register (as defined below) as the holder of PIBS or, in the case of a joint holding of PIBS, the first person whose name is entered in the PIBS Register in respect of the joint holding of the PIBS.
- (4) “**PIBS Register**” means the records of the Society maintained for the purposes of the PIBS.
- (5) “**Registrar**” means Lloyds TSB Registrars or such other registrar appointed by the Society from time to time in respect of the PIBS.
- (6) Terms defined in the Rules of the Society for the time being (the “**Rules**”) will, unless the context otherwise requires, have the same meanings when used in these Conditions.
- (7) The PIBS:
  - (a) are deferred shares for the purposes of section 119 of the Building Societies Act 1986 as amended (the “**Building Societies Act**”);
  - (b) are not protected deposits for the purpose of the Financial Services Compensation Scheme established under the Financial Services and Markets Act 2000;
  - (c) are not withdrawable; and
  - (d) are permanent interest bearing shares for the purposes of the Rules.
- (8) The expressions “**Creditors**” and “**Relevant Supervisory Consent**” shall have the meanings given thereto in Conditions 6(3) and 6(7) respectively.
- (9) Upon a transfer of PIBS by a PIBS holder the Society will procure that the new PIBS holder is issued with a PIBS Certificate within 14 days after the lodgement of the instrument of transfer if the holder wishes to hold PIBS in certificated form. The PIBS Certificate will be made available at the offices of the Registrar or the Transfer Agent (as the case may be).

- (10) A PIBS may be held jointly by up to four persons.
- (11) Rights to Conversion Benefits to which a PIBS holder may become entitled to by reason of his holding of PIBS shall not be required to be assigned to a charity nominated by the Society pursuant to any scheme for charitable assignment established by the Society for the time being. In the event that a holder of PIBS is a Member of the Society other than by reason of its holding in PIBS and has made a declaration to assign any Conversion Benefits to a charity, that assignment declaration shall not apply to Conversion Benefits derived from his holding of PIBS. If there is a conflict between these Conditions and any other provisions for the assignment of Conversion Benefits to which a Member is subject, then these Conditions shall prevail in relation to Conversion Benefits derived from PIBS held by any PIBS holder, whenever the assignment of Conversion Benefits is made. For these purposes, “**Conversion Benefits**” shall mean any benefits under the terms of any future transfer of the Society’s business to a company and if the Society merges with any other building society, “**Society**” shall, after the date of such merger, extend to such other society.

## 2. Form and denomination

The PIBS are in registered form and are available and transferable in accordance with the Rules in amounts and integral multiples of £1,000.

## 3. Registrar, Transfer Agent and Notice Agent

- (1) The Society has appointed Lloyds TSB Registrars as the Registrar under the terms of a Registrar Agreement (the “**Registrar Agreement**”) dated 1 June 2004 and made between the Society and the Registrar. The Society has also appointed Dexia Banque Internationale à Luxembourg, société anonyme as the Transfer Agent in respect of transfers of the PIBS and HSBC Bank plc as the Notice Agent under the terms of an Agency Agreement (the “**Agency Agreement**”) dated 1 June 2004 and made between the Society, the Transfer Agent and the Notice Agent. The Society shall at all times maintain a Transfer Agent in Luxembourg so long as the PIBS are listed on the Luxembourg Stock Exchange.
- (2) The Society shall procure that the Registrar maintains a register for the purposes of the PIBS (the “**PIBS Register**”), in which shall be entered the name and address of each PIBS holder. Each PIBS holder shall notify the Registrar immediately of any change of name or address and shall produce such evidence of change of name or address as the Registrar may reasonably require.
- (3) Transfers and other documents or instructions relating to or affecting the legal title to any PIBS shall be recorded in the PIBS Register. No charge shall be made in respect of any entry in the PIBS Register. The PIBS Register shall be maintained at the principal office of the Registrar or at such other place as the Society and the Registrar shall agree.
- (4) The Registrar or the Transfer Agent shall, on behalf of the Society, issue a certificate in respect of each holding of PIBS (a “**PIBS Certificate**”) to each PIBS holder within 14 days after one is requested.
- (5) No person shall have any right to enforce any term or condition of the PIBS under the Contracts (Rights of Third Parties) Act 1999.

## 4. Transfers

No legal transfer of a PIBS shall be valid unless made in the form endorsed on the PIBS Certificate or in such other form as the Board of Directors of the Society may agree, which form shall be presented to the Registrar or the Transfer Agent. Legal title to the PIBS will pass upon registration of such transfer in the PIBS Register and the Registrar or the Transfer Agent shall on behalf of the Society issue a PIBS Certificate in respect of such holding (which will be made available at the offices of the Transfer Agent or the Registrar, as the case may be).

*Beneficial interests in the PIBS held through accounts with Euroclear and/or Clearstream, Luxembourg will be evidenced by, and transfers thereof will be effected only through, records maintained in book-entry form by Euroclear and Clearstream, Luxembourg in accordance with the applicable procedures of Euroclear and Clearstream, Luxembourg.*

## 5. Interest

- (1) The PIBS bear interest from and including 1 June 2004 to but excluding 1 June 2020 at the rate of 7 per cent. per annum and thereafter at a rate calculated in accordance with Condition 5(2) below (each a “**Rate of Interest**”), in each case payable, subject as set out below, in arrear by equal half-yearly instalments on 1 June and 1 December in each year (each an “**Interest Payment Date**”), commencing on 1 December 2004. Each half-yearly period from (and including) one Interest Payment Date to (but excluding) the next succeeding Interest Payment Date is called an “**Interest Period**”. Interest on the PIBS is non-cumulative.

Where it is necessary to calculate an amount of interest in respect of any PIBS for a period which is not an Interest Period, such interest shall be calculated on the basis of the actual number of days in the period from (and including) the most recent Interest Payment Date (or, if none, 1 June 2004) to (but excluding) the date on which the relevant interest is payable, divided by the product of (a) the actual number of days in the period from (and including) such Interest Payment Date (or, if none, 1 June 2004) to (but excluding) the next (or first) scheduled Interest Payment Date and (b) two.

- (2) (i) The Rate of Interest payable in respect of the PIBS from and including 1 June 2020 in respect of each Reset Period (as defined below) shall be determined by such leading bank or investment banking firm in London as shall be appointed by the Society (the “**Agent Bank**”) on the following basis. On the Determination Date (as defined below) relating to each Reset Period, the Agent Bank shall determine the Gross Redemption Yield (as defined below). The Rate of Interest for the relevant Reset Period shall be the aggregate of 3.00 per cent. per annum and the Gross Redemption Yield for that Reset Period, as determined by the Agent Bank.

In these Conditions:

“**Benchmark Gilt**” means, in respect of a Reset Period, such fixed income United Kingdom government security denominated in sterling having a maturity date on or about the last day of such Reset Period as the Agent Bank, with the advice of the Reference Market Makers, may determine to be appropriate;

“**Determination Date**” means, in relation to any Reset Period, the 45th day prior to the first day of such Reset Period; provided that if such day is not a day on which banks are open for business in London, it shall be postponed to the next such day;

“**Gross Redemption Yield**” means, in respect of a Reset Period, the gross redemption yield (as calculated by the Agent Bank on the basis set out by the United Kingdom Debt Management Office in the paper “Formulae for Calculating Gilt Prices from Yields” page 4, Section One: Price/Yield Formulae “Conventional Gilts; Double-dated and Undated Gilts with Assumed (or Actual) Redemption on a Quasi-Coupon Date” (published 8 June 1998 and as updated on 15 January 2002) on a semi-annual compounding basis (converted to an annualised yield and rounded up (if necessary) to four decimal places) of the Benchmark Gilt in respect of that Reset Period, with the price of the Benchmark Gilt for this purpose being the arithmetic average (rounded up (if necessary) to four decimal places) of each of the bid and offered prices of such Benchmark Gilt quoted by the Reference Market Makers at 3.00 p.m. (London time) on the relevant Determination Date on a dealing basis for settlement on the next following dealing day in London;

“**Reference Market Makers**” means three gilt edged market makers selected by the Agent Bank, failing which such other three persons operating in the gilt edged market as are selected by the Agent Bank;

“**Reset Date**” means 1 June 2020 and every fifth successive year thereafter; and

“**Reset Period**” means the period beginning on and including a Reset Date and ending on and including the day immediately preceding the next succeeding Reset Date.

- (ii) As soon as practicable after 3.00 p.m. (London time) on each Determination Date, the Agent Bank shall determine the Rate of Interest for the relevant Reset Period and calculate the amount of interest payable on each £1,000 principal amount of PIBS (the “**Interest Amount**”) on each of the 10 Interest Payment Dates that fall after the commencement of the Reset Period to which such Determination Date relates. The Society shall cause such Rate of Interest, Reset Period and each such Interest Amount to be notified to the Registrar as soon as practicable after their determination and calculation and shall procure that the Registrar gives notice thereof to the PIBS holders in accordance with Condition 13 and, so long as the PIBS are listed on the Luxembourg Stock Exchange, to the Luxembourg Stock Exchange.
  - (iii) The Society may from time to time appoint any leading bank or investment banking firm in London as the Agent Bank in substitution for any existing Agent Bank. In the event of the appointed office of the Agent Bank being unable or unwilling to continue to act as the Agent Bank, the Society shall forthwith appoint the London office of such other leading bank or investment banking firm in London to act as such in its place. The Agent Bank may not resign its duties or be removed without a successor having been appointed as aforesaid.
  - (iv) All notifications, opinions, advice, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of this Condition 5(2) by the Agent Bank shall (in the absence of wilful default, bad faith or manifest error) be binding on the Society, the Agent Bank, the Registrar, the Transfer Agent, the Notice Agent and all PIBS holders and (in the absence as aforesaid) no liability shall attach to the Agent Bank or the Reference Market Makers in connection with the exercise or non-exercise of their powers, duties and discretions.
- (3) Interest in respect of the PIBS shall not be paid or credited in respect of any Interest Period if the Society has at any time before the date for payment of that interest cancelled, or failed to make, the payment of any interest or dividend upon:
- (a) any other Share of any class (other than deferred shares (as defined in the Building Societies Act)) of the Society; or
  - (b) any Deposit (as defined in the Building Societies Act) with the Society,
- which falls, in accordance with the terms of the Share or Deposit, to be paid or credited at any time before the end of the relevant Interest Period.
- For the purposes of this Condition 5(3):
- (a) where the Society has deferred or suspended or otherwise failed to make any payment it shall be taken to have cancelled and failed to make the payment only for so long as the payment remains outstanding; and
  - (b) a payment is to be taken to fall to be paid or credited in circumstances where it would have so fallen but for any provisions relating thereto entitling the Society to cancel, defer or suspend payment.
- If, and to the extent that, the payment or crediting of interest is prohibited under this Condition 5(3), interest in respect of the PIBS will be cancelled and the PIBS holders will have no rights in respect of the cancelled interest.
- (4) Interest in respect of the PIBS shall not be paid or credited for any Interest Period if the Board is of the opinion that:
- (a) there has been a failure by the Society to satisfy any requirement relating to capital adequacy imposed on the Society by or pursuant to the Financial Services and Markets Act 2000, including any statutory modification or re-enactment thereof, and such failure is then continuing; or

- (b) the payment or crediting of the interest or, as the case may be, the payment or crediting in full of the interest would cause or contribute to such a failure by the Society,

and, in the case of (a) above, the Board passes a resolution cancelling such interest or, in the case of (b) above, the Board passes a resolution cancelling or, as the case may require, reducing the interest to such extent as may be necessary to secure that, in the opinion of the Board, such payment would not cause or contribute to a failure to satisfy the requirement in Condition 5(4)(a). On the passing of any such resolution, the PIBS holder shall cease to have any right to the interest for that period so cancelled or, as the case may be, any interest other than the reduced amount payable in accordance with that resolution.

- (5) Any amount representing principal or interest in respect of which no cheque or warrant has been cashed and no payment claimed shall cease to be payable after twelve years from the due date and shall revert to the Society.

## 6. Repayment

- (1) The PIBS constitute permanent non-withdrawable deferred shares in the Society and have no specified final maturity.
- (2) The Society may, having obtained Relevant Supervisory Consent (as defined in Condition 6(7)) and having given not less than 30 nor more than 60 days' notice to the PIBS holders in accordance with Condition 13 (which notice shall be irrevocable), elect to repay all, but not some only, of the PIBS on any Reset Date (as defined in Condition 5(2)) at their principal amount together, subject to Conditions 5(3) and 5(4), with any interest accrued to but excluding the date of repayment.
- (3) The PIBS will become repayable on the date that an instrument or order is made or an effective resolution is passed for the winding-up or, otherwise than by virtue of section 93(5), section 94(10), section 97(9) or section 97(10) of the Building Societies Act, dissolution of the Society but only if and subject to the condition that all sums due from the Society to Creditors claiming in the winding-up or dissolution have been paid in full.

For the purposes of these Conditions, “**Creditors**” means all creditors (including all subordinated creditors) of the Society and Shareholding Members (other than holders of deferred shares (including the PIBS)) as regards the principal and interest due in respect of their Shares.

- (4) The claims of the PIBS holders in a winding-up or dissolution of the Society will be for the principal amount of their PIBS together, subject to Condition 5, with interest accrued to but excluding the date of repayment after all sums due from the Society to Creditors have been paid in full.
- (5) The Society may, having obtained prior Relevant Supervisory Consent, purchase any of the PIBS. In the case of purchases by tender, tenders shall be made available to all PIBS holders alike.
- (6) All PIBS repaid or purchased by the Society as aforesaid shall be cancelled forthwith and such PIBS may not be reissued or resold.
- (7) For the purposes of these Conditions, “**Relevant Supervisory Consent**” means consent by the Financial Services Authority (or any successor body performing for the time being the same or similar functions in relation to building societies (or, in the event that the Society transfers its business to a company under section 97 of the Building Societies Act, companies of that nature) in the United Kingdom) to the relevant repayment or (as referred to in Condition 6(5)) purchase.

## 7. Payments

All payments in respect of the PIBS will be made by sterling cheque drawn on a bank or building society in the United Kingdom, posted on the business day immediately preceding the relevant due date and made payable to the PIBS holders appearing in the PIBS Register on the Record Date (as

defined below) and made payable to the order of the relevant PIBS holder (which shall be the person appearing in the PIBS Register in respect of the PIBS of which he is the holder at the close of business on the fifteenth day before the relevant due date (the “**Record Date**”)) at the addresses shown in the PIBS Register at the Record Date provided that payments of principal in respect of the PIBS will be made against presentation and surrender of such PIBS at the specified office of the Transfer Agent or the Registrar. Upon application of a PIBS holder to the Society, the Registrar or the Transfer Agent in the form obtainable from the Principal Office of the Society or the specified office of the Registrar or the Transfer Agent, not less than ten days before the due date for any payment, the payment may be made by transfer on the due date or, if the due date is not a business day, on the immediately following business day to a sterling account maintained by the relevant PIBS holder with a bank or building society in the United Kingdom. In this Condition 7, “**business day**” means any day (other than a Saturday or a Sunday) on which banks are open for business in England. All payments in respect of the PIBS shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature (“**Taxes**”) imposed or levied by or on behalf of the United Kingdom or any political subdivision or any authority thereof or therein having power to tax, unless the withholding or deduction of the Taxes is required by law.

*For a description of applicable United Kingdom Taxation Considerations see “United Kingdom Taxation” on page 62.*

*Notwithstanding Condition 7, all payments in respect of interests in PIBS held through Euroclear and Clearstream, Luxembourg accounts will be credited to the cash accounts of Euroclear and Clearstream, Luxembourg accountholders in accordance with each system’s rules and procedures.*

#### **8. Replacement of PIBS Certificates**

A PIBS holder who has lost a PIBS Certificate shall immediately give notice in writing of such loss to the Society at its Principal Office and to the Registrar or the Transfer Agent at its specified office. If a PIBS Certificate is damaged or alleged to have been lost, stolen or destroyed, a duplicate PIBS Certificate shall be issued by the Registrar, on behalf of the Society, to the PIBS holder upon request, subject to delivery up of the old PIBS Certificate or (if alleged to have been lost, stolen or destroyed) subject to compliance with such conditions as to evidence and indemnity as the Registrar may think fit and to payment of any expenses of the Registrar in connection therewith. The duplicate PIBS Certificate will be made available at the offices of the Transfer Agent or the Registrar (as the case may be).

#### **9. Succession and transfers**

(1) Upon an amalgamation by the Society with another building society under section 93 of and Schedule 16 to the Building Societies Act or a transfer of its engagements to any extent to another building society under section 94 of and Schedule 16 to the Building Societies Act, the PIBS shall become deferred shares in the amalgamated or transferee building society (as appropriate) without any alteration in their terms.

(2) Upon a transfer by the Society of the whole of its business to a successor in accordance with section 97 of the Building Societies Act, the successor will, in accordance with section 100(2)(a) of the Building Societies Act, assume as from the vesting date a liability (subject to this Condition 9(2)) to every qualifying Member of the Society as in respect of a deposit made with the successor corresponding in amount to the value of the qualifying Shares held by the Member in the Society.

The liability so assumed by the successor in respect of each PIBS shall be as in respect of a nontransferable subordinated deposit carrying the same rate of interest as the PIBS (each a “**Subordinated Deposit**”).

Each Subordinated Deposit will be applied on the vesting date (or as soon as reasonably practicable thereafter), on behalf of the holder, in the subscription of a principal amount of undated subordinated bonds of the successor ranking behind any undated subordinated debt previously issued by the Society or its successor (the “**Bonds**”) equivalent to the principal amount of the Subordinated Deposit and carrying the same Rate of Interest as the PIBS.

The terms of each Subordinated Deposit and the terms and conditions of the Bonds will be such as to secure in the opinion of the Board that they will be treated as capital designated perpetual subordinated debt (as referred to in Chapter CA of the Interim Prudential Sourcebook for Banks as replaced, amended or supplemented from time to time) or its equivalent (if any) as determined by the auditors of the Society for the purposes of capital adequacy regulations made from time to time by the Financial Services Authority or any successor body performing for the time being the same or similar functions in the United Kingdom in relation to companies of a similar nature.

The terms of the Subordinated Deposits and the terms and conditions of the Bonds will, not later than the time at which notice is given to Members of resolutions to be proposed to approve such transfer, be available for inspection by the PIBS holders at the Principal Office of the Society at that time and, subject as provided above, will be determined by the Board in its absolute discretion.

- (3) The Society undertakes to procure that any amalgamation or transfer referred to in Condition 9(1) or (2) above will comply with the provisions of Condition 9(1) or, as the case may be, (2) above.

#### **10. Variations of these Conditions**

- (1) These Conditions may only be varied by the Society with the consent in writing of the PIBS holders holding not less than three-quarters in principal amount of the PIBS for the time being outstanding or with the sanction of a resolution passed at a separate meeting of the PIBS holders held in accordance with Condition 11.
- (2) The Society undertakes not to initiate any change to the Rules that is both (a) inconsistent with the provisions of these Conditions and (b) materially prejudicial to the interests of the PIBS holders in that capacity.
- (3) These Conditions do not limit the rights of Members to change the Rules.

Any amendment to the Rules that is both (a) inconsistent with the provisions of these Conditions and (b) materially prejudicial to the interests of the PIBS holders in that capacity shall not limit any rights of any PIBS holder to bring an action for breach of contract against the Society in circumstances where the Society is in breach of these Conditions nor afford the Society any defence to any claim made in any such action.

*Notwithstanding Condition 10, investors holding PIBS through Euroclear and/or Clearstream, Luxembourg accounts shall give their instructions in relation to Condition 10 to Euroclear and/or Clearstream, Luxembourg in accordance with each Clearing System's rules and procedures as appropriate.*

#### **11. Meetings of the PIBS holders**

- (1) The Society alone may at any time convene a separate meeting of the PIBS holders. Every meeting shall be held at such place as the Society may approve.
- (2) At least 21 clear days' notice, calculated from the final date for the receipt of proxies under Condition 11(11), specifying the hour, date and place of the meeting shall be given to the PIBS holders entered in the PIBS Register 35 days prior to the date specified for the meeting by sending it by post to the addresses shown in the PIBS Register. The notice shall specify generally the nature of the business to be transacted at the meeting and the terms of any resolution to be proposed to alter these Conditions.
- (3) Any person (who may, but need not, be a PIBS holder) nominated in writing by the Society shall be entitled to take the chair at every meeting but if no nomination is made or if at any meeting the person nominated shall not be present within 15 minutes after the time appointed for holding the meeting, the PIBS holders present shall choose one of their number who is present to be chairman.

- (4) At any meeting one or more persons present in person or by proxy and holding or representing in aggregate not less than one-third of the principal amount of the PIBS for the time being outstanding shall form a quorum for the transaction of business and no business (other than the choosing of a chairman) shall be transacted at any meeting unless the requisite quorum shall be present at the commencement of business. Every question submitted to the meeting (other than the choosing of a chairman which will be decided by a simple majority) shall be decided by a poll of one or more persons present and holding PIBS or being proxies and representing in aggregate not less than three-quarters of the principal amount of the PIBS represented at such meeting voting in favour of such question.
- (5) If within half an hour after the time appointed for any meeting a quorum is not present, the meeting shall stand adjourned for such period, being not less than 14 days nor more than 42 days and at such place as may be appointed by the chairman and if at the adjourned meeting a quorum shall not be present within half an hour from the time appointed for the adjourned meeting, the PIBS holders present in person or by proxy at the adjourned meeting shall be a quorum.
- (6) Notice of any adjourned meeting shall be given in the same manner as notice of an initial meeting but as if 11 were substituted for 21 in Condition 11(2).
- (7) A poll shall be taken in such manner as the chairman directs and the result of the poll shall be deemed to be the resolution of the meeting.
- (8) The chairman may with the consent of (and shall if directed by a resolution of) the meeting adjourn any meeting from time to time and from place to place but no business shall be transacted at any adjourned meeting other than business left unfinished or not reached at the meeting from which the adjournment took place.
- (9) Any director or officer of the Society and its professional advisers may attend and speak at any meeting of the PIBS holders. Save as provided above, no person shall be entitled to attend and speak nor shall any person be entitled to vote at any such meeting unless he is a PIBS holder or is a proxy thereof.
- (10) Subject as provided in Condition 11(9), at any meeting every person who is present shall have one vote in respect of each £1,000 in principal amount of the PIBS so held or in respect of which he is a proxy. Any person entitled to more than one vote need not use all his votes or cast all the votes to which he is entitled in the same way.
- (11) A PIBS holder entitled to attend a separate meeting of the Society:
  - (a) may appoint one Person (whether a PIBS holder or not) as his proxy to attend and, on a resolution, to vote at such meeting instead of him; and
  - (b) may direct the proxy how to vote at the meeting.

A proxy shall be appointed by an instrument in writing which shall be in such form and include such declarations as the Board may from time to time determine. The instrument shall enable the PIBS holder appointing the proxy to direct him how to vote and, if the instrument is not in the form specified by the Society or is not signed by the appointer, the appointment of the proxy shall be invalid. The appropriate forms of declaration shall, with such additional or amended wording as the Board may consider appropriate, be used in the case of a body corporate. If the appropriate declaration is not included in the instrument, the appointment of the proxy shall be invalid. The instrument appointing a proxy or a representative shall be deposited at the Principal Office not less than two clear days before the day appointed for holding the meeting, or adjourned meeting, and in default the instrument shall not be treated as valid. The instrument appointing a proxy shall be deemed to confer authority to demand or join in demanding a poll but, save as provided by this Condition 11(11), a proxy shall have no right to speak at the meeting. A vote given in accordance with the terms of an instrument of proxy shall be valid notwithstanding the previous death or mental disorder of the appointer or revocation of the proxy or of the authority under which the proxy was executed, or the

transfer of a PIBS in respect of which the proxy is given, provided that no intimation in writing of such death, mental disorder, revocation or transfer shall have been received by the Society at its Principal Office before the commencement of the meeting or adjourned meeting at which the proxy is used.

- (12) Any resolution passed at a meeting duly convened and held in accordance with these provisions shall be binding upon all the PIBS holders whether or not present at the meeting and whether or not voting and each of them shall be bound to give effect to the resolution accordingly and the passing of any resolution shall be conclusive evidence of the circumstances justifying the passing of the resolution. Notice of any resolution duly passed by the PIBS holders shall be given in writing to each PIBS holder by the Society within 14 days of the passing of the resolution, provided that the non-publication of the notice shall not invalidate the resolution.
- (13) Minutes of all resolutions and proceedings at every meeting shall be made and duly entered in books to be from time to time provided for that purpose by the Society and any minutes purporting to be signed by the chairman of the meeting at which resolutions were passed or proceedings had shall be conclusive evidence of the matters contained in the minutes and until the contrary is proved every meeting in respect of the proceedings of which minutes have been so made and signed shall be deemed to have been duly held and convened and all resolutions passed or proceedings had to have been duly passed or had.
- (14) The accidental omission to send notice of a separate meeting or to send any document required to be sent with the notice or otherwise before the meeting to, or the non-receipt of notice of a separate meeting or any such document as aforesaid by, any person entitled to receive notices or documents shall not invalidate the proceedings at that meeting.

*Notwithstanding Condition 11, investors holding PIBS through Euroclear and/or Clearstream, Luxembourg accounts shall give their instructions in relation to Condition 11 to Euroclear and/or Clearstream, Luxembourg in accordance with each Clearing System's rules and procedures as appropriate.*

## 12. Further issues

The Society shall be at liberty from time to time without the consent of the PIBS holders to create and issue further permanent interest bearing shares either:

- (a) ranking *pari passu* in all respects (or in all respects save for the first payment of interest thereon) and so that the same shall be consolidated and form a single series with the outstanding permanent interest bearing shares of any series (including the PIBS); or
- (b) upon such other special terms of issue as the Society may at the time of issue determine provided that the Society shall not issue any further permanent interest bearing shares ranking ahead of the PIBS.

## 13. Notices

All notices regarding the PIBS shall be valid if sent by post to the PIBS holders at their respective addresses in the PIBS register. Any such notice shall be deemed to have been given on the second day following the mailing of such notice. In addition, if required by the rules of the Luxembourg Stock Exchange all notices will also be published in a leading newspaper having general circulation in Luxembourg (which is expected to be the *Luxemburger Wort*).

*In addition, in the event that the PIBS are withdrawn from CRESTCo. but held within Euroclear and/or Clearstream, Luxembourg, investors holding PIBS through Euroclear and/or Clearstream, Luxembourg accounts shall receive notices from the Notice Agent for and on behalf of the Society in accordance with each Clearing System's rules and procedures as appropriate.*

## 14. Governing law

The rights and obligations in respect of the PIBS are governed by, and shall be construed in accordance with, English law.

### **Amalgamation**

Section 93 of the Building Societies Act permits a building society to amalgamate with one or more building societies by establishing a building society as their successor. Amalgamation requires a shareholding members' resolution passed by the shareholding members of each amalgamating society and by a borrowing members' resolution (as defined in Schedule 2 to the Building Societies Act) of the borrowing members of each amalgamating society and confirmation by the FSA. The Building Societies Act provides that on the date specified by the FSA all of the property, rights and liabilities (which, in the case of the Society, would include the PIBS) of each of the societies shall by virtue of the Building Societies Act be transferred to and vested in the successor, whether or not otherwise capable of being transferred or assigned. In the event of a transfer of all or part of the property and/or all or some of the liabilities (including the PIBS) of the Society, the PIBS would, pursuant to their terms, become deferred shares in the transferee without any alteration of their terms.

### **Transfer of Engagements**

Section 94 of the Building Societies Act permits a building society to "transfer its engagements to any extent" to another building society which undertakes to fulfil such engagements. A transfer requires approval by a shareholding members' resolution passed by the shareholding members of the transferor society and the transferee society, and by a borrowing members' resolution of the borrowing members of the transferor society and the transferee society. However, the resolutions of the transferor society and transferee society are not required if the FSA consents to the transfer proceeding by a resolution of its board of directors only. The transfer must be confirmed by the FSA. The Building Societies Act provides that on the date specified by the FSA and to the extent provided in the instrument of transfer, the property, rights and liabilities of the transferor society shall by virtue of the Building Societies Act be transferred to and vested in the transferee society, whether or not otherwise capable of being transferred or assigned. In the event of a transfer of all or part of the property and/or all or some of the liabilities (including the PIBS) of the Society, the PIBS would, pursuant to their terms, become deferred shares in the transferee without any alteration of their terms.

### **Transfer of Business**

Sections 97 to 102D of the Building Societies Act permit a building society to transfer the whole of its business to a company which has been specially formed by the society wholly or partly for the purpose of assuming and conducting the society's business in its place or is an existing company which is to assume and conduct the society's business in its place. The transfer must be approved by a requisite shareholding members' resolution, in accordance with Schedule 2, paragraph 30(2)-(5) of the Building Societies Act, passed by shareholding members and by a borrowing members' resolution passed by borrowing members and the society must obtain the confirmation of the FSA to the transfer and its terms. If the FSA confirms the transfer then the Building Societies Act provides that on the vesting date (as defined in the Building Societies Act) all of the property, rights and liabilities (which would include the PIBS) of the transferor society, whether or not capable of being transferred or assigned, shall by virtue of the Building Societies Act and in accordance with the transfer regulations (then in force) be transferred to and vested in the company. Pursuant to section 100(2)(a) of the Building Societies Act, the PIBS would be converted into deposits with the successor. The terms of the PIBS provide that the deposits will be subordinated and will be applied in the subscription of perpetual subordinated bonds of the successor subject as provided therein.

Where, in connection with any transfer by a building society, rights are to be conferred on members of the society to acquire shares in priority to other subscribers, the right is restricted to investing members of the society who have held their shares throughout the period of two years expiring on a qualifying day specified by the society in the transfer agreement. Also, all investing members' shares, including PIBS, are converted into deposits with the successor. On any such transfer, investing members of the society who were members on the qualifying date but not entitled to vote on the transfer resolution will receive a cash bonus equal to

their notional share of the reserves of the society. If the transfer is to an existing company, any distribution of funds (apart from the statutory cash bonus referred to above) may only be made to certain investing members of the society who have held their shares for at least two years expiring on a qualifying day specified by the society in the transfer agreement.

The Society may, as a result of an amalgamation, transfer of engagements or transfer of business as described above, be replaced, as the principal debtor under all or some of the PIBS, by an entity substantially different in nature from the Society at present or with a substantially different capital position. In all cases the confirmation of the FSA is required before any such change can take place.

### **Introduction and Constitution**

The Society was incorporated in England and Wales for an unlimited duration under the Building Societies Act 1874 as the Principality Permanent Benefit Building Society. It adopted its present name in 1913. It operates under the Building Societies Act and the Memorandum and Rules of the Society. It is an authorised building society under FSMA and is registered as an authorised building society with, and supervised by, the FSA.

The affairs of the Society are conducted and managed by a Board of Directors who are elected and serve in accordance with the Society's Memorandum and Rules. The Board is responsible to the members of the Society for the proper conduct of affairs of the Society, and a Management Board, which reports to the Board, is responsible for the daily management of the Society.

The principal purpose of the Society as stated in Clause 3 of its Memorandum is that of making loans which are secured on a residential property and are funded substantially by its members. The Group also raises funds in the wholesale money markets. It is an independent regionally based building society with a strong commitment to mutuality. Reflecting this commitment to mutuality, the Society introduced a charitable assignment scheme in June 2000 to reduce disruption to its business caused by speculators opening investment accounts in the hope of receiving a windfall conversion benefit. The PIBS are excluded from the charitable assignment scheme.

As the Society is a mutual organisation, both retail investors and borrowers with the Society have membership rights including rights to vote at general meetings of the Society as prescribed by the Society's Rules. Their eligibility to vote at general meetings is governed by the Building Societies Act and by the Society's Rules. Members are eligible to vote as an investor or borrower or both, but are only entitled to one vote except where there are separate shareholding members' and borrowing members' resolutions.

### **Business and Strategy of the Society**

The Society's core business is the making of mortgage advances to members secured on residential property, funded out of shares and deposits subscribed by members supplemented by funds raised in the wholesale money markets. The Society's strategy for its core business is to differentiate itself from its competitors by building its brand to reflect a business built on long term relationships with members, rather than a commodity price driven transactional model.

Alongside its core business the Society's strategy is to build a portfolio of new businesses within the Group broadly related to its core, in order to utilise its central competencies to create additional value for members.

As at 31 December 2003, 92.4 per cent. of business assets (as prescribed by Sections 6 and 7 of the Building Societies Act) were in the form of loans fully secured on residential properties. At the same date, funding from members represented 85.6 per cent. of all shares and borrowings of the Society.

In 2002 the Society began a forward looking programme to assess its current and future capability in a rapidly evolving marketplace for its core activity. A three year plan was created to build a programme of change to modernise the Society, in particular building new channels to market, using the innovative application of technology. The Society's future strategy will focus heavily on members, seeking to understand their needs and deliver solutions to create a service-based, rather than a product-based, relationship with them. The Society's investment in technology and marketing is enabling it to understand better its existing customer base as a prerequisite to building such long term relationships with its members.

The Society has significant opportunity to secure further organic growth within its core territory in Wales and the Welsh borders, where long-term member relationships can be built face to face on the high street. The Society is committed to its branch network, with an investment programme agreed to open new branches and relocate and refurbish others where necessary. The Society currently raises the great majority of its retail funds and makes at least half of its mortgage lending within its core territory.

The Society aims to continue to develop its presence in its core territory and offer tangible support to the community there, through sponsorship programmes. Whilst concentrating on opportunities in its core territory, the Society will also continue to develop business through appropriate distribution channels outside its core territory.

## **Mortgage Lending**

The Group's mortgage lending activity consists mainly of the making of loans to individuals for the purchase or re-mortgage of residential property, secured by a first legal charge over the property. At 31 December 2003, loans fully secured on residential property amounted to approximately £2.6 billion, comprising 92.5 per cent. of all loans and advances to members and customers. Of the Group's total residential mortgage loan portfolio at 31 December 2003, 27.5 per cent. was at fixed or capped interest rates, 23.1 per cent. was linked to the Bank of England base rate, and 32.8 per cent. at discounted administered variable rates, with the remainder on administered variable rates. Residential Mortgage products are distributed through a number of channels, including the Society's branch network, direct telephone links, as well as intermediaries.

At 31 December 2003, the Group also had loans of approximately £0.2 billion secured on commercial property. During 2002 the Board made a decision to expand its commercial lending activity to better balance the Society's overall portfolio, and exploit a known business opportunity.

Lending is conducted in accordance with Board approved lending policy statements drawn up in compliance with the Interim Prudential Sourcebook for Building Societies published by the FSA. Within the agreed policy parameters, care, prudence and control are exercised by experienced underwriting staff to ensure that the quality of lending is maintained. Despite increasing market pressures in recent years, the Society has not relaxed its underwriting criteria with the fundamental pre-requisite for new mortgages continuing to be the perceived ability of the borrower to repay.

Appropriate Excess of Loss Insurance cover is arranged for each year of lending. The scope of cover relates to primary residential mortgage advances to individuals with loan to value ("LTV") ratios of more than 75 per cent. The cover provides for the Society to bear the first part of any losses (this amount is directly related to the volume of new lending business) with the insurance policy then providing cover against further losses incurred during a specified period. In the minority of cases where the LTV ratio exceeds 90 per cent. (primarily for first time buyers), the Society recoups the cost of the Excess of Loss Insurance through an additional fee charged to the borrower.

## **Arrears and Loan Loss Provisions**

The Society reports on mortgage arrears for regulatory purposes where arrears on the account represent 2.5 per cent. or more of the mortgage balance outstanding. As at 31 December 2003 only 0.68 per cent. of all mortgage advances had arrears of 2.5 per cent. or more of the balance outstanding.

These arrears have reduced significantly over recent years, in part reflecting the effectiveness of the Society's ongoing commitment to proactive arrears management.

The amount of actual loss arising from default on mortgage advances in the year ended 31 December 2003 was £0.2 million. In that year the provision for potential future losses on default was increased by £1.3 million to create carried forward provisions for bad and doubtful debts of approximately £3.0 million at 31st December 2003, of which approximately £2.6 million represented a general provision. In addition to the provision for bad and doubtful debts the Society defers part of the initial income attributable to loans above 75 per cent. LTV and, save to the extent that it is required to absorb default losses on such lending, the deferred income is released to revenue over a period. The amount held as deferred income at 31 December 2003 was £10.8 million (2002: £10.6 million)

The number of mortgage accounts 12 months or more in arrears at 31 December 2003 was 22. The number of properties in possession at the end of 31 December 2003 was 18.

## Other Income

In addition to net interest receivable, the Group has other sources of income which, for the last two financial years, can be analysed as follows:

	2003	2002
	<i>£m</i>	<i>£m</i>
Estate agency fees	7.3	6.8
Commission earned on life insurance products	2.1	3.6
Commission earned on general insurance products	3.6	5.9
Rents	1.1	1.4
Other fees and commissions (net)	0.1	(0.2)
	<u>14.2</u>	<u>17.5</u>

The Society entered the estate agency sector in 1987 by purchasing existing agencies. The estate agency subsidiary Peter Alan currently operates a chain of 25 branches in South Wales and opportunities for new offices and re-locations are kept under regular review. The business has been profitable for each of the last three years and has been a major source of mortgage business for the Society.

Peter Alan has applied to the FSA for direct authorisation under the new regulatory regimes for mortgages and for general insurance, commencing 31 October 2004 and 15 January 2005 respectively.

The Society is currently tied with Norwich Union Marketing Group for the distribution of that institution's investment products.

The Society also markets a range of general insurance products related to residential properties and to the protection of borrowing members.

## Liquidity

The Society, in common with other building societies, is required by the FSA, in accordance with the Interim Prudential Sourcebook for Building Societies, to maintain adequate assets in the form of cash or other liquid form. The classes of instrument which may be treated by the Society as liquid assets for these purposes are prescribed by the FSA, and include cash balances, advances to credit institutions and certain debt securities.

The Group's liquid assets for these purposes stood at £688.4 million at 31 December 2003, representing approximately 20.5 per cent. of the total shares and borrowings of the Group at that date.

In addition the Society maintains standby liquid facilities with a range of credit institutions (amounting to £173 million at 31 December 2003).

## Group Funding

The Society's activities are funded through a mixture of retail and non-retail funding. The proportion of retail to non-retail funds varies from time to time depending on market conditions. At 31 December 2003 the Group's total share and deposit liabilities ("SDL") were £3.35 billion of which retail balances amounted to £2.88 billion, representing 85.6 per cent. of SDL as at that date.

## Retail Funding

The Society offers its members and potential members a range of investment products covering both fixed and variable rates and varying notice periods. Up to the present time the majority of the Society's retail funding has been obtained through the branch network. The remainder have been derived from direct contact with members through the Society's head office as a result of advertising and marketing activities. In 2003 the Society achieved a net increase in retail savings balances of £196.3 million, the majority being secured in the first half of that year.

## Non-Retail (Wholesale) Funding

The Society is an active participant in the wholesale money markets. The Society increased its non-retail funding by a total of £278.7 million in 2003. The Society transacts with a range of counter-parties, benefitting in these activities from its credit rating.

## Capital Base

At 31 December 2003 the consolidated gross and free capital ratios of the Group, as calculated for the purposes of the Building Societies (Accounts and Related Provisions) Regulations 1998, were as follows:

	%
Gross capital ratio	5.95
Free capital ratio	5.06

Other capital ratios at 31 December 2003 are set out below:

Total capital (i) as a percentage of risk weighted assets (ii)	11.48
Tier 1 capital (iii) as a percentage of risk weighted assets	11.32

For the purpose of these capital ratios:

- (i) "Total capital" represents the aggregate of Group general reserves, subordinated liabilities and general provisions for bad and doubtful debts;
- (ii) "Risk weighted assets" represent Group assets weighted according to risk category as stated in Annex 1B of the Interim Prudential Sourcebook for Building Societies issued by the FSA; and
- (iii) "Tier 1 Capital" represents Group general reserves.

## Subsidiaries

The following are the principal operating subsidiaries of the Society:

<i>Name of Subsidiary</i>	<i>Principal Activity</i>	<i>Country of Registration</i>	<i>Interest of the Society</i>	<i>Class of Shares Held</i>
Peter Alan Limited	Estate agency and financial services	England and Wales	100%	Ordinary and preference
Principality Mortgage Corporation Limited	Secured lending on land and buildings	England and Wales	100%	Ordinary

## Directors and Employees

### *The Directors*

At the date of this circular the Society has nine directors, comprising six non-executive directors and three executive directors who are the Society's most senior executives. Brief details of the directors are set out below:

#### *D. Peter L. Davies DL FCA LL D (Wales) (Hon) Chairman (Aged 66)*

Background in accountancy and finance having been a partner in KPMG and a director of the Wales subsidiary of N M Rothschild & Sons Limited. Also spent a period as Finance Director of a listed manufacturing company. Became non-executive Chairman in 2000, having been appointed a director in 1989. Chairs the Remuneration and Nominations Committees and is a member of the Commercial Lending Asset Management Committee.

#### *David R. Gibbard MBE MA MSc Deputy Chairman (Aged 61)*

Formerly commercial director then operations director of South Wales Electricity plc. He is also a non-executive director of Teesside Power Limited. Became non-executive Deputy Chairman of the Society in 2000 having been appointed a director in 1993. He chairs the subsidiary, Peter Alan Limited, and is a member of the Remuneration and Nominations Committees.

#### *Peter L. Griffiths ACIB Chief Executive (Aged 45)*

Joined the Society in December 2001 and became Chief Executive in March 2002. He was appointed a director from 2 January 2002. Prior to joining the Society he was a senior executive with National Westminster Bank PLC having at one point been that bank's Director of Retail Banking for Wales. He has extensive experience in Commercial Lending.

He is Chairman of the Commercial Lending Asset Management Committee and a member of the Asset and Liability Committee.

*W. Guy Thomas BSc (Hons), ACA, FCT, C.Dir, Finance Director (Aged 48)*

Joined the Society as Finance Director on 1 November 2003 having been a Finance Director of two other Building Societies in a career in financial services spanning twenty years. He is the Chairman of the Asset and Liability Committee and a member of the Commercial Lending Asset Management Committee.

*Margaret S. Foster OBE BA MSc CIHM FIHM (Aged 52)*

Appointed a non-executive director on 1 November 1999. She is Chief Executive of the Pontypridd & Rhondda NHS Trust, and a Governor of the University of Glamorgan. She is a member of the Remuneration and Nominations Committees.

*Eurfyl ap Gwilym BSc PhD (Aged 59)*

Appointed a non-executive director on 9 June 2000. Prior to his retirement from executive duties he was chief executive of a listed company engaged in the Information Technology sector. He is currently a non-executive director of two other companies. He is a member of the Audit and Nominations Committees.

*David B. Williams (Aged 63)*

Formerly Chief Executive of the Bank of Wales, he was appointed a non-executive director on 1 November 2000. He is currently a director of the Welsh Development Agency and two other companies. He is chair of the Audit Committee, and a member of the Commercial Lending Asset Management and Nominations Committees.

*Haydn Warman LLB, Director of Operations (Aged 54)*

A solicitor by profession he joined the Society as Assistant General Manager in 1985, was appointed Secretary in 1994 and also Director of Operations in 2002. He was appointed a director on 1 October 2002. He is a member of the Commercial Lending Asset Management Committee and is a member of the Asset and Liability Committee.

*Gwyneth V. Burr BSc (Hons) (Aged 41)*

A professional marketing executive, she currently runs a consultancy specialising in that discipline. Was previously an executive with Asda plc fulfilling senior roles in retail management, marketing and financial services. Appointed a non-executive director on 24 March 2003. She is a member of the Nominations Committee.

## Management Board

Peter L. Griffiths ACIB	Chief Executive
W. Guy Thomas BSc (Hons), ACA, FCT, C.Dir.	Finance Director
Haydn Warman LLB	Director of Operations
Brian Kultschar BSc (Econ) FIPD	Director of Personnel
William Mayne BA (Hons) MCIM ANEA	Director of Marketing and Distribution
Michael McGuire MA (Cantab) ACII	Director of Business Development
John Williams	Director of IT
Chris McVeigh ACII	Managing Director of Peter Alan Limited
Julie Evans	Head of Retail Network
Neil Andrews	Head of Direct Channels
Robin Matthews BA(Hons)	Head of e-Commerce and Strategic Planning
Neil Pritchard ACII FLIA (dip) ASFA	Head of Financial Services
Jayne Robinson Dip M, MA (Oxon)	Head of Marketing

## Employee Numbers

During the year to 31 December 2003, the Group employed an average of 620 full time and 130 part time employees. For the financial year ended 31 December 2002 the corresponding figures were 525 full time and 112 part time employees. This increase in employee members is attributable to the investments made by the Society in providing higher service levels for members.

## Certain Provisions of the Rules relating to the Directors

The Rules contain, *inter alia*, the following provisions in relation to the Directors.

Except in certain circumstances, including a resolution of the Board to determine the annual remuneration of the Directors, no Director may vote as a Director in regard to any contract, or proposal for a contract, in which he is interested, whether directly or indirectly, or upon any matter arising out of it. If he shall so vote, his vote shall not be counted nor shall he be counted in any quorum when any such contract, or proposal for a contract, is under consideration.

All powers of the Society to borrow money are exercisable by the Directors.

The Board may determine from time to time the annual remuneration of the Directors as members of the Board (exclusive of any remuneration paid in respect of executive duties) which shall be paid at a rate not exceeding 3p per £100 of total assets of the Society as at the first day of the financial year in which payment is made, together with such reasonable travelling, accommodation and other expenses as might be incurred while attending business of the Society with the approval of the Board.

The Board may also resolve that a Director may be paid for professional or other work done by him on behalf of the Society in addition to his usual services as a Director. The Board may provide, establish, maintain and administer pension, life assurance, sickness, annuity and other funds schemes (whether contributory or not) for the benefit of past, present or future executive directors of the Society and any society with which the Society may merge in the future and their spouses, children and dependents. In addition, the Board may grant pensions, allowances, gratuities, donations and bonuses to such persons.

A Director shall cease to hold office upon the conclusion of the annual general meeting next following the date at which he attains 70 years of age.

## CAPITALISATION AND INDEBTEDNESS

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The following table is a summary of the Consolidated Shareholders' Funds and Indebtedness of the Group as shown in the Consolidated Balance Sheet as at 31 December 2003, being the date of the Society's most recent audited financial statements, unadjusted for the proposed issue of the PIBS:

	<i>Group £m</i>
<b>Shareholders' funds</b>	
Share accounts	2,882.5
Subscribed capital	—
General reserves	199.3
Total shareholders' funds	<u>3,081.8</u>
<b>Other indebtedness</b>	
Amounts owed to credit institutions	24.5
Amounts owed to other customers	395.5
Debt securities in issue	48.3
Accruals	1.0
Total indebtedness	<u>469.3</u>
Total capitalisation and indebtedness	<u>3,551.1</u>

Save for the proposed issue of the PIBS, there has been no material change to the consolidated capitalisation and indebtedness of the Group since 31 December 2003.

## GROUP FINANCIAL STATEMENTS

The information on pages 28 to 30 has been extracted without material adjustment from figures appearing in the Annual Report and Accounts of the Society for the year ended 31 December 2003.

### Consolidated Income and Expenditure Accounts

	<i>Notes</i>	<i>2003</i> <i>£m</i>	<i>2002</i> <i>£m</i>
Interest receivable and similar income	3	150.7	139.2
Interest payable and similar charges	4	(106.3)	(104.3)
Net interest receivable		<u>44.4</u>	<u>34.9</u>
Fees and commissions receivable		17.8	19.9
Fees and commissions payable		(4.7)	(3.8)
Other operating income		<u>1.1</u>	<u>1.4</u>
Total net income		<u>58.6</u>	<u>52.4</u>
Administrative expenses	6	(35.3)	(26.8)
Depreciation and amortisation	18	(3.3)	(3.2)
Provisions for bad and doubtful debts	16	(1.3)	(0.8)
Profit on ordinary activities before tax		<u>18.7</u>	<u>21.6</u>
Tax on profit on ordinary activities	10	(5.9)	(6.7)
Profit for the financial year		<u>12.8</u>	<u>14.9</u>
<b>Statement of Consolidated Total Recognised Gains and Losses</b>			
Profit for the financial year		12.8	14.9
Actuarial loss recognised in the pension scheme		(2.0)	(8.1)
Movement in deferred tax relating to pension scheme		0.5	2.1
Current tax relating to pension liability		<u>0.1</u>	<u>0.3</u>
Total recognised gains for the year	27	<u>11.4</u>	<u>9.2</u>
Prior year adjustment	27	<u>—</u>	<u>(1.9)</u>
Total gains recognised since last annual report		<u>11.4</u>	<u>7.3</u>

There is no difference between the profit on ordinary activities before tax and the profit for the financial year as stated above, and their historical cost equivalents.

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

## Consolidated Balance Sheet

	<i>Notes</i>	<i>2003</i> <i>£m</i>	<i>2002</i> <i>£m</i>
<b>Assets</b>			
Liquid assets:			
Cash in hand and balances with the Bank of England		4.4	3.8
Loans and advances to credit institutions	11	73.2	58.2
Debt securities	12	610.8	548.6
		688.4	610.6
Loans and advances to customers:			
Loans fully secured on residential property	13	2,639.7	2,344.2
Other loans fully secured on land	14	215.1	99.9
	15	2,854.8	2,444.1
Tangible fixed assets	18	32.8	31.5
Other assets	19	1.0	1.2
Prepayments and accrued income	20	1.2	0.9
<b>Total assets</b>		<b>3,578.2</b>	<b>3,088.3</b>
<b>Liabilities</b>			
Shares	21	2,882.5	2,686.2
Borrowings:			
Amounts owed to credit institutions	22	24.5	17.8
Amounts owed to other customers	23	395.5	143.6
Debt securities in issue	24	48.3	28.2
		468.3	189.6
Other liabilities	25	14.9	14.0
Accruals		5.0	3.7
Provisions for liabilities and charges	26	0.7	0.6
Net pension liability	9	7.5	6.3
General reserves	27	199.3	187.9
<b>Total liabilities</b>		<b>3,578.2</b>	<b>3,088.3</b>

These Accounts were approved by the Board on 23 January 2004.

Signed on behalf of the Board.

D. Peter L. Davies	Chairman
Peter L. Griffiths	Chief Executive
W. Guy Thomas	Finance Director

## Consolidated Cashflow Statement

	2003 £m		2002 £m
Net cash inflow from operating activities (see below)	97.4		123.6
Taxation	(6.4)		(6.9)
Capital expenditure and financial investment:			
Purchase of tangible fixed assets	(5.2)		(4.0)
Disposal of tangible fixed assets	0.6		0.2
Purchase of investment securities	(2,388.8)		(940.0)
Sale and maturity of investment securities	2,326.6		839.6
Increase in cash (see below)	<u>24.2</u>		<u>12.5</u>
<b>Reconciliation of operating profit to net cash inflow from operating activities</b>			
Profit on ordinary activities before tax	18.7		21.6
(Increase)/decrease in prepayments and accrued income	(0.3)		0.2
Increase/(decrease) in accruals	1.3		(0.1)
Provision for bad and doubtful debts and deferred income	1.3		0.8
Loans and advances written off net of recoveries	—		0.7
Depreciation and amortisation	3.3		3.2
Profit on sale of tangible fixed assets	—		—
Net cash inflow from trading activities	<u>24.3</u>		<u>26.4</u>
Increase in loans and advances to customers	(412.0)		(266.2)
Increase in shares	196.3		453.2
Increase/(decrease) in deposits and other borrowings	278.7		(108.2)
Decrease in loans and advances to credit institutions	8.6		18.0
Decrease in other assets	0.2		0.6
Increase/(decrease) in other liabilities	1.3		(0.2)
Net cash inflow from operating activities	<u><u>97.4</u></u>		<u><u>123.6</u></u>
	At		At
	31 December	Net	31 December
	2002	Movement	2003
	£m	£m	£m
<b>Analysis of cash balances</b>			
Cash in hand and balances with the Bank of England	3.8	0.6	4.4
Loans and advances to credit institutions repayable on demand	<u>29.2</u>	<u>23.6</u>	<u>52.8</u>
	<u><u>33.0</u></u>	<u><u>24.4</u></u>	<u><u>57.2</u></u>

The Group is required to maintain interest free balances with the Bank of England which at 31 December 2003 amounted to £3.1 million (2002 – £2.6m).

## NOTES TO THE ACCOUNTS

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The following are notes to the accounts as extracted from the Annual Report and Accounts of the Society for the year ended 31 December 2003, with references therein to page numbers amended to accord to the page numbering used in this document.

### 1. Accounting Policies

#### (a) *Accounting Convention*

The Accounts have been prepared in accordance with the Building Societies (Accounts and Related Provisions) Regulations 1998 and accounting standards currently applicable to the United Kingdom. The principal accounting policies, which have been applied consistently throughout the year, are explained below.

#### (b) *Basis of Accounting*

The Accounts have been prepared in accordance with the historical cost convention.

#### (c) *Basis of Consolidation*

The consolidated income and expenditure account and balance sheet include the accounts of the Society and its subsidiary undertakings from the date of acquisition up to the date of disposal. The accounts of all trading subsidiary undertakings are made up to 31 December. Investments in subsidiary undertakings are stated either at cost or net underlying asset value at the date of acquisition.

#### (d) *Goodwill*

Goodwill arising on the acquisition of subsidiary undertakings, representing the excess of consideration over the fair value of net tangible assets acquired was, until 1997, charged against reserves on acquisition. Goodwill arising subsequently will be capitalised and amortised over its useful economic life in accordance with FRS 10.

#### (e) *Financial Instruments*

The accounting policy in respect of financial instruments is set out in Note 2.

#### (f) *Mortgage Incentive Costs*

Mortgage incentive costs are deducted from interest receivable and similar income in the year in which the costs are incurred.

#### (g) *Fees and Commissions*

Fees charged to borrowers in respect of mortgage advances with high loan-to-value ratios which carry an increased risk of default are deducted as a deferred income provision from loans and advances to customers. Fees deferred are released on a systematic basis within interest receivable and similar income.

Other fees and commissions receivable and payable are recognised on an accruals basis in the period during which they are earned.

#### (h) *Pension Costs*

The Society operates two pension schemes.

For the defined contribution scheme, contributions are charged to the Income and Expenditure Account as they become payable in accordance with the rules of the scheme.

For the defined benefit 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.

The increase in the present value of the liabilities of the defined benefit scheme expected to arise from employee service in the period is charged to the Income and Expenditure Account. 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 the Statement of Total Recognised Gains and Losses.

## 1. Accounting Policies (continued)

### (i) *Repairs and Renewals*

All repairs and renewals, excluding major improvements to office premises which are capitalised, are written off when incurred.

### (j) *Leases*

Costs in respect of operating leases are charged to the Income and Expenditure Account on a straight line basis over the lease term.

### (k) *Taxation*

Corporation tax is provided on the profit on ordinary activities, as adjusted for taxation purposes.

### (l) *Deferred Taxation*

Provision for deferred tax is made in respect of all timing differences that have originated but not reversed by the balance sheet date. Timing differences represent differences between gains and losses recognised for tax purposes in periods different from those in which they are recognised in the financial statements. No deferred tax is recognised on permanent differences between the Society's taxable gains and losses and its results as stated in the financial statements. Deferred tax assets and liabilities are included without discounting.

### (m) *Liquid Assets*

Debt securities intended for use on a continuing basis are classified as financial fixed assets. They are shown at maturity value plus any premium and less any discount not yet amortised. The premium or discount representing the difference between the purchase price and par value of financial fixed assets is amortised on a straight line basis to maturity.

### (n) *Provisions for bad and doubtful debts*

Provisions for losses are based on a year-end appraisal of the recoverability of advances and loans and the extent to which the losses have been mitigated by indemnity insurance.

A specific provision is made against residential loans where arrears amount to 2.5 per cent. or more of the total balance. The provision takes into account estimated sales proceeds of properties held as security, costs of disposal and recoveries from mortgage indemnity insurance. For non-residential loans the provision is based on a case by case assessment where loans are in arrear.

A general provision is made against residential loans where arrears are below 2.5 per cent. of the total balance and where the Group's exposure and the general economic climate would indicate that losses may ultimately materialise. For non-residential loans a provision is made to cover potential losses which are expected to arise in the loan portfolio that have not yet been specifically identified.

Credit is taken in the Income and Expenditure Account for interest as it becomes receivable except where collectability is in significant doubt or where the property is taken into possession. Interest receivable after the date of possession or where there is doubt that it will be collected is accounted for only to the extent that it is received.

### (o) *Tangible Fixed Assets and Depreciation*

Depreciation is provided on the cost, less the estimated residual value, of tangible fixed assets over their expected useful lives in equal annual instalments, at the following rates:

Freehold buildings	2%
Leasehold buildings or unexpired term of lease, whichever is the greater	2%
Major alterations to existing buildings	10%
Computer equipment	20% to 33%
Office equipment and furniture	10% to 15%
Motor vehicles	25%

No depreciation is provided on freehold land.

## 1. Accounting Policies (continued)

### (p) *Segmental Reporting*

A Group segmental analysis is not disclosed as the Group's business is UK based within one business sector.

## 2. Financial Instruments

Financial Reporting Standard 13 defines a financial instrument as any contract that gives rise to a financial asset in one entity and a financial liability or equity instrument in another entity.

As a building society, the Society and Group are only involved in financial instrument transactions, as follows:

### (a) *Retailer of financial instruments.*

The Society retails mortgages, savings and insurance products.

### (b) *Management of risk.*

The Society and Group use wholesale financial instruments, liquid assets and financial derivatives (see below) to manage liquidity and interest rate risks.

The Group has formal structures to manage the Treasury risks associated with its activities. The principal areas of risk are:

- (i) liquidity risk; and
- (ii) interest rate risk.

The Group is not directly subject to any currency risks.

The management of the Group's exposure to liquidity and interest rate risk is reviewed and controlled by the Asset and Liability Committee (ALCO). This committee is responsible to the Board for managing and controlling the balance sheet exposures of the Group. There is a formal structure for managing risks and establishing risk limits. Reporting lines and terms of reference are set out clearly by the Board. Minutes of the ALCO are presented monthly to the Board.

### *Liquidity Risk*

The Board exercises control over the Group's liquidity position through the operation of strict liquidity policies and the close monitoring of the Group's liquidity position. The policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding. The Board applies prudent policies to ensure the interests of members and depositors are protected and that public confidence is retained in the Society.

The liquid resources available to the Group, which facilitates the management of the liquidity risks, comprise:

- (i) liquid assets; and
- (ii) wholesale funding facilities.

In addition, control is exercised over the various aspects of the Group's activities to ensure cash flows are balanced and growth is achieved in a controlled manner.

### *Interest Rate Risk*

The Group is exposed to movements in interest rates. This exposure is managed on a continual basis, within limits set by the Board, using a combination of "on" and "off" balance sheet instruments.

Off balance sheet instruments used for risk management purposes comprise derivative financial instruments ("derivatives"), which are contracts or agreements whose value is derived from one or more underlying price(s) or rate(s) which are inherent in the contract or agreement. The Group generally uses derivatives whose value is linked to underlying fixed rates of interest. As a result, the value of these derivatives changes with movements in interest rates.

## 2. Financial Instruments (continued)

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. These derivatives are used to hedge the Group's balance sheet exposures arising principally from fixed rate mortgage lending and fixed rate savings products. The use of derivatives by the Group is in accordance with the Building Societies Act 1986. The objective of the Group in using derivatives is to limit the extent to which the Group will be affected by changes in interest rates or other factors specified in the legislation.

The following table describes the principal activities undertaken by the Group, the related risks associated with those activities and the types of derivatives which are typically used to manage such risks:

<i>Activity</i>	<i>Risk</i>	<i>Type of Derivative</i>
Fixed rate savings products and fixed rate funding	Sensitivity to changes in interest rates	Interest rate swaps and options
Fixed rate mortgage lending and fixed rate investments	Sensitivity to changes in interest rates	Interest rate swaps and options
Capped rate mortgage	Sensitivity to changes in interest rates	Interest rate caps
Equity linked investment products	Sensitivity to equity indices	Interest rate swaps and equity linked options

Such risks may also be managed by using on balance sheet instruments which offset the risks. Maintaining an appropriate balance between the use of "on" and "off" balance sheet instruments is part of the Group's integrated approach to risk management.

The Society uses interest rate contracts solely for hedging purposes; it never uses them for speculative purposes. Income and expenditure in relation to these contracts is accounted for on an accruals basis and is recognised on an equivalent basis to the assets, liabilities or positions that are being hedged. Where an interest rate contract is redeemed early, or no longer used as a hedge, the gain or loss is immediately recognised in the income and expenditure account.

## 3. Interest Receivable and Similar Income

	<i>Group</i>	
	<u>2003</u>	<u>2002</u>
	<i>£m</i>	<i>£m</i>
On loans fully secured on residential property	124.2	119.0
Deferred income on high lending fees	1.7	1.9
Incentives to borrowers	(0.1)	(1.6)
	<u>125.8</u>	<u>119.3</u>
On other loans	8.1	4.4
On debt securities:		
Interest and other income	24.2	23.6
Amortisation of premiums and discounts	(0.2)	(0.2)
Loss on realisation of investments	(0.1)	—
	23.9	23.4
On other liquid assets	1.7	1.8
Net expense on financial instruments	(8.8)	(9.7)
	<u>150.7</u>	<u>139.2</u>

### 3. Interest Receivable and Similar Income (continued)

Provision is made against interest on loans and advances to customers where properties are taken into possession, in accordance with the Group's accounting policy. The interest provision is deducted from loans and advances to customers in the balance sheet. Movements in the interest provision are as follows:

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£000</i>	<i>£000</i>
At 1 January	13	20
Interest suspended during the year	23	50
Interest written off during the year	(23)	(57)
At 31 December	<u>13</u>	<u>13</u>

### 4. Interest Payable and Similar Charges

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
On shares held by individuals	96.4	93.7
On other shares	0.2	0.2
On deposits and other borrowings	9.7	10.7
Net income on financial instruments	0.0	(0.3)
	<u>106.3</u>	<u>104.3</u>

### 5. Income from Investments

Income from investments relates to dividends from subsidiary undertakings.

### 6. Administrative Expenses

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Wages and salaries	17.6	13.7
Social Security costs	1.7	1.2
Other pension costs (see Note 9)	1.4	1.3
	<u>20.7</u>	<u>16.2</u>
Other administrative expenses	14.6	10.6
	<u>35.3</u>	<u>26.8</u>
Other administrative expenses include:		
	<i>£000</i>	<i>£000</i>
Auditor's remuneration		
for audit work	80	78
for other services	57	197
	<u>137</u>	<u>275</u>

## 7. Employees

The average monthly number employed, including executive directors, during the year:

	<i>Full-time</i>		<i>Part-time</i>	
	<i>2003</i> <i>Number</i>	<i>2002</i> <i>Number</i>	<i>2003</i> <i>Number</i>	<i>2002</i> <i>Number</i>
Society's Chief Office and administration office	316	241	27	24
Society branch offices	164	152	59	49
Employed by the Society	480	393	86	73
Subsidiaries	140	132	44	39
Employed by the Group	620	525	130	112

## 8. Emoluments of the Society's Directors

Directors' emoluments are shown as part of the Report of the Remuneration Committee on Pages 55 to 57 in accordance with Schedule 5, paragraphs 4 and 5 to the Building Societies (Accounts and Related Provisions) Regulations 1998.

In addition, pensions amounting to £56,177 (2002: £54,538) were paid to former directors.

## 9. Pension Schemes

Staff employed after 1 February 2001 are eligible to join a defined contribution scheme. The cost to the Group and Society of employer's contributions to the scheme in 2003 was £78,747 (2002: £19,998). There were no contributions outstanding or prepaid at the end of the year.

Staff, including executive directors, who entered service before 1 February 2001 were eligible to join the Society's defined benefit scheme which is designed to provide pension entitlements based on final salary with assets held outside the Society in separate funds administered by the Trustees. Membership of the scheme is available at the discretion of the Board for persons engaged in senior executive positions subsequent to 1 February 2001.

The defined benefit scheme was subject to a triennial valuation by the Scheme's independent actuary on 30 September 2002. The market value of the scheme's assets at 30 September 2002 was £14.6 million. The valuation revealed that this represented 70 per cent. of the value of the benefits accrued to members in respect of service to that date, allowing for future expected increases in earnings; this equates to a past service deficit at that date of £6.2 million. After taking into account an injection of £1.1 million into the scheme prior to 31 December 2002 to partially reduce this deficit, the actuary has recommended that the Society's future contributions should be set at 12.4 per cent. per annum of pensionable earnings plus an annual contribution of £675,000 over the next eleven years. This is in addition to employees' contributions of 5 per cent. per annum. The recommended level of contributions has been accepted by the Society but will be subject to review at subsequent actuarial valuations.

In practice the defined benefit scheme is a closed scheme and as the age of membership rises in future the service cost is likely to increase as a percentage of pensionable earnings.

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

The Society has elected to account for employee pensions in accordance with Financial Reporting Standard No. 17, Retirement Benefits (FRS17), which prescribes the basis for valuing defined benefit scheme assets and liabilities. The prescribed basis for valuing the schemes' assets and liabilities differs from the basis used by the scheme actuary in producing the triennial valuation of the scheme. As a result the deficit arising under FRS17 differs from that indicated above. Updated calculations prepared by the scheme actuary on the FRS17 basis at 31 December 2003 revealed a deficit amounting to £10.7 million.

## 9. Pension Schemes (continued)

The major assumptions used by the actuary under FRS17 were:

	<i>At 31 December</i>		
	<i>2003</i>	<i>2002</i>	<i>2001</i>
Rate of increase in salaries	4.1%	3.75%	3.75%
Rate of increase of pensions in payment	2.6%	2.25%	2.25%
Discount rate	5.4%	5.60%	5.75%
Inflation assumption	2.6%	2.25%	2.25%

The long term rates of return expected on investments in the schemes were:

Equities	8.2%	8.5%	7.5%
Bonds and Cash	5.0%	4.5%	5.2%

The deficit and net pension liability relating to the Schemes are made up as follows:

	<i>As at 31 December</i>		
	<i>2003</i>	<i>2002</i>	<i>2001</i>
	<i>£m</i>	<i>£m</i>	<i>£m</i>
<b>Market value of assets:</b>			
Equities	14.9	13.6	15.2
Bonds and Cash	6.2	3.4	3.7
Total market value of assets	21.1	17.0	18.9
Present value of scheme liabilities	(31.8)	(26.0)	(20.8)
Deficit in schemes	(10.7)	(9.0)	(1.9)
Related deferred tax asset	3.2	2.7	0.6
Net pension liability	<u>(7.5)</u>	<u>(6.3)</u>	<u>(1.3)</u>

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
<b>Analysis of pensions costs (included in administrative expenses)</b>		
Current service cost	1.1	1.1
Past service cost	0.2	0.2
	<u>1.3</u>	<u>1.3</u>
<b>Analysis of finance income (included in other operating income)</b>		
Expected return on pension scheme assets	1.3	1.3
Interest on pension scheme liabilities	(1.4)	(1.2)
Net (charge)/credit to other financial income	<u>(0.1)</u>	<u>0.1</u>
<b>Analysis of amount recognised in statement of total recognised gains and (losses)</b>		
Actual return less expected return on pension scheme assets	1.8	(4.6)
Experience losses arising on scheme liabilities	(0.9)	(1.0)
Losses on change in assumptions underlying the present value of scheme liabilities	(2.9)	(2.5)
Actuarial loss	<u>(2.0)</u>	<u>(8.1)</u>

## 9. Pension Schemes (continued)

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
<b>Movement in (deficit)/surplus during the year</b>		
Deficit in schemes at beginning of year	(9.0)	(1.9)
Movement in year:		
Current service cost	(1.1)	(1.1)
Contributions	1.7	2.2
Past service costs	(0.2)	(0.2)
Other finance (charge)/income	(0.1)	0.1
Actuarial loss	(2.0)	(8.1)
Deficit in schemes at end of year	<u>(10.7)</u>	<u>(9.0)</u>
<b>Details of experience gains and (losses)</b>		
Difference between the expected and actual return on scheme assets:		
Gain/(loss) amount	£1.8m	(£4.6m)
Percentage of scheme assets	8.6%	26.8%
Experience gains and (losses) on scheme liabilities:		
Loss amount	(£0.9m)	(£1.0m)
Percentage of the present value of scheme liabilities	2.9%	3.8%
Total amount recognised in statement of total recognised gains and (losses):		
Loss amount	(£2.0m)	(£8.1m)
Percentage of the present value of scheme liabilities	6.2%	30.8%

## 10. Tax on Profit on Ordinary Activities

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
<b>Analysis of charge for the year</b>		
<b>Current Tax</b>		
The charge for taxation is made up as follows:		
UK Corporation Tax on profits of the year	5.9	7.2
Adjustments to prior years	(0.1)	—
	<u>5.8</u>	<u>7.2</u>
<b>Deferred Tax</b>		
Origination and reversal of timing differences	0.1	(0.5)
Total tax on profits on ordinary activities	<u>5.9</u>	<u>6.7</u>
Factors affecting the current tax charge for the year:		
Profit before tax	<u>18.7</u>	<u>21.6</u>
Profit multiplied by the standard rate of corporation tax in the UK (30%)	5.6	6.5
Effects of:		
Temporary differences between taxable and accounting profit		
Accelerated capital allowances	—	—
Short term timing differences	0.1	0.4
Permanent differences	0.2	0.3
	<u>5.9</u>	<u>7.2</u>
Adjustments to prior years	(0.1)	—
	<u>5.8</u>	<u>7.2</u>

## 11. Loans and Advances to Credit Institutions

	<i>Group</i>	
	2003	2002
	<i>£m</i>	<i>£m</i>
Repayable from the date of the balance sheet in the ordinary course of business:		
On demand	52.8	29.2
Less than three months	20.4	29.0
	<u>73.2</u>	<u>58.2</u>

## 12. Debt Securities

	<i>Group</i>	
	2003	2002
	<i>£m</i>	<i>£m</i>
Issued by public bodies and listed on a recognised investment exchange	41.3	25.3
Issued by other borrowers and unlisted	569.5	523.3
	<u>610.8</u>	<u>548.6</u>
Market value of listed debt securities, which includes accrued interest of	41.1	26.3
	<u>0.4</u>	<u>0.2</u>
All debt securities are transferable and held as financial fixed assets. The debt securities set out above are repayable from the date of the balance sheet in the ordinary course of business as follows:		
Accrued interest	6.1	7.5
Less than one year	400.9	428.0
Between one year and five years	203.8	113.1
	<u>610.8</u>	<u>548.6</u>
The movement in transferable debt securities is set out below:		
Adjusted cost excluding accrued interest		
At 1 January	541.3	443.3
Additions	2,388.8	940.0
Disposals/maturities	(2,325.1)	(842.0)
At 31 December	<u>605.0</u>	<u>541.3</u>
Amortisation of premiums/discounts		
At 1 January	0.2	0.9
Charge for the year	0.2	0.2
Disposals/maturities	(0.1)	(0.9)
At 31 December	<u>0.3</u>	<u>0.2</u>
Net book value at 31 December	604.7	541.1
Accrued Interest	6.1	7.5
	<u>610.8</u>	<u>548.6</u>

The Society engages in gilt stock lending controlled through the Central Gilt Office of the Bank of England. At 31 December 2003 £25.1 million (2002 £25.1 million) of the listed debt securities (UK Government Stocks) were loaned under secured arrangements.

### 13. Loans Fully Secured on Residential Property

	<i>Group</i>	
	2003 <i>£m</i>	2002 <i>£m</i>
Gross lending	2,651.6	2,355.9
Provisions for bad and doubtful debts	(1.1)	(1.1)
Deferred income in respect of high lending fees	(10.8)	(10.6)
	<u>2,639.7</u>	<u>2,344.2</u>

### 14. Other Loans Fully Secured on Land

	<i>Group</i>	
	2003 <i>£m</i>	2002 <i>£m</i>
Amounts due from subsidiary undertakings	—	—
Other Loans	217.2	100.9
Provisions for bad and doubtful debts	(2.1)	(1.0)
	<u>215.1</u>	<u>99.9</u>

### 15. Loans and Advances to Customers

Maturity analysis of loans and advances to customers from the date of the balance sheet:

	<i>Group</i>	
	2003 <i>£m</i>	2002 <i>£m</i>
Repayable on demand	5.1	2.9
Less than three months	57.4	34.1
Between three months and one year	148.2	112.9
Between one year and five years	664.6	469.3
More than five years	1,993.5	1,837.6
	<u>2,868.8</u>	<u>2,456.8</u>
Provisions for bad and doubtful debts	(3.2)	(2.1)
Deferred income in respect of high lending fees	(10.8)	(10.6)
	<u>2,854.8</u>	<u>2,441.1</u>

### 16. Provisions for Bad and Doubtful Debts

	<i>Loans fully secured on residential property</i>		<i>Other loans fully secured on land</i>		<i>Total</i>	
	<i>Specific £m</i>	<i>General £m</i>	<i>Specific £m</i>	<i>General £m</i>	<i>Specific £m</i>	<i>General £m</i>
Group and Society At 1 January 2003	0.4	0.7	—	1.0	0.4	1.7
Amounts written off during the year	(0.2)	—	—	—	(0.2)	—
Increase in provisions during the year	—	0.2	—	1.1	—	1.3
At 31 December 2003	<u>0.2</u>	<u>0.9</u>	<u>—</u>	<u>2.1</u>	<u>0.2</u>	<u>3.0</u>

## 17. Investments in Subsidiary Undertakings

	<i>Society</i>	
	<u>2003</u>	<u>2002</u>
	<i>£m</i>	<i>£m</i>
Shares held in subsidiary undertakings:		
At cost	4.4	4.4
Amounts written off investments on acquisition	<u>(3.0)</u>	<u>(3.0)</u>
	1.4	1.4
Loans to subsidiary undertakings	<u>2.0</u>	<u>2.7</u>
	<u>3.4</u>	<u>4.1</u>
	<i>Subsidiary Undertakings</i>	
	<i>Shares</i>	<i>Loans</i>
	<i>£m</i>	<i>£m</i>
Movement in Investments in Subsidiary Undertakings:		
1 January 2003	1.4	2.7
Additions	—	0.4
Repayments	—	<u>(1.1)</u>
31 December 2003	<u>1.4</u>	<u>2.0</u>

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

	<i>Place of Registration</i>	<i>Principal Activity</i>	<i>Class of Shares held</i>	<i>Interest of Society</i>	<i>Direct or Indirect</i>
Peter Alan Limited	England and Wales	Estate agency and financial services	Ordinary and preference	100%	Direct
Principality Mortgage Corporation Limited	England and Wales	Secured lending on land and buildings	Ordinary	100%	Direct
Principality Independent Financial Advisers Limited	England and Wales	Provision of advisory and administration services	Ordinary	100%	Direct

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

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

## 18. Tangible Fixed Assets

	<i>Land and Buildings £m</i>	<i>Equipment, Fixtures, Fittings &amp; Vehicles £m</i>	<i>Total £m</i>
<b>Group</b>			
Cost:			
At 1 January 2003	34.4	13.2	47.6
Additions	1.1	4.1	5.2
Disposals	(0.3)	(3.0)	(3.3)
At 31 December 2003	<u>35.2</u>	<u>14.3</u>	<u>49.5</u>
Depreciation:			
At 1 January 2003	8.4	7.7	16.1
Charge for the year	1.3	2.0	3.3
Disposals	(0.1)	(2.6)	(2.7)
At 31 December 2003	<u>9.6</u>	<u>7.1</u>	<u>16.7</u>
Net book amounts:			
At 31 December 2003	<u>25.6</u>	<u>7.2</u>	<u>32.8</u>
At 31 December 2002	<u>26.0</u>	<u>5.5</u>	<u>31.5</u>
	<i>2003</i>		<i>2002</i>
	<i>£m</i>		<i>£m</i>
Land and Buildings:			
Freehold	23.3		23.6
Long Leasehold	0.8		0.8
Short leasehold	1.5		1.6
	<u>25.6</u>		<u>26.0</u>
Occupied by the Society and subsidiary undertakings	<u>12.6</u>		<u>12.5</u>

## 19. Other Assets

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Due within one year:		
Due from subsidiary undertaking	—	—
Other	1.0	1.2
	<u>1.0</u>	<u>1.2</u>

## 20. Prepayments and Accrued Income

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Accrued interest	0.2	—
Other	1.0	0.9
	<u>1.2</u>	<u>0.9</u>

## 21. Shares

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Held by individuals	2,869.5	2,672.7
Other shares	13.0	13.5
	<u>2,882.5</u>	<u>2,686.2</u>

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

Accrued interest	71.6	71.6
On demand	637.1	675.1
Less than three months	1,073.2	937.0
Between three months and one year	1,092.7	1,002.5
Between one year and five years	7.9	—
	<u>2,882.5</u>	<u>2,686.2</u>

## 22. Amounts Owed to Credit Institutions

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

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Accrued Interest	0.1	0.1
On demand	8.4	2.7
Less than three months	10.0	—
Between three months and one year	6.0	15.0
	<u>24.5</u>	<u>17.8</u>

## 23. Amounts owed to Other Customers

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

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Accrued Interest	3.1	2.1
On demand	4.3	3.6
Less than three months	251.5	78.9
Between three months and one year	106.6	56.0
Between one year and five years	30.0	3.0
	<u>395.5</u>	<u>143.6</u>

## 24. Debt Securities in Issue

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

	<i>Group</i>	
	<i>2003</i>	<i>2002</i>
	<i>£m</i>	<i>£m</i>
Accrued Interest	0.3	0.2
Less than three months	43.0	28.0
Between three months and one year	5.0	—
	<u>48.3</u>	<u>28.2</u>

## 25. Other Liabilities

	<i>Group</i>	
	<u>2003</u>	<u>2002</u>
	<i>£m</i>	<i>£m</i>
Due within one year:		
Income tax	0.2	0.2
Corporation tax	2.8	3.4
Other taxation and social security	0.5	0.4
Other creditors	<u>11.4</u>	<u>10.0</u>
	<u><u>14.9</u></u>	<u><u>14.0</u></u>

Other creditors include amounts due to subsidiary undertakings

## 26. Provision for Liabilities and Charges

	<i>Group</i>
	<u>2003</u>
	<i>£m</i>
Deferred taxation:	
At 1 January	0.6
Transferred to income and expenditure account	0.1
At 31 December	<u>0.7</u>
Deferred taxation has been accounted for in respect of:	
Capital allowances in excess of depreciation	1.1
Other short term timing differences	<u>(0.4)</u>
	<u><u>0.7</u></u>

## 27. Analysis of Reserves

	<i>Group</i>	
	<u>2003</u>	<u>2002</u>
	<i>£m</i>	<i>£m</i>
Reserves at beginning of year	187.9	180.6
Prior year adjustment	<u>—</u>	<u>(1.9)</u>
Restated	187.9	178.7
Total recognised gains for the year	11.4	9.2
Reserves at end of year	199.3	187.9
Reserves excluding pension liability	206.8	194.2
Pension liability	<u>(7.5)</u>	<u>(6.3)</u>
	<u><u>199.3</u></u>	<u><u>187.9</u></u>

The prior year adjustment related to the introduction of FRS17, accounting for retirement benefits.

## 28. Guarantees and Other Financial Commitments

- (a) In common with other financial institutions the Society has a contingent liability in respect of contributions to the Financial Services Compensation Scheme.

	<u>2003</u>	<u>2002</u>
	<i>£m</i>	<i>£m</i>
(b) Contracted capital commitments for which no provision has been made	1.3	—

- (c) Annual commitments under non-cancellable operating leases:

	<u>2003</u>		<u>2002</u>	
	<i>Land and Buildings</i>	<i>Other</i>	<i>Land and Buildings</i>	<i>Other</i>
	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>
Group annual commitments in respect of operating lease rentals:				
Expiring within one year	0.1	0.2	0.1	—
Expiring between two and five years	0.1	0.2	0.1	—
Expiring after five years	0.5	—	0.3	—
	<u>0.7</u>	<u>0.4</u>	<u>0.5</u>	<u>—</u>
Society annual commitments in respect of operating lease rentals:				
Expiring within one year	0.1	0.2	0.1	—
Expiring between two and five years	—	0.2	0.1	—
Expiring after five years	0.2	—	0.1	—
	<u>0.3</u>	<u>0.4</u>	<u>0.3</u>	<u>—</u>

## 29. Analysis of Financial Instruments

The notional principal amounts, credit risk weighted and replacement costs of derivatives are summarised below:

	<u>2003</u>			<u>2002</u>		
	<i>Interest Rate Swaps</i>	<i>Swaps</i>	<i>Option</i>	<i>Interest Rate Swaps</i>	<i>Swaps</i>	<i>Option</i>
	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>
Notional principal amounts	839.5	40.0	—	570.2	112.0	30.0
Replacement cost	5.1	—	—	0.2	—	0.9
Credit risk weighted amounts	1.6	—	—	0.5	—	0.2

Notional principal amounts indicate the volumes of business outstanding at the balance sheet dates but do not represent the amounts at risk.

Replacement cost represents the cost of replacing contracts with positive value, calculated at market rates current at the balance sheet date, reflecting the Group's maximum exposure should all counter-parties default.

Credit risk weighted amounts are based on the replacement cost, but also reflect weightings of risk specified in rules provided by the Financial Services Authority. These risk weightings are intended to take account of the extent of potential exposures and the risk of counter-party default.

## 29. Analysis of Financial Instruments (continued)

### Interest Rate Risk

The table below summarises the interest rate sensitivity exposure of the Group's Balance Sheet after taking into account the various derivatives entered into by the Group. Items are allocated to time bands by reference to the earlier of the next repricing date and maturity.

	2003						Total £m
	Not more than 3 months £m	More than 3 months but not more than 6 months £m	More than 6 months but not more than 1 year £m	More than 1 year but not more than 5 years £m	More than 5 years £m	Non- Interest bearing £m	
<b>Assets</b>							
Liquid Assets	434.9	65.0	35.0	145.0	—	8.5	688.4
Loans & advances to customers	2,212.4	75.4	81.7	472.1	26.9	(13.7)	2,854.8
Tangible fixed assets	—	—	—	—	—	32.8	32.8
Other assets	—	—	—	—	—	2.2	2.2
<b>Total Assets</b>	<u>2,647.3</u>	<u>140.4</u>	<u>116.7</u>	<u>617.1</u>	<u>26.9</u>	<u>29.8</u>	<u>3,578.2</u>
<b>Liabilities</b>							
Shares	(2,805.5)		(3.1)	(2.4)	—	(71.5)	(2,882.5)
Borrowings	(325.9)	(58.7)	(55.2)	(25.0)	—	(3.5)	(468.3)
Other liabilities, accruals, provisions and pension liability	—	—	—	—	—	(28.1)	(28.1)
Reserves	—	—	—	—	—	(199.3)	(199.3)
<b>Total Liabilities</b>	<u>(3,131.4)</u>	<u>(58.7)</u>	<u>(58.3)</u>	<u>(27.4)</u>	<u>—</u>	<u>(302.4)</u>	<u>(3,578.2)</u>
Off Balance Sheet items	<u>685.6</u>	<u>(133.0)</u>	<u>(74.0)</u>	<u>(444.1)</u>	<u>(34.5)</u>	<u>—</u>	<u>—</u>
Interest rate sensitivity gap	<u>201.5</u>	<u>(51.3)</u>	<u>(15.6)</u>	<u>145.6</u>	<u>(7.6)</u>	<u>(272.6)</u>	<u>—</u>

## 29. Analysis of Financial Instruments (continued)

	2002						
	<i>Not more than 3 months</i>	<i>More than 3 months but not more than 6 months</i>	<i>More than 6 months but not more than 1 year</i>	<i>More than 1 year but not more than 5 years</i>	<i>More than 5 years</i>	<i>Non-Interest bearing</i>	<i>Total</i>
	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>
<b>Assets</b>							
Liquid Assets	358.1	60.0	105.0	80.1	—	7.4	610.6
Loans & advances to customers	1,892.0	38.6	103.4	407.7	15.1	(12.7)	2,444.1
Tangible fixed assets	—	—	—	—	—	31.5	31.5
Other assets	—	—	—	—	—	2.1	2.1
<b>Total Assets</b>	<b>2,250.1</b>	<b>98.6</b>	<b>208.4</b>	<b>487.8</b>	<b>15.1</b>	<b>28.3</b>	<b>3,088.3</b>
<b>Liabilities</b>							
Shares	(2,666.2)	—	(20.0)	—	—	—	(2,686.2)
Borrowings	(139.6)	(18.6)	(26.5)	(3.0)	—	(1.9)	(189.6)
Other liabilities, accruals, provisions and pension liability	—	—	—	—	—	(24.6)	(24.6)
Reserves	—	—	—	—	—	(187.9)	(187.9)
<b>Total Liabilities</b>	<b>(2,805.8)</b>	<b>(18.6)</b>	<b>(46.5)</b>	<b>(3.0)</b>	<b>—</b>	<b>(214.4)</b>	<b>(3,088.3)</b>
Off Balance Sheet items	628.2	(50.0)	(127.0)	(426.0)	(25.2)	—	—
Interest rate sensitivity gap	72.5	30.0	34.9	58.8	(10.1)	(186.1)	—

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

Other assets include other loans, other assets, prepayments and accrued income.

Other liabilities include other liabilities, accruals and deferred income, provisions for liabilities and charges and pension liability.

### Fair Values for Financial Instruments

The table below is a comparison of book and fair values as at 31 December of the Group's financial instruments (including accrued interest) which are listed or publicly traded. Where available, market values have been used to determine fair values. If market values are not available fair values have been calculated by discounting cash flows at prevailing interest rates.

	2003		2002	
	<i>Book Value</i>	<i>Fair Value</i>	<i>Book Value</i>	<i>Fair Value</i>
	<i>£m</i>	<i>£m</i>	<i>£m</i>	<i>£m</i>
<b>Assets/(Liabilities)</b>				
On balance sheet instruments:				
Liquid assets	688.4	691.2	608.0	610.3
Amounts owed to credit institutions and other customers and debt securities in issue	(468.3)	(468.2)	(189.6)	(189.6)
Off balance sheet and similar instruments	—	5.1	—	1.1

Liquid assets comprise cash in hand, loans and advances to credit institutions and debt securities.

The table excludes mortgages and savings products involved in the retail activities of the Group and other balance sheet items whose book and fair values differ.

## 29. Analysis of Financial Instruments (continued)

### Gains and Losses on Derivatives

Fair value gains and losses which arise on off balance sheet and similar instruments used for hedging are not recognised until the exposure which has been hedged has itself been recognised in the Accounts.

Unrecognised net gains and losses on derivative instruments used for hedging and the movements therein, are as follows:

	<i>Total Net Gains/(Losses) £m</i>
Unrecognised gains at 1 January 2003	1.1
Gains arising in previous years that were recognised in the year to 31 December 2003	—
Gains arising before 1 January that were not recognised in the year to 31 December 2003	1.1
Gains arising in the year to 31 December 2003 that were not recognised in the same year	4.0
Unrecognised gains on hedges at 31 December 2003	5.1
Gains expected to be recognised in the year to 31 December 2004	—
Gains expected to be recognised after 31 December 2004	5.1

## 30. Loans to and Shares held by Directors

There was an aggregate of £373,910 (2002 £433,683) outstanding at the end of the financial year in respect of secured advances made prior to or during the year to three Directors.

Insofar as it is required under Section 68(1) and Section 68(3) of the Building Societies Act 1986, details of such loans are maintained in a Register kept at Principality Buildings, Queen Street, Cardiff and a statement containing requisite particulars will be available for inspection by members at the same address for the period of fifteen days prior to the Annual General Meeting to be held on 23 April 2004.

As required by the Society's Rules, each Director has a share account. The Society's duty of confidentiality to its members precludes disclosure of these details.

**ANNUAL BUSINESS STATEMENT  
FOR THE YEAR ENDED 31 DECEMBER 2003**

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*The information on pages 49 and 50 has been extracted from figures appearing in the Annual Report and Accounts of the Society for the year ended 31 December 2003, amended to reflect references to pages in this document.*

**1. Statutory Percentages**

	<i>At 31 December 2003</i>	<i>Statutory Limit</i>
	%	%
The Lending Limit	7.64	25
The Funding Limit	14.36	50

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

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

The Funding Limit is the proportion of shares and borrowings not in the form of shares held by individuals.

Business assets are the total assets of the Society and its subsidiary undertakings as shown in the balance sheet plus provisions for bad and doubtful debts and deferred income in respect of high lending fees, less fixed assets and liquid assets.

Loans fully secured on residential property are the amount of principal owed by borrowers and interest accrued not yet payable. This is the amount shown in the balance sheet plus provisions for bad and doubtful debts and deferred income in respect of high lending fees and interest in suspense.

**2. Other Percentages**

Calculated from the consolidated accounts.

	<i>2003</i>	<i>2002</i>
	%	%
As a percentage of shares and borrowings:		
Gross Capital	5.95	6.54
Free Capital	5.06	5.50
Liquid Assets	20.54	21.23
As a percentage of mean total assets:		
Profit after taxation	0.38	0.51
Management expenses	1.16	1.03

Gross Capital is the general reserve in the consolidated balance sheet.

Free Capital is the general reserve plus the general provision for bad and doubtful debts less fixed assets.

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

Mean total assets represent the average of the total assets in the consolidated balance sheet at the beginning and end of the year.

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

### 3. Directors and Management Board

Details of directors are contained in the Directors' Report on Pages 51 to 54.

Details of directors' service contracts are included in the Report of the Remuneration Committee on Pages 55 to 57.

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

#### *The Management Board*

<i>Name</i>	<i>Directorships</i>
Michael McGuire MA (Cantab) ACII	None
Brian Kultschar BSc(Econ)FIPD	None
William Mayne BA(Hons) MCIM ANEA	Peter Alan Limited
John Williams	None
Robin Matthews BA(Hons)	None
Jayne Robinson Dip M, MA (Oxon)	None
Neil Andrews	None
Neil Pritchard ACII FLIA (dip) ASFA	None
Julie Evans	None
Chris McVeigh ACII	Peter Alan Limited

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.

## DIRECTORS' REPORT

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*The following pages 51 to 54, with the exception of the sentence in italics, contain information which has been reproduced from the Annual Report and Accounts of the Society for the year ended 31 December 2003 (amended to reflect references to pages in this document). This information is included in this document to comply with the provisions of section 80(6) of the Building Societies Act 1986.*

The Board has pleasure in presenting our Report for the Society's 144th year, with the Annual Accounts and Annual Business Statement of the Society and its subsidiary undertakings for the financial year ended 31 December 2003.

### Directors

*The names of the directors at the date of this report, together with brief biographical details are listed on pages 24 and 25.*

On 24 March 2003 Gwyneth Burr was appointed to the Board as a non-executive director. On 1 November 2003 Guy Thomas was appointed to the Board as Finance Director. At the Annual General Meeting to be held on 23 April 2004 Gwyneth Burr and Guy Thomas will retire as required by Society Rule 25(4), and David Williams and Peter Davies retire by rotation under Rule 26(1). All four are eligible and willing to continue serving on the Board and there have been no other nominations. In 2005, David Gibbard and Margaret Foster are due to retire from the Board by rotation.

James Jamieson resigned as a director on 31 March 2003.

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.

### Corporate Governance

The Society has adopted and complies with all aspects of the sample Code of Governance contained in the Interim Prudential Sourcebook for Building Societies issued by the Financial Services Authority.

### The Board

At 31 December 2003, the Board comprised three executive and seven non-executive directors. The offices of Chairman and Chief Executive are distinct and held by different people. All non-executive directors are independent of management and free of any relationship which could interfere with the exercise of their professional judgement.

The Board operates through meetings of the full Board and its main committees (as set out below). The Board meets as often as necessary for the proper conduct of business, normally at least 12 times per year.

As well as having responsibility for matters such as overall strategy and business performance, the Board also has ultimate responsibility for the risk management and internal control systems that operate across the Group and for monitoring the ongoing effectiveness of those systems. The Audit Committee and Risk Committees have clearly defined, delegated authorities to assist the Board in its monitoring of the risk management and internal control systems.

### Board Committees

#### *Audit Committee*

The Audit Committee is chaired by John Bowen. The other members are Eurfyl ap Gwilym and David Williams. *John Bowen retired as a director on 23 April 2004, and David Williams has taken over as chairman of the Audit Committee.*

The Committee meets four times a year. Representatives of the Society's executive, internal audit department and its external auditors, PricewaterhouseCoopers LLP, attend the Committee's meetings. The Committee meet in private with the external auditors at least once each year and the Chairman of the Committee has regular private meetings with the Head of the Society's internal audit function.

The Committee's responsibilities include:

- review of the Group's processes for the identification, assessment, monitoring and control of business risks including market, credit and operational risks. The Committee receives reports from the Risk Committee which comprises the executives and the Head of Business Risk;
- assessment of internal systems of control within the framework established under the Financial Services and Markets Act 2000;
- monitoring the relationship between internal and external auditors;
- review of internal and external audit functions;
- consideration of accounting policies;
- review of statutory, regulatory and prudential requirements generally;
- consideration of the Annual Report and Accounts before they are reviewed by the Board;
- consideration of reports from the Society's Compliance Officer and the Money Laundering Reporting Officer; and
- reporting on its activities to the Board.

#### *Remuneration Committee*

This Committee is chaired by Peter Davies. The other members are David Gibbard and Margaret Foster. It considers remuneration policy and the Board delegates to this non-executive committee decisions on executives' remuneration and compensation packages. Fees payable to non-executive directors are determined by the executive directors. Details of directors' remuneration are set out on pages 55 to 57. The Committee reports on its activities to the Board.

#### *Nominations Committee*

The Nominations Committee is chaired by Peter Davies. It comprises all the non-executive directors. It is responsible for succession planning and acts as a nomination committee for all new Board appointments. The Committee reports on its activities to the Board.

#### *Asset and Liability Committee*

The Asset and Liability Committee is chaired by Peter Davies. Other members during the year included the executive directors together with a number of senior managers.

The Committee's responsibilities include:

- review of the Society's treasury policy statement;
- establishing and monitoring procedures for Treasury operations;
- review of the Society's policy for managing balance sheet interest rate risk;
- review and approval of mortgage and savings interest rates and products;
- review and monitoring of the investment of surplus funds;
- review and monitoring of the raising of wholesale funds; and
- reporting on its activities to the Board.

#### *Commercial Lending Asset Management Committee*

This committee is chaired by Peter Griffiths. Other members during the year included Peter Davies, David Williams, Haydn Warman, Guy Thomas and certain senior managers.

The Committee's responsibilities include:

- review and approval of commercial lending products;
- monitoring the Society's commercial lending portfolio;

- review of new lending, high risk and non performing assets and provisioning requirements;
- review and approval of the commercial lending base rate; and
- reporting on its activities to the Board.

#### *Business Objectives and Activities of the Society and its Subsidiaries*

The Society's business objective is to provide members with the benefit 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 a range of insurance and financial services.

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

- (a) estate agency and property services; and
- (b) acquisition of mortgage books from other lenders.

We are satisfied that no activity carried out during 2003 was 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.

#### **Review of the Year**

##### *Significant events occurring during the year*

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

- the activities of the Commercial Lending Business unit were further expanded;
- the final Rules for the regulation of mortgages were published by the Financial Services Authority;
- the Board approved the development of an internet-based distribution channel for mortgages;
- a review of the Society's information technology concluded that the core systems were fundamentally fit for purpose but required enhancement in a number of areas. The board approved plans to secure these enhancements;
- the Board approved further expansion of the Society's branch network in Wrexham and Llanelli; and
- a review of the Society's brand image was initiated.

##### *Financial position at the year-end*

At 31 December 2003:

- Group assets increased by £489.9 million to £3,578.2 million;
- The pre-tax profit for the Group was £18.7 million, and the net profit after tax was £12.8 million, equivalent to 0.38 per cent. of mean assets employed;
- Liquid assets held in the form of Government stocks, short term deposits and cash totalled £688.4 million, equivalent to 20.54 per cent. of shares and borrowings;
- Mortgage assets increased by 16.80 per cent. to £2,854.8 million;
- Shares and borrowings increased by 16.52 per cent. to £3,350.8 million;
- The Group gross capital ratio was 5.95 per cent. of total share and deposit liabilities whilst the free capital ratio was 5.06 per cent. of those liabilities; and
- There were 22 mortgage accounts on which payments were twelve or more months in arrear. On these accounts the total amount of principal outstanding was £799,738 and the total amount of arrears was £69,798 for which provision has been made, where appropriate.

### **Supplier Payment Policy and Practice**

It is the Society's policy to discharge suppliers' invoices for the complete provision of goods and services (unless there is an express provision for stage payments) in full conformity with the conditions of the purchase and within the agreed payment terms. It is intended that this policy be continued in 2004.

At 31 December 2003 the total amounts owed to suppliers was the equivalent to 20 days' credit (2002 – 20 days).

### **Employees**

The Society has maintained and developed systems for the provision of information to employees, and has continued to consult actively with staff and their union representatives. In addition, staff rallies lead by the Chief Executive, team briefings and the Society's intranet are used to ensure staff are kept informed regularly of business objectives and performance.

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 designed to re-enforce this approach.

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

### **Auditors**

PricewaterhouseCoopers resigned as auditors in April 2003 and the Board appointed PricewaterhouseCoopers LLP to fill the vacancy arising. The Board will propose at the 2004 Annual General Meeting that PricewaterhouseCoopers LLP be appointed as auditors for the ensuing year. As previously announced the Board will undertake a market review of auditing firms later this year.

### **Future Developments**

2004 will undoubtedly bring further competition in the financial services marketplace. We will continue to keep our distribution channels under review to ensure we are able to serve members' needs in the way they require. The forthcoming regulation of mortgages and general insurance by the Financial Services Authority presents new challenges which we are actively addressing.

We are confident that with our strong financial base, planned investment in the business to meet members' future service requirements, the commitment of our staff and, above all, loyal support from the membership, the Principality will continue to prosper as a mutual building society.

On behalf of the Board of Directors

D. Peter L. Davies

*Chairman*

23 January 2004

## REPORT OF THE REMUNERATION COMMITTEE

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The Society has adopted the sample Code of Governance for Building Societies issued by the Financial Services Authority. The members of the Remuneration Committee are Peter Davies, David Gibbard and Margaret Foster. The Remuneration Committee is provided with comparative salary data produced by the Building Societies Association and procures relevant data from independent expert sources.

### **Non-executive Directors' Remuneration Policy**

Fees for non-executive directors are set by the executive directors by reference to benchmark information from a building society comparator group.

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

### **Executive Directors' Remuneration Policy**

The Society's overall policy is designed to ensure that executive directors' remuneration reflects performance and enables the Society to attract, retain and motivate executives to deliver improving business performance for the benefit of members.

The remuneration of executive directors consists of basic salary, performance bonus, medium term incentive bonus, pension benefits and benefits in kind (details of which are set out below).

The salaries of the executive directors are reviewed annually based on advice from external consultants and take into account comparative data for building societies to ensure they are in line with the sector.

The Society operates both annual and medium term bonus schemes. Bonus schemes are designed to give executives the opportunity to earn additional financial rewards in return for delivering specific and incremental improvements in business performance. Key performance criteria set for the annual bonus scheme are linked to corporate, team and individual objectives. These key performance measures are set by the Remuneration Committee and approved by the Board and are designed to improve performance year on year, deliver extra value and maintain the Society's financial strength. Annual and periodic reviews are conducted with each executive to assess performance against these specific measures with the outcome reported to the Board.

The medium term executive scheme was introduced from 1 January 2003 to assist with retention of selected key executives and to encourage changes in culture in specific aspects of the Society's activities. The scheme is designed to last for a discrete term of three years. Under the scheme a bonus equal to the Annual Bonus is set aside for each year but is deferred in payment until January 2006, and is only payable at that time upon achievement of specific additional performance criteria. The maximum bonus payable over the term of this scheme for any individual is 30% of the 2003 basic salary as at 31 December and will be payable to those participants in the scheme who remain in the Society's employ at 31 December 2005. No amounts relating to this scheme are included in the table on page 56 as it is not known whether the criteria for payment will be met.

Awards made under both bonus schemes are non pensionable.

Each executive director is provided with an expensed car (or an equivalent allowance), and private medical insurance.

## Executive Directors' Remuneration Policy (continued)

The following disclosure in this report contains information which is subject to audit – 'the auditable part'.

	<i>Salary &amp; Fees</i>	<i>Benefits</i>	<i>Annual Bonus</i>	<i>Sub-Total</i>	<i>Increase in accrued pension</i>	<i>Pension payment contributions</i>	<i>2003</i>	<i>2002</i>
	£000	£000	£000	£000	£000	£000	£000	£000
<b>Executive</b>								
Peter Griffiths	162	14	50	226	—	19	245	212
James Jamieson (to 31/3/03)	30	3	—	33	1	—	34	132
Haydn Warman	102	8	24	134	2	—	136	45
John Mitchell (to 22/3/2002)	—	—	—	—	—	—	—	45
Guy Thomas (from 1/11/2003)	21	1	7	29	—	—	29	—
<b>Non-Executive</b>								
Peter Davies	47	—	—	47	—	—	47	46
David Gibbard	39	—	—	39	—	—	39	38
John Bowen	25	—	—	25	—	—	25	24
Gwyneth Burr (from 24/3/03)	20	—	—	20	—	—	20	—
Margaret Foster	24	—	—	24	—	—	24	23
Eurfyl ap Gwilym	24	—	—	24	—	—	24	28
David Williams	25	—	—	25	—	—	25	23
	<u>519</u>	<u>26</u>	<u>81</u>	<u>626</u>	<u>3</u>	<u>19</u>	<u>648</u>	<u>616</u>

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

	<i>Date of Contract</i>
Peter Griffiths	1/12/01
Haydn Warman	31/10/03
Guy Thomas	1/11/03

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

The figures under benefits include cars, medical insurance and staff mortgages.

As at 31 December 2003 Haydn Warman and Guy Thomas are members of the Society's contributory Pension Scheme. This is a final salary scheme with potential to achieve a pension of up to 2/3 of final pensionable salary on retirement after 40 years service. The Scheme also provides dependants' pensions and a lump sum of 4 times basic salary in the event of death in service. The payments to a personal pension scheme for Peter Griffiths are at a rate of 12.5 per cent. of basic salary.

James Jamieson, the previous Finance Director, retired from the Board on 31 March 2003 having been with the Society since 1979. The following payments associated with Mr Jamieson's retirement are not included in the above table:

	£000
Payment in to Pension Fund to secure additional pension	153
Termination payment	30
	<u>183</u>

### Executive Directors' Remuneration Policy (continued)

Following his resignation from the Board Mr Jamieson served as General Manager (Finance) until 30 September 2003 pending the arrival of the new Finance Director. Mr Jamieson received salary of £58,000 for this period calculated at the same rate as hitherto.

Information on the Executive Directors' pension arrangements is set out below:

	<i>Accrued pension entitlement at 31/12/03</i>	<i>Increase in accrued pension during the year</i>	<i>Increase in accrued pension during the year (net of inflation)</i>	<i>Transfer value of accrued pension at 31/12/02 (Start of year assumptions)</i>	<i>Transfer of value of accrued pension at 31/12/02 (Current assumptions)</i>	<i>Transfer of value of accrued pension at 31/12/03 (Current assumptions)</i>	<i>Director's contributions during the year</i>	<i>Increase in transfer value over the year, net of directors contributions</i>
	<i>£000 pa</i>	<i>£000 pa</i>	<i>£000 pa</i>	<i>£000</i>	<i>£000</i>	<i>£000</i>	<i>£000</i>	<i>£000</i>
Haydn Warman	31	2	1	283	307	376	5	64
Guy Thomas (from 1/11/03)	—	—	—	—	—	2	1	1
James Jamieson (to 31/3/03)	41	1	1	384	419	499	4	76

D. Peter L. Davies  
Chairman

23 January 2004

## RESPONSIBILITIES OF THE DIRECTORS

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The following statement, which should be read in conjunction with the statement of the auditors' responsibilities on page 59, is made by the directors to explain their responsibilities in relation to the preparation of the Annual Accounts, the Directors' Emoluments disclosures within the Report of the Remuneration Committee, Annual Business Statement and Directors' Report.

The directors are required by the Building Societies Act 1986 ("the Building Societies Act") 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 Building Societies 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 Building Societies 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.

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

The directors are satisfied that the Society has adequate resources to continue in business for the foreseeable future. For this reason the accounts continue to be prepared on a going concern basis.

The directors are also responsible for the maintenance and integrity of the Society's website [www.principality.co.uk](http://www.principality.co.uk). 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.

On behalf of the Board of Directors

D. Peter L. Davies  
*Chairman*

23 January 2004

## INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF PRINCIPALITY BUILDING SOCIETY

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We have audited the Annual Accounts which comprise the income and expenditure accounts, the balance sheets, the cash flow statement and the statement of total recognised gains and losses and the related notes, which have been prepared under the historical cost convention, and the accounting policies set out in the statement of accounting policies. We have also audited the disclosures required by the applicable requirements of Part VIII of the Building Societies Act 1986 and regulations made under it contained in the Report of the Remuneration Committee ('the auditable part'). In addition we have examined the Annual Business Statement (other than the details of Directors and Officers upon which we are not required to report) and the Directors' Report.

### **Respective Responsibilities of Directors and Auditors**

The Directors' responsibilities for the preparation of the Annual Report include responsibilities for the Annual Accounts, the Report of the Remuneration Committee, the Annual Business Statement and the Directors' Report and are set out in the statement of directors' responsibilities. Our responsibility is to audit the Annual Accounts in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards issued by the Auditing Practices Board. This report, including the opinion, has been prepared for and only for the Society's members as a body in accordance with Section 78 of the Building Societies Act 1986 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or in to whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Annual Accounts give a true and fair view, whether the Annual Accounts and the auditable part of the Report of the Remuneration Committee have been properly prepared in accordance with the applicable requirements of Part VIII of the Building Societies Act 1986 and regulations made under it, on certain information included within the Annual Business Statement and on whether, in our opinion, the Directors' Report is consistent with the accounting records and the Annual Accounts. We also report to you if in our opinion we have not received all the information and explanations we require for our audit, or if the Annual Accounts are not in agreement with the accounting records.

We read the other information contained in the Annual Report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Annual Accounts, the Annual Business Statement or the Directors' Report. The other information comprises the Chairman's Statement and the Chief Executive's Review and the remainder of the Report of the Remuneration Committee.

### **Basis of Audit Opinion**

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Annual Accounts, the Annual Business Statement and the auditable part of the Report of the Remuneration Committee. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Annual Accounts, and of whether the accounting policies are appropriate to the Society's and Group's circumstances, consistently applied and adequately disclosed.

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

### **Opinion**

In our opinion:

- (a) the Annual Accounts give a true and fair view of the state of affairs of the Society and of the Group as at 31 December 2003, of the income and expenditure of the Society and the income and expenditure and cash flows of the Group for the year then ended;

**Opinion (continued)**

- (b) the information given in the Annual Business Statement (other than the information upon which we are not required to report) gives a true representation of the matters in respect of which it is given;
- (c) the information given in the Directors' Report is consistent with the accounting records and the Annual Accounts; and
- (d) the Annual Accounts, the Annual Business Statement, the Directors' Report and the auditable part of the Report of the Remuneration Committee have each been prepared in accordance with the applicable requirements of Part VIII of the Building Societies Act 1986 and regulations made under it.

PricewaterhouseCoopers LLP  
*Chartered Accountants and Registered Auditors*

23 January 2004  
Cardiff

## USE OF PROCEEDS

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The net proceeds of the issue of the PIBS (estimated to be approximately £58,789,200) will be used by the Society to strengthen its capital base. It is intended that the discounted proceeds of the issue of the PIBS will be treated for capital adequacy purposes as Tier 1 capital.

## UNITED KINGDOM TAXATION

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The following is a summary of the Society's understanding of current law and practice in the United Kingdom relating to the taxation of the PIBS. The summary only relates to the deduction of United Kingdom tax from interest on the PIBS and to the taxation treatment of United Kingdom corporation taxpayers which are the absolute beneficial owners of the PIBS and the interest on them and some aspects do not apply to certain classes of taxpayer (such as dealers). The summary does not apply to other United Kingdom taxpayers. **Prospective PIBS holders who are not United Kingdom corporation taxpayers, who are in any doubt as to their tax position or who may be subject to tax in a jurisdiction other than the United Kingdom should seek their own professional advice.**

### Interest on the PIBS

1. While the PIBS continue to be listed on a recognised stock exchange within the meaning of section 841 Income and Corporation Taxes Act 1988, payments of interest may be made without withholding or deduction for or on account of income tax. The Luxembourg Stock Exchange is a recognised stock exchange for these purposes.
2. Persons in the United Kingdom paying interest to or receiving interest on behalf of another person who is an individual may be required to provide certain information to the United Kingdom Inland Revenue regarding the identity of the payee or person entitled to the interest and, in certain circumstances, such information may be exchanged with tax authorities in other countries.
3. If the PIBS cease to be listed interest will generally be paid under deduction of income tax at the lower rate (currently 20 per cent.) subject to any direction to the contrary from the Inland Revenue in respect of such relief as may be available pursuant to the provisions of any applicable double taxation treaty.

### Corporation Taxpayers

4. PIBS holders within the charge to United Kingdom corporation tax will be subject to tax as income on all profits and gains broadly in accordance with their statutory accounting treatment. Such PIBS holders will generally be charged in each accounting period by reference to interest and any profit or loss which, in accordance with such PIBS holder's authorised accounting method, is applicable to that period.

### Stamp Duty

5. No United Kingdom stamp duty or stamp duty reserve tax is payable on the issue or transfer of the PIBS or on their purchase by the Society.

### Proposed European Union Directive on the Taxation of Savings Income

6. The European Union has adopted a Directive regarding the taxation of savings income. Subject to a number of important conditions being met, it is proposed that Member States will be required from a date not earlier than 1 January 2005 to provide to the tax authorities of other Member States details of payments of interest or other similar income paid by a person to an individual in another Member State, except that Austria, Belgium and Luxembourg will instead impose a withholding system for a transitional period unless during such period they elect otherwise.

## MARKETING ARRANGEMENTS

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The Manager has, pursuant to a subscription agreement dated 28 May 2004 (the “**Subscription Agreement**”), agreed with the Society, subject to the satisfaction of certain conditions, to subscribe for, or procure subscribers for, the PIBS at the issue price of 99.232 per cent. of their principal amount. The Society has agreed to pay the Manager a commission of 1.25 per cent. of such principal amount if the conditions to which the issue of the PIBS is subject are satisfied or waived by the Manager. The Manager is entitled to terminate the Subscription Agreement in certain circumstances prior to payment to the Society. The Society has agreed to indemnify the Manager against certain liabilities in connection with the issue of the PIBS.

It is the intention of the Society to distribute the PIBS as widely as possible. Accordingly, the Manager reserves the right to retain a portion of the offering for the purpose of making ongoing sales, at its absolute discretion, to professional intermediaries. The Manager will not directly market the PIBS to the public.

The PIBS have not, prior to the date of this document, been marketed or made available in whole or part to the public.

The PIBS have not been and will not be registered under the Securities Act and, subject to certain exceptions, may not be offered or sold within the United States. The PIBS are being offered and sold outside of the United States in reliance on Regulation S.

In addition, until 40 days after the commencement of the offering of the PIBS, an offer or sale of PIBS within the United States by any dealer (whether or not participating in the offering) may violate the registration requirements of the Securities Act.

The Manager has represented that (1) it has not offered or sold and, prior to the expiry of a period of six months from the issue date of the PIBS, will not offer or sell any PIBS to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended), (2) it has complied and will comply with all applicable provisions of FSMA with respect to anything done by it in relation to the PIBS in, from or otherwise involving the United Kingdom, and (3) it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of FSMA) received by it in connection with the issue or sale of any PIBS in circumstances in which Section 21(1) of FSMA does not apply to the Society.

No action has been or will be taken by the Society or the Manager that would, or is intended to, permit a public offer of the PIBS in any country or jurisdiction where action for that purpose is required. The PIBS may not be, directly or indirectly, offered or sold in any country or jurisdiction where action for that purpose is required. Accordingly, the PIBS may not, directly or indirectly, be offered or sold and neither this document nor any other circular, prospectus, form of application, advertisement or other material may be distributed in or from, or published in, any country or jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations.

Neither the Society nor the Manager represents that the PIBS may at any time lawfully be sold in or from any jurisdiction (other than in or from the United Kingdom) in compliance with any applicable registration requirements or pursuant to an exception available thereunder or assumes any responsibility for facilitating such sales.

## GENERAL INFORMATION

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### Listing

In connection with the application to list the PIBS on the Luxembourg Stock Exchange, a legal notice relating to the issue of the PIBS and copies of the constitutional documents of the Society will be deposited with the Luxembourg Trade and Companies Register (“**Registre de Commerce et des Sociétés à Luxembourg**”) where such documents may be examined and copies obtained.

### Significant change

There has been no significant change in the financial or trading position of the Society or of the Group or any material adverse change in the prospects of the Society or the Group since 31 December 2003, being the date to which the latest published audited accounts of the Society were made up.

### Litigation

Neither the Society nor the Group is or has been involved in any litigation or arbitration proceedings relating to claims or amounts that are material in the context of the issue of the PIBS nor so far as the Society or the Group is aware is any such litigation or arbitration pending or threatened.

### Accounts

The consolidated accounts of the Society for the two years ended 31 December 2002 have been audited by PricewaterhouseCoopers, independent auditors. The consolidated accounts of the Society for the year ended 31 December 2003 have been audited by PricewaterhouseCoopers LLP, independent auditors. The audit reports for each of the three years ended 31 December 2003, 2002 and 2001 were unqualified. The Society does not publish non-consolidated accounts other than the Society balance sheet, income and expenditure accounts and cash-flow statement included in the annual audited consolidated accounts of the Society. Unaudited interim accounts are produced on a half yearly basis.

### Authorisation

The issue of the PIBS was authorised by resolutions of a duly appointed committee of the Board on 25 May 2004, which was, by resolution of the Board passed on 22 April 2004, duly empowered to deal with matters relating to the PIBS.

### PIBS Certificates

No temporary documents of title shall be issued by the Society in respect of the PIBS. The Registrar will, from 1 June 2004, commence despatching the PIBS Certificates to all PIBS holders who decide to hold their PIBS in certificated form, at the risk of the persons entitled thereto, by first class post to the address detailed on the relevant application form.

The SEDOL number for the PIBS is B010CN56 and the PIBS have been accepted for and may be held and transferred through CRESTCo. The PIBS may also be held and transferred through the Clearstream, Luxembourg and Euroclear systems with a Common Code of 019252779 and the International Securities Identification Number of GB00B010CN56.

### Documents

Copies of the following documents may be inspected at, and in the case of the accounts, obtainable from, the offices of the Registrar at The Causeway, Worthing, West Sussex, BN99 6DA and of the Transfer Agent in Luxembourg during normal business hours on any weekday (Saturdays and public holidays excepted):

- (i) the Rules and the Memorandum of the Society;
- (ii) the published audited consolidated accounts of the Society for each of the years ended 31 December 2001, 2002 and 2003 and all the future published audited annual and unaudited interim consolidated accounts of the Society;
- (iii) a draft (subject to modification) of a PIBS Certificate (including the special conditions of issue of the PIBS);
- (iv) the Registrar Agreement; and
- (v) the Agency Agreement.

**PRINCIPAL OFFICE OF THE SOCIETY**

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United Kingdom

**REGISTRAR**

**Lloyds TSB Registrars**

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West Sussex BN99 6DA  
United Kingdom

**TRANSFER AGENT**

**Dexia Banque Internationale à Luxembourg, société anonyme**

69 route d'Esch  
L-2953  
Luxembourg

**NOTICE AGENT**

**HSBC Bank plc**

8 Canada Square  
London E14 5HQ  
United Kingdom

**LISTING AGENT**

**Dexia Banque Internationale à Luxembourg, société anonyme**

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