

# Half Year Financial Statements 2011

**Principality Building Society**  
**Half-year financial report**  
**for the period ended 30 June 2011**

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#### **FORWARD-LOOKING STATEMENTS**

This half-year report contains certain forward-looking statements. These statements are made by the directors in good faith based on the information available to them up to the time of their approval of this report and such statements should be treated with caution due to the inherent uncertainties, including both economic and business risk factors, underlying any such forward-looking information. Therefore actual results may differ materially from those expressed or implied by these forward-looking statements.

The directors undertake no obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

## Responsibility statement

We confirm that to the best of our knowledge:

(a) the condensed set of financial statements has been prepared in accordance with IAS 34 'Interim Financial Reporting';

(b) the interim management report includes a fair review of the information required by DTR 4.2.7 (indication of important events during the first six months and the description of principal risks and uncertainties for the remaining six months of the year); and

(c) the interim management report includes a fair review of the information required by DTR 4.2.8 (disclosure of related party transactions and changes therein).

The information for the period ended 30 June 2011 does not constitute statutory accounts as defined in the Building Societies Act 1986. The auditor's report on the 2010 Annual Report and Accounts was not qualified and did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying the report.

By order of the Board,

P L Griffiths  
Chief Executive

W G Thomas  
Group Finance Director

## Chief Executive's review

The Society has once again delivered a very robust set of results demonstrating its resilience in a marketplace where macro economic issues dominate the current agenda. Our profitability, capital position and funding levels remain strong and we face the future with optimism notwithstanding current market and regulatory pressures.

Growth will continue to be constrained until these challenges are alleviated which is unlikely to occur in the short term. We remain ever-conscious of the impact tight credit conditions have on home ownership aspirations and the knock-on effect into the current housing crisis. Serious challenges also exist for savers in this low interest rate environment and we would expect rates to remain at this level for some time to come.

## Trading Highlights

- Strong half year pre-tax profits of £14.8m (30 June 2010: £13.2m)
- General reserves increased by £10.4m (30 June 2010: £9.6m)
- A robust net interest margin of 1.79% (30 June 2010: 1.72%)
- Overall balance sheet impairment provisions of £59.6m (30 June 2010: £57.9m)
- A cost/income ratio of 50.8% (30 June 2010: 50.3%)
- Savings growth of £101.9m (30 June 2010: £54.9m)

All of our principal businesses performed well during the first half and our diversified model has continued to deliver good returns. We have further invested in our property related businesses and have an ambition to rapidly grow our estate agency and lettings propositions. We have launched 'PA Black', a new brand focusing on higher value properties, and initial results since launch have been very encouraging.

With interest rates remaining lower for longer we would expect reasonable stability in house prices in the near term. All of our lending books performed well across the Retail Financial Services, Secured Personal Lending and the Commercial Lending business with impairment at expected levels.

As we look forward, we do so in a world where the average consumer is feeling financially squeezed and there is a huge trust deficit building with consumers wondering who to turn to for financial advice. We are attracting strong numbers of new Members and seeing positive growth in savings balances. Prudently, all of our loans remain fully funded by Member deposits. This provides strong insulation from the current dislocation in wholesale funding markets.

Gross and net lending levels across the sector remain very low, with little sign of sustained recovery, and credit conditions and capital markets remain nervous in view of wider European contagion issues.

We continue to invest heavily in the future of the business, particularly in technology and our underlying service proposition which continues to underpin our excellent customer satisfaction rating levels.

This background, coupled to our strong brand, history and provenance, leave us well placed to compete in what is likely to be a rapidly changing landscape once the final results of the review by the Independent Commission on Banking are published and the Mortgage Market and the Retail Distribution Reviews are concluded.

There is undoubtedly a major structural shift in home ownership, which continues to decline with the overall level of owner-occupied households now at the same level evident some 20 years ago. A sobering statistic and, sadly, the idea that year-on-year more people will own their own home looks to be over. The Society continues to seek to drive innovative housing solutions for its Welsh-based Members, believing passionately that this approach will help drive the economic and social agendas in Wales.

P L Griffiths  
Chief Executive  
26 July 2011

## Business review for the six months ended 30 June 2011

### Income statement

The Group's profit before tax for the 6 months ended 30 June 2011 was £14.8m (30 June 2010: £13.2m). Trading profit was £19.7m (30 June 2010: £14.7m) which excludes provisions for liabilities and charges and other gains. This demonstrates a strong start to 2011 with an increase of over 34% on last year's trading profit for the same period. The improved profit performance is driven by reduced provisions for impairment losses and an increase in net interest margin.

### Profit

#### *Net interest margin*

At 1.79% (30 June 2010: 1.72%) the Group's net interest margin benefits from higher margins earned in the secured personal lending division. Net interest margin has been enhanced by gains of £0.8m (30 June 2010: £4.4m), equivalent to 2bps (30 June 2010: 8bps) arising from the profit on the sale of gilts.

Wholesale markets remain subdued and short term funding largely inaccessible. Retail funding continues to be relatively more expensive and along with the requirement to hold more lower yielding UK sovereign securities, is placing downward pressures on future net interest margin. Management remains focused on maintaining a strong but balanced net interest margin that provides value and security to Members in the months and years ahead.

#### *Other income*

The Group's non-interest income at £10.3m (30 June 2010: £9.2m) includes insurance income, estate agency income, property services income and income generated from a number of other complementary activities. These together generated 15.8% (30 June 2010: 14.7%) of total income. Sales of life, investment and general insurance products continued to perform well during the first half of the year. The housing market remains subdued and uncertain with buyers continuing to adopt a 'wait and see' strategy on both interest rates and house prices. This has resulted in lower income from the estate agency business which has been offset by the continued growth in lettings activity and the managed book.

#### *Administrative expenses*

Strategic investments to enhance the Society's 'e' capabilities, including a new website, along with other key investments in Principality Property Solutions and the 'PA Black' brand, has resulted in an increase in the ratio of operating expense as a percentage of total mean assets to 1.01% (30 June 2010: 0.97%). The cost to income ratio was 50.8% (30 June 2010: 50.3%). This increase is as a result of the deliberate investment strategy to increase diversity in our income streams and provide long-term value.

The impact of the VAT increase from 17.5% to 20.0%, which is largely irrecoverable, has increased costs by £0.3m on the same period last year.

#### *Impairment provisions for losses on loans and advances*

The charge for impairment provisions of £12.3m for the Group is lower than that for the same period last year (30 June 2010: £16.4m). Continuing difficult market conditions and a fall in property prices has resulted in provision charges in first charge residential lending being broadly flat with second charge residential lending provisions increasing by £1.0m. Arrears growth has been contained by prudent lending and arrears management policies.

Market conditions for our Commercial lending division remain difficult; however the growth in impairment is slowing, resulting in a charge of £2.5m (30 June 2010: £7.3m). Accumulated impairment on our mortgages secured on commercial property currently stands at 1.79% (30 June 2010: 1.63%).

#### *Provisions for other liabilities and charges*

Provisions of £4.9m (30 June 2010: £4.6m) have been made in respect of various customer claims, including claims in relation to previous sales of payment protection insurance which are expected to crystallise over the next 12 months. The prior year comparative includes the release of an FSCS provision of £1.4m.

## Business review for the six months ended 30 June 2011 (continued)

### Statement of Financial Position

#### *Loans and advances to customers*

Lending criteria remain tight and lending volumes, whilst deliberately low, continue to show signs of improvement with residential mortgage completions during the first half of the year broadly flat compared to the same period last year. During the first half of the year, the Society has begun to re-offer 90% loan-to-value (LTV) mortgages as we seek to continue to support people in their home ownership aspirations. 90% mortgages have not previously been offered since 2008. Mortgage assets have increased by 2.1% to £5,065.5m since the year end however, management will continue to apply controls prudently to the Group's lending, reflecting the continued uncertainty in the wider economy.

The average LTV of the residential portfolio stands at 63.8% (31 December 2010: 61.6%) with 71.2% of the portfolio under 80% LTV and only 2.6% in negative equity based on indexed property values.

During the first half of the year, £12.6m of loans in our secured lending division were sold, resulting in a gain on disposal of £0.4m.

#### *Liquidity*

Liquid assets have remained broadly flat since the year end and represent 19.6% of shares and borrowings (31 December 2010: 21.1%). Asset quality has increased with 65.9% of the portfolio being held in UK sovereign and central bank exposures (31 December 2010: 57.2%). Other than UK sovereign and central bank exposures, liquidity is held in the form of investments with other financial institutions, with 98.2% (31 December 2010: 98.9%) of these exposures rated between A and AAA under Fitch credit ratings.

The Group holds a £10.0m (31 December 2010: £10.0m) exposure to Anglo Irish Bank Corporation Limited due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. The Group continues to monitor this exposure in light of the ongoing political and economic situation in Ireland but, based on the current guarantee in place, we do not consider any impairment to be necessary at this time. Further detail is provided in note 2 to the Annual Report and Accounts for 2010.

#### *Funding*

The Society has a strong funding base, predominantly represented by retail savings. As a result, less reliance is placed on wholesale markets. The savings environment remains highly competitive and Management's focus has been to secure and retain funds at economic rates whilst providing value to our Members. The Principality brand continues to attract savers who seek a safe haven for their funds and has resulted in record saving balances at the half year of £5,140.9m. This represents 101.5% (31 December 2010: 101.6%) of all mortgage balances with fixed rate bonds accounting for 57.6% (31 December 2010: 54.8%) of all savings balances.

Borrowings from wholesale sources, administered by the Group's treasury function, have reduced by £89.2m since the year end. At 9.3% (31 December 2010: 11.0%) of all shares, deposits and loans, the Group's borrowings represent a low dependence on wholesale markets. Principality's strong retail brand and reputation has allowed choice over funding sources during a period when wholesale markets remain subdued. Balancing the mix of funding through wholesale markets and retail remains a key focus and Management is committed to maintaining a prudent position.

The Society's long-term debt ratings with Fitch and Moody's, at BBB+ and Baa2 respectively, currently remain unchanged from last year; however, in May, Moody's announced that it will be reviewing the ratings of 14 financial institutions for possible downgrade as it believes that the perceived level of systematic government support available to each institution needs to be reassessed in the post-crisis environment. These institutions have been named as five banks, including Royal Bank of Scotland, Lloyd's and Santander, along with the top nine building societies, including Principality. The outcome of this review has not yet been published.

## **Business review for the six months ended 30 June 2011 (continued)**

### *Capital*

Capital comprises the Group's general reserve, permanent interest-bearing shares (subscribed capital) and subordinated liabilities. This capital is held to support the development of the business, to protect Members' deposits and provide a buffer against unexpected losses. Total capital has increased from £492.5m at the end of 2010 to £499.9m. The Core Tier 1 and Tier 1 ratios (with profits) have increased to 11.56% and 13.61% respectively compared to 11.27% and 13.34% as at 31 December 2010. The Core Tier 1 and Tier 1 ratios are well in excess of the minimum Basel III requirements as currently drafted.

The Group's total solvency ratio, a measure of the Group's total capital as a proportion of the Group's risk weighted assets at the balance sheet date, increased by 0.25% to 17.58% since the year end. This is well in excess of the minimum established by the FSA.

### **Going concern**

As presented in the consolidated statement of financial position, the Group meets its funding requirements mainly from retail savings supplemented from wholesale sources. The current economic conditions create some uncertainty over the availability of wholesale funding in the foreseeable future. The Group's forecasts and projections include scenario testing as carried out in accordance with the Internal Capital Adequacy Assessment Process (ICAAP) and Individual Liquidity Adequacy Assessment (ILAA), which are processes required by our regulator to demonstrate appropriate levels of capital and liquidity respectively under stressed conditions. This takes account of severe but plausible adverse scenarios affecting changes in trading performance, and shows that with contingencies, the Group will be able to operate within the sources of funding currently available to it, even under stressed scenarios.

The assets held for liquidity purposes are assessed and reviewed for counterparty risks, and the directors consider that the Group is not exposed to losses on those assets that would affect the decision to adopt the basis of going concern. The directors consider that the overall level of capital, including Tier 1 capital of £378.0m (13.61% as a percentage of risk-weighted assets) and a solvency ratio of 17.58% is adequate. Having considered the plans and forecasts for the Group the directors believe that there are no material uncertainties that lead to significant doubt on the Group's ability to continue in business for our Members as a mutual building society for the foreseeable future. Accordingly, the financial statements continue to be prepared on a going concern basis.

### **Principal risks and uncertainties**

The Group Risk Committee, which meets at least quarterly, is responsible for reviewing strategic, operational and financial risks and ensuring that appropriate action is taken to mitigate those risks. The principal risks and uncertainties for the remaining six months of the financial year, which have an impact on the Group's long-term performance, remain those outlined on pages 12 to 15 of the 2010 Annual Report and Accounts. These risks include:

#### *Credit risk*

This is the risk that a customer or counterparty will fail to meet their financial obligations to the Group as they become due. The volatility and continued fragility of the economy presents, amongst other things, a risk of increased unemployment and declining house prices which would impact arrears and loan loss provision levels.

The current turmoil in the Eurozone also presents such a risk which is discussed on pages 3 and 4 of the Business Review.

#### *Liquidity risk*

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

The directors have considered the funding and liquidity risk under the heading 'Going concern' above.

## Business review for the six months ended 30 June 2011 (continued)

### *Market risk*

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

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

The levies payable to the FSCS in relation to the restructuring of a number of failed institutions are due to finish in 2012 and it is currently uncertain as to how Scheme shortfalls are to be funded in the future.

### *Operational risk*

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

### *Pension obligation risk*

The risk that the value of the Fund's assets, together with ongoing employer and Member contributions, will be insufficient to cover the projected obligations of the Fund over time. To mitigate these risks, management, together with the Trustees of the Fund, regularly review reports prepared by the Fund's independent actuaries and take appropriate actions which may, for example, include adjusting the investment strategy and/or contribution levels.

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

Details of the pension obligations of the Group can be found on page 11 and on page 15 of the 2010 Annual Report and Accounts.

Further information on the outlook for the second half of the year is detailed in the Chief Executive's report on page 1. Additional information on risk is also provided in the Pillar 3 disclosure available at:

<http://www.principality.co.uk/~media/Files/PDF/Financial%20Reports/2010/Principality%20Pillar%203%20Disclosure%202010%20Final%20Final.ashx>

W G Thomas  
Group Finance Director  
26 July 2011



## **Independent review report to Principality Building Society**

We have been engaged by the Society to review the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2011 which comprises the condensed consolidated statement of comprehensive income, the condensed consolidated statement of recognised income and expense, the condensed consolidated statement of financial position, the condensed consolidated statement of cash flows and related notes 1 to 17. We have read the other information contained in the half-yearly financial report and considered whether it contains any apparent misstatements or material inconsistencies with the information in the condensed set of financial statements.

This report is made solely to the Society in accordance with International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Auditing Practices Board. Our work has been undertaken so that we might state to the Society those matters we are required to state to it in an independent review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Society, for our review work, for this report, or for the conclusions we have formed.

### **Directors' responsibilities**

The half-yearly financial report is the responsibility of, and has been approved by, the directors. The directors are responsible for preparing the half-yearly financial report in accordance with the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

As disclosed in note 1, the annual financial statements of the Group are prepared in accordance with IFRSs as adopted by the European Union. The condensed set of financial statements included in this half-yearly financial report has been prepared in accordance with International Accounting Standard 34, "Interim Financial Reporting," as adopted by the European Union.

### **Our responsibility**

Our responsibility is to express to the Society a conclusion on the condensed set of financial statements in the half-yearly financial report based on our review.

### **Scope of Review**

We conducted our review in accordance with International Standard on Review Engagements (UK and Ireland) 2410 "Review of Interim Financial Information Performed by the Independent Auditor of the Entity" issued by the Auditing Practices Board for use in the United Kingdom. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing (UK and Ireland) and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

### **Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the condensed set of financial statements in the half-yearly financial report for the six months ended 30 June 2011 is not prepared, in all material respects, in accordance with International Accounting Standard 34 as adopted by the European Union and the Disclosure and Transparency Rules of the United Kingdom's Financial Services Authority.

### **Deloitte LLP**

Chartered Accountants and Statutory Auditor  
Cardiff, United Kingdom  
26 July 2011

**Condensed consolidated statement of comprehensive income**  
**Group Interim results for six months to 30 June 2011**

	Notes	6 months to 30.06.11 £m (Unaudited)	6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Interest receivable and similar income	3	115.0	105.8	222.4
Interest payable and similar charges	4	(60.5)	(52.3)	(110.6)
Net interest income		54.5	53.5	111.8
Fees and commission receivable	5	10.2	9.4	17.9
Fees and commission payable	6	(0.8)	(0.7)	(1.6)
Net fee and commission income		9.4	8.7	16.3
Other operating income		0.9	0.5	0.8
Other fair value gains and losses	7	0.3	(0.1)	0.2
Net operating income		65.1	62.6	129.1
Administrative expenses	8	(30.0)	(28.6)	(56.4)
Depreciation and amortisation		(3.1)	(2.9)	(5.7)
Total operating expenses		(33.1)	(31.5)	(62.1)
Impairment provision for losses on loans and advances		(12.3)	(16.4)	(22.2)
Provision for other liabilities and charges	12	(4.9)	(4.6)	(17.1)
Operating profit		14.8	10.1	27.7
Other gains	9	-	3.1	3.1
Profit before tax		14.8	13.2	30.8
Taxation expense	10	(3.9)	(3.1)	(7.6)
Profit for the period/year		10.9	10.1	23.2

**Condensed consolidated statement of recognised income and expense**

Profit for the period/year	10.9	10.1	23.2
Actuarial loss on retirement benefit obligations	(0.4)	(0.7)	(0.5)
Movement in deferred tax relating to retirement benefit obligations	(0.1)	0.2	-
	10.4	9.6	22.7

All items dealt with in arriving at the profit before tax relate to continuing operations.

The accounting policies and notes on pages 11 to 20 form part of these accounts.

Condensed consolidated statement of financial position  
As at 30 June 2011

	Notes	As at 30.06.11 (Unaudited) £m	As at 30.06.10 (Unaudited) £m	As at 31.12.10 (Audited) £m
<b>Assets</b>				
Liquid assets:				
Cash in hand and balances with the Bank of England		485.3	404.3	320.7
Loans and advances to credit institutions		51.8	36.5	73.3
Debt securities		574.3	925.7	800.8
		1,111.4	1,366.5	1,194.8
Derivative financial instruments		37.3	43.9	38.7
Loans and advances to customers:				
Loans fully secured on residential property		4,460.9	4,224.7	4,338.1
Other loans fully secured on land		555.9	580.0	571.5
Other loans		48.7	53.9	50.8
	11	5,065.5	4,858.6	4,960.4
Investment in joint venture		-	1.9	-
Intangible fixed assets		2.2	2.2	2.1
Property, plant and equipment		42.4	36.5	40.9
Deferred tax assets		3.1	4.1	3.3
Other assets		3.0	3.3	3.8
Prepayments and accrued income		20.3	22.6	18.1
<b>Total assets</b>		<b>6,285.2</b>	<b>6,339.6</b>	<b>6,262.1</b>
<b>Liabilities</b>				
Shares		5,140.9	4,988.1	5,039.0
Deposits and debt securities:				
Amounts owed to credit institutions	13	169.5	443.2	245.4
Amounts owed to other customers		290.7	195.0	286.9
Debt securities in issue		69.2	102.6	86.3
		529.4	740.8	618.6
Derivative financial instruments		50.8	72.6	55.7
Current tax liabilities		3.6	4.2	1.3
Other liabilities		7.7	9.0	6.7
Provision for liabilities and charges	12	29.3	14.4	24.8
Accruals and deferred income		13.1	11.9	12.7
Deferred tax liabilities		1.3	1.8	1.5
Retirement benefit obligations		9.2	10.7	9.3
Subordinated liabilities		110.3	114.3	112.3
Subscribed capital		69.3	70.4	69.2
<b>Total liabilities</b>		<b>5,964.9</b>	<b>6,038.2</b>	<b>5,951.1</b>
General reserve	14	321.0	297.5	310.6
Other reserves		(0.7)	3.9	0.4
<b>Total equity and liabilities</b>		<b>6,285.2</b>	<b>6,339.6</b>	<b>6,262.1</b>

The accounting policies and notes on pages 11 to 20 form part of these accounts.

Loans and advances to customers of £40.0m have been reclassified from other loans to loans secured on residential property for the period ended 30 June 2010 as this is considered to more appropriately represent the nature of the balance. There was no effect on net assets as a result of the reclassification.

Condensed consolidated statement of cash flows  
Group Interim results for six months to 30 June 2011

	6 months to 30.06.11 (Unaudited) £m	6 months to 30.06.10 (Unaudited) £m	Year ended 31.12.10 (Audited) £m
<b>Net cash (outflow)/inflow from operating activities (see below)</b>	(77.2)	19.2	(118.8)
<b>Cash flows from investing activities</b>			
Purchase of intangible assets and property, plant and equipment	(4.6)	(2.6)	(9.9)
Purchase of investment securities	(998.2)	(1,355.9)	(2,228.2)
Proceeds from sale and maturity of investment securities	1,223.0	1,517.6	2,510.1
Disposal of shares in joint venture	-	-	1.9
<b>Cash flows from financing activities</b>			
Repurchase of subordinated liabilities	-	(6.9)	(6.9)
<b>Increase in cash and cash equivalents</b>	<b>143.0</b>	<b>171.4</b>	<b>148.2</b>
Cash and cash equivalents at beginning of period/year	390.9	242.7	242.7
<b>Cash and cash equivalents at end of period/year</b>	<b>533.9</b>	<b>414.1</b>	<b>390.9</b>
<b>Represented by:</b>			
Cash and balances with the Bank of England	485.3	404.3	320.7
Loans and advances to credit institutions repayable on demand	48.6	9.8	70.2
	<b>533.9</b>	<b>414.1</b>	<b>390.9</b>
<b>Net cash (outflow)/inflow from operating activities</b>			
Profit before taxation	14.8	13.2	30.8
<b>Adjusted for:</b>			
Depreciation and amortisation	3.1	2.9	5.7
Loss on sale of property, plant and equipment	-	-	0.3
Increase in impairment losses on loans and advances to customers	12.3	16.4	22.2
Change in fair values	4.7	(10.2)	(1.2)
Other non-cash movements	-	(2.9)	(2.9)
<b>Changes in net operating assets</b>			
Decrease in loans and advances to credit institutions not repayable on demand	-	38.9	50.0
Increase in loans and advances to customers	(122.2)	(116.8)	(242.5)
Decrease/(increase) in other assets	0.8	(1.8)	(2.6)
(Increase)/decrease in prepayments and accrued income	(2.2)	(3.6)	0.9
(Decrease)/increase in derivative financial instruments	(3.5)	14.5	2.8
Increase in shares	98.7	47.2	103.8
(Decrease)/increase in deposits and debt securities	(87.8)	15.0	(94.6)
Increase in other liabilities	1.0	3.2	1.0
Increase in accruals and deferred income	4.9	4.9	15.9
Decrease in pension fund obligations	(0.5)	-	(1.1)
<b>Taxation</b>	<b>(1.3)</b>	<b>(1.7)</b>	<b>(7.3)</b>
	<b>(77.2)</b>	<b>19.2</b>	<b>(118.8)</b>

**Notes to the accounts  
for the period ended 30 June 2011**

**1. Accounting policies**

**Basis of preparation**

The condensed consolidated set of financial statements included in this half-year financial report has been prepared in accordance with the Disclosure and Transparency Rules of the Financial Services Authority and with International Accounting Standard (“IAS”) 34 ‘Interim Financial Reporting’, as adopted by the European Union. The annual financial statements of the Group are prepared in accordance with IFRSs as adopted by the European Union.

The same accounting policies are followed in this condensed set of financial statements as applied in the Group’s latest annual audited financial statements.

Within the consolidated statement of financial position loans and advances to customers of £40.0m in the period ended 30 June 2010 have been reclassified from other loans to loans fully secured on residential property in the statement of financial position. This restatement is considered to more appropriately represent the nature of the balance. There was no effect on the 2009 profit for the year as a result of the reclassification and no effect on the 2009 opening and closing reserves.

**Judgements in applying accounting policies and critical accounting estimates**

The same accounting judgements are followed in this condensed set of financial statements as applied in the Group’s latest annual audited financial statements and reflect managements current estimates, except for calculations of retirement benefit obligations.

***Retirement benefit obligation***

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

Changes to the actuarial assumptions for inflation and the discount rate applied to calculate the present value of future scheme liabilities have resulted in a net charge to the statement of recognised income and expense of £0.4m.

	<b>6 months to 30.06.11 (Unaudited)</b>	<b>6 months to 30.06.10 (Unaudited)</b>	<b>Year ended 31.12.10 (Audited)</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Discount rate assumption	5.50	5.30	5.40
Inflation assumption (RPI)	3.65	3.30	3.55
Inflation assumption (CPI)	3.15	n/a	3.05
Rate of increase in pensionable salaries	3.65	3.30	3.55

**Going concern**

The directors are satisfied that the Group has sufficient resources to continue in operation for the foreseeable future, a period of not less than 18 months from the date of this report. Accordingly, they continue to adopt the going concern basis in preparing the condensed financial statements. Further information regarding the directors’ assessment of Going Concern can be found in the Business Review on pages 3 to 6.

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for the period ended 30 June 2011

2. Business segments

The Group operates four main business segments retail financial services, commercial lending, secured personal lending, and property services.

Transactions between the business segments are on normal commercial terms and conditions.

	6 months to 30.06.11 (Unaudited)					Total £m
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Property services £m	Adjustment for Group transactions £m	
	Interest receivable and similar income	87.5	19.2	29.4	-	
Interest payable and similar charges	(60.5)	(13.7)	(7.4)	-	21.1	(60.5)
Net interest income	27.0	5.5	22.0	-	-	54.5
Net fee and commission income	2.9	0.4	1.3	4.9	(0.1)	9.4
Other operating income	1.0	-	-	-	(0.1)	0.9
Fair value gains	0.3	-	-	-	-	0.3
<b>Net operating income</b>	<b>31.2</b>	<b>5.9</b>	<b>23.3</b>	<b>4.9</b>	<b>(0.2)</b>	<b>65.1</b>
Administrative expenses	(22.5)	(1.0)	(5.1)	(4.7)	0.2	(33.1)
Impairment provision for losses on loans and advances	(1.1)	(2.5)	(8.7)	-	-	(12.3)
Provisions for other liabilities and charges	-	-	(4.7)	(0.2)	-	(4.9)
<b>Operating profit</b>	<b>7.6</b>	<b>2.4</b>	<b>4.8</b>	<b>-</b>	<b>-</b>	<b>14.8</b>
<b>Other gains</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Profit before taxation</b>	<b>7.6</b>	<b>2.4</b>	<b>4.8</b>	<b>-</b>	<b>-</b>	<b>14.8</b>

	6 months to 30.06.10 (Unaudited)					Total £m
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Property services £m	Adjustment for Group transactions £m	
	Interest receivable and similar income	78.7	18.7	28.4	-	
Interest payable and similar charges	(52.3)	(13.1)	(6.9)	-	20.0	(52.3)
Net interest income	26.4	5.6	21.5	-	-	53.5
Net fee and commission income	3.5	0.5	0.1	4.7	(0.1)	8.7
Other operating income	0.6	-	-	-	(0.1)	0.5
Fair value losses	(0.1)	-	-	-	-	(0.1)
<b>Net operating income</b>	<b>30.4</b>	<b>6.1</b>	<b>21.6</b>	<b>4.7</b>	<b>(0.2)</b>	<b>62.6</b>
Administrative expenses	(22.7)	(0.9)	(4.4)	(3.3)	(0.2)	(31.5)
Impairment provision for losses on loans and advances	(1.4)	(7.3)	(7.7)	-	-	(16.4)
Provisions for other liabilities and charges	1.4	-	(6.0)	-	-	(4.6)
<b>Operating profit/(loss)</b>	<b>7.7</b>	<b>(2.1)</b>	<b>3.5</b>	<b>1.4</b>	<b>(0.4)</b>	<b>10.1</b>
<b>Other gains</b>	<b>3.1</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3.1</b>
<b>Profit/(loss) before taxation</b>	<b>10.8</b>	<b>(2.1)</b>	<b>3.5</b>	<b>1.4</b>	<b>(0.4)</b>	<b>13.2</b>

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for the period ended 30 June 2011

2. Business segments (continued)

	Year ended 31.12.10 (Audited)					Total £m
	Retail financial services £m	Commercial lending £m	Secured personal lending £m	Property services £m	Adjustment for Group transactions £m	
Interest receivable and similar income	139.1	38.1	59.2	-	(14.0)	222.4
Interest payable and similar charges	(83.3)	(27.3)	(14.1)	-	14.1	(110.6)
Net interest income	55.8	10.8	45.1	-	0.1	111.8
Net fee and commission income	6.4	0.9	(0.1)	9.3	(0.2)	16.3
Other operating income	1.2	-	-	-	(0.4)	0.8
Fair value gains	0.2	-	-	-	-	0.2
<b>Net operating income</b>	<b>63.6</b>	<b>11.7</b>	<b>45.0</b>	<b>9.3</b>	<b>(0.5)</b>	<b>129.1</b>
Administrative expenses	(42.9)	(2.0)	(9.3)	(8.9)	1.0	(62.1)
Impairment provision for losses on loans and advances	(2.8)	(9.6)	(9.8)	-	-	(22.2)
Provisions for other liabilities and charges	(0.5)	-	(16.2)	(0.4)	-	(17.1)
<b>Operating profit</b>	<b>17.4</b>	<b>0.1</b>	<b>9.7</b>	<b>-</b>	<b>0.5</b>	<b>27.7</b>
<b>Other gains</b>	<b>3.1</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3.1</b>
<b>Profit before taxation</b>	<b>20.5</b>	<b>0.1</b>	<b>9.7</b>	<b>-</b>	<b>0.5</b>	<b>30.8</b>

	6 months to 30.06.11 £m (Unaudited)	6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
<b>Total assets by business segments</b>			
Retail financial services	4,688.3	4,722.3	4,640.0
Secured personal lending	665.0	664.2	680.2
Commercial lending	927.1	948.0	937.9
Property services	4.8	5.1	4.0
<b>Total assets</b>	<b>6,285.2</b>	<b>6,339.6</b>	<b>6,262.1</b>
<b>Total liabilities and reserves by business segment</b>			
Retail financial services	5,615.4	5,670.3	5,577.9
Secured personal lending	665.0	664.2	680.2
Commercial lending	-	-	-
Property services	4.8	5.1	4.0
<b>Total liabilities and reserves</b>	<b>6,285.2</b>	<b>6,339.6</b>	<b>6,262.1</b>

Net proceeds of funding will be used by the Group for the general purposes of its business.

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

Notes to the accounts  
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3. Interest receivable and similar income

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
On loans fully secured on residential property	116.8	111.3	232.1
On other loans fully secured on land	10.9	10.9	22.2
On debt securities	3.9	6.7	11.7
Profit on realisation of investments	0.8	4.4	6.3
On other liquid assets	1.1	0.7	1.7
On derivative financial instruments	(18.5)	(28.2)	(51.6)
	<u>115.0</u>	<u>105.8</u>	<u>222.4</u>

The derivative arrangements in place for the Group result in a net payment of fixed interest on mortgage related derivatives. Due to the continued low rates of LIBOR over the first half of the year, net interest of £18.5m has been payable.

4. Interest payable and similar charges

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
On shares held by individuals	63.8	54.7	124.5
On other shares	0.1	0.1	-
On deposits and debt securities	5.0	10.1	7.9
On subscribed capital	2.1	2.1	4.2
On subordinated liabilities	3.0	3.0	5.9
On derivative financial instruments	(13.5)	(17.7)	(31.9)
	<u>60.5</u>	<u>52.3</u>	<u>110.6</u>

The derivative arrangements in place for the Group result in a net receipt of fixed interest on savings related derivatives. Due to the continued low rates of LIBOR over the first half of the year, net interest of £13.5m has been received.

5. Fees and commission receivable

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Insurance and related financial service products	4.9	3.1	6.3
Estate Agency and lettings income	2.8	2.9	6.0
Mortgage related fees	1.7	2.2	3.4
Other fees and commission	0.8	1.2	2.2
	<u>10.2</u>	<u>9.4</u>	<u>17.9</u>

6. Fees and commission payable

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Mortgage related fees	0.6	0.5	1.2
Bank charges	0.2	0.2	0.4
	<u>0.8</u>	<u>0.7</u>	<u>1.6</u>



Notes to the accounts  
for the period ended 30 June 2011

7. Other fair value gains and losses

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Gains/(losses) on derivatives	3.6	(14.4)	(2.8)
(Losses)/gains on hedged items attributable to the hedged risk	(3.3)	14.3	3.0
	0.3	(0.1)	0.2

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

8. Administrative expenses

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Wages and salaries	15.9	15.1	31.2
Social security costs	1.6	1.4	2.9
Other pension costs	0.6	0.7	1.1
	18.1	17.2	35.2
Other administrative expenses	11.9	11.4	21.2
	30.0	28.6	56.4

9. Other gains

Included in the profit for the 6 months to 30 June 2010 was a gain of £3.1m on the repurchase of £10.0m of subordinated liabilities. There have been no other gains included in the profit for the 6 months to 30 June 2011.

10. Tax

Tax for the Group for the six month period is charged at 26.4% (30 June 2010: 30.7%), representing the best estimate of the annual effective tax rate expected for the full year, applied to the pre-tax income of the six month period. The reduction in rate is largely driven by the reduction in the UK Corporation tax rate from 28% to 26% from 1 April 2011 along with the enhanced contribution into the defined benefit contribution scheme as outlined in note 15.

The reduction in rate has resulted in a deferred tax charge arising from the reduction in the statement of financial position carrying value of the net deferred tax asset to reflect the anticipated rate of tax at which the asset is expected to reverse. The relevant charge is not material. The forthcoming change in the rate of corporation tax to 25% from 1 April 2012 will not materially affect the future tax charge.

Included in the profit for the 6 months to 30 June 2010 was a gain of £3.1m on the repurchase of £10.0m of subordinated liabilities which was treated as non-taxable.

Notes to the accounts  
for the period ended 30 June 2011

11. Loans and advances to customers

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Maturity analysis of loans and advances to customers from the date of the balance sheet:			
Repayable on demand	44.8	58.0	83.1
Less than three months	141.1	126.5	80.3
Between three months and one year	275.4	240.1	267.4
Between one year and five years	1,042.1	1,061.3	1,081.0
More than five years	3,543.2	3,327.6	3,417.4
	<u>5,046.6</u>	<u>4,813.5</u>	<u>4,929.2</u>
Provision for impairment losses	(59.6)	(57.9)	(55.5)
Unamortised loan origination fees	31.7	33.2	35.1
Fair value adjustment for hedged risk	46.8	69.8	51.6
	<u>5,065.5</u>	<u>4,858.6</u>	<u>4,960.4</u>

As at 30 June 2011, £845.1m (30 June 2010: £842.7m) of loans issued by the Society had been transferred to Principality Covered Bond LLP. These loans secure a £700m AAA rated bond issued by the Society. The loans remain on the balance sheet of the Society as the risks and rewards are retained by the Society.

12. Provisions for liabilities

	As at 30.06.11 (Unaudited) £m	Group As at 30.06.10 (Unaudited) £m	As at 31.12.10 (Audited) £m
At 1 January	24.8	9.4	9.4
Charge for the period/year	4.9	5.0	17.1
Utilisation	(0.4)	-	(1.7)
At 30 June	<u>29.3</u>	<u>14.4</u>	<u>24.8</u>

Other provisions of £4.9m have been made in respect of various customer claims, including claims in relation to previous sales of payment protection insurance. It is expected that the liability will predominantly crystallise over the next 12 months. The contingent aspect of this provision is described in note 15.

Included within the charge for the period ended 30 June 2010 is £0.4m which was charged to fees and commissions receivable in the Statement of Comprehensive Income.

Provisions for liabilities are analysed as follows:

	As at 30.06.11 (Unaudited) £m	Group As at 30.06.10 (Unaudited) £m	As at 31.12.10 (Audited) £m
PPI	24.3	10.1	19.8
FSCS	3.8	3.6	3.8
Regulatory and other complaints	1.2	0.7	1.2
At 30 June	<u>29.3</u>	<u>14.4</u>	<u>24.8</u>

Further details of the provisions held and expected timing of payments is set out in note 39 to the 2010 Annual Report and Accounts.

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13. Amounts owed to credit institutions

As part of the Covered Bond Programme, and included in amounts owed to credit institutions, is £100.0m (30 June 2010: £398.1m) relating to securities sold under short-term agreements to repurchase.

14. Analysis of general reserve

	As at 30.06.11 (Unaudited) £m	Group As at 30.06.10 (Unaudited) £m	As at 31.12.10 (Audited) £m
Balance at 1 January	310.6	287.9	287.9
Profit for the financial period/year	10.9	10.1	23.2
Actuarial loss on retirement benefit obligations	(0.4)	(0.7)	(0.5)
Movement in deferred tax relating to retirement benefit obligations	(0.1)	0.2	-
Total recognised income for the period/year	10.4	9.6	22.7
Balance at end of period/year	321.0	297.5	310.6
Reserves excluding pension liability	330.2	308.0	319.9
Pension liability	(9.2)	(10.5)	(9.3)
	321.0	297.5	310.6

15. Contingent liabilities and commitments

a) Financial Services Compensation Scheme levy

As described in note 39 to the 2010 Annual Report and Accounts, the Society is required to make payments to the Financial Services Compensation Scheme (FSCS) in relation to the restructuring of a number of failed financial institutions.

A provision of £3.8m (31 December 2010: £3.8m) is held in respect of these levies and represents the Society's best estimate of total levies payable in September 2011 and 2012. The Society has not yet been directly notified of the levies payable as a result of the claims against the FSCS and there are a number of factors that prevent accurate calculation of this future liability. As more information becomes available, the Society will continue to review provision levels as appropriate.

b) Payment protection insurance (PPI)

During 2010, the FSA published a Policy Statement (PS10/12) on The Assessment and Redress of PPI Complaints which applies to all types of PPI policies, which, in the Group's case, relate to secured personal lending PPI products. The British Bankers Association initiated a judicial review on the approach outlined in the Policy Statement with the review finding in favour of the FSA in April 2011.

An additional £4.7m charge has been incurred during the first half of the year taking total provisions to £24.3m which represents the best estimate of expected redress payments calculated in accordance with the guidance with PS10/12m, where the Group had responsibility for the original sale of the product.

c) Defined benefit pension scheme

£0.5m was injected into Scheme during the first half of the year. The Group will inject a further £0.5m into the defined benefit pension scheme on 31 July 2011 in accordance with the scheme closure agreement.

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**16. Related party transactions**

Transactions between the Society and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note. There were no other significant related party transactions in the current or prior period which require disclosure in the half year financial report.

**17. Financial instruments – credit risk**

The table below shows the Group's estimated maximum exposure to credit risk for all financial assets.

**Loans and advances to credit institutions, debt securities and derivative financial instruments**

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
Financial assets:			
Loans and advances to credit institutions	51.8	36.5	73.3
Debt securities	574.3	925.7	800.8
Loans and advances to customers	5,065.5	4,858.6	4,960.4
Derivative financial instruments:			
Interest rate swaps	28.3	35.8	33.4
Cross currency interest rate swaps	9.0	8.1	-
	5,728.9	5,864.7	5,867.9

The percentage of these exposures that are rated between A and AAA under Fitch ratings for 2011 is 98.2% (31 December 2010: 98.9%).

Collateral is not held over loans and advances to credit institutions and debt securities.

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

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

The International Swaps and Derivatives Association (ISDA) Master Agreement is Principality's preferred agreement for documenting derivative activity. For certain counterparties a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counterparties to mitigate the market contingent counterparty risk inherent in the outstanding positions. Collateral of £5.4m (31 December 2010: £5.3m) is held over derivative financial instruments.

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17. Financial instruments – credit risk (continued)

Loans and advances to customers

The table shows loans and advances to customers disaggregated by security type and by loan type.

	6 months to 30.06.11 £m (Unaudited)	Group 6 months to 30.06.10 £m (Unaudited)	Year ended 31.12.10 £m (Audited)
In respect of loans and advances to customers:			
Fully secured by a first charge on residential property	3,847.5	3,616.9	3,711.2
Fully secured by a first charge on land	555.9	580.0	571.5
Fully secured by a second charge on residential property	613.4	607.8	626.9
Partially secured by a second charge on residential property	48.7	53.9	50.8
	5,065.5	4,858.6	4,960.4
Retail financial services	3,476.3	3,248.9	3,344.8
Commercial loans	927.1	948.0	937.9
Secured personal lending	662.1	661.7	677.7
	5,065.5	4,858.6	4,960.4

*(a) Retail financial services and secured personal lending*

Loans and advances to residential customers account for 89.0% of total loans and advances to customers (31 December 2010: 87.1%). 76.0% of loans and advances to residential customers are secured by a first charge on residential property (31 December 2010: 79.1%); 11.2% are fully secured by a second charge on residential property (31 December 2010: 12.9%).

The average index-linked loan to value (LTV) in respect of the Group's loans secured on residential property, including mortgages under offer, is estimated to be 63.8% (31 December 2010: 61.6%).

The Group provides loans secured on residential property across England and Wales and the Society, as a regional building society, has a geographical concentration in Wales. As at 30 June 2011, approximately 36.0% of residential exposures by account and 36.5% by value were concentrated in Wales (31 December 2010: 37.3% by account and 37.5% by value).

The percentage of residential lending cases fully secured by a first charge currently with arrears greater than 2.5% of the total outstanding balance is 0.93% (31 December 2010: 1.04%) which compares favourably with the industry average of 1.47% (latest available Council of Mortgage Lenders (CML) arrears and possessions data as at 31 March 2011).

The Society holds Excess of Loss Insurance cover which provides additional protection against subsequent residential loan impairment, up to an agreed threshold, after a prescribed level of 'first loss' or excess. Cover is restricted to new owner occupier mortgage loans advanced prior to 30 April 2010, where the original LTV exceeds 75%.

The percentage of residential lending cases fully secured by a second charge currently in arrears by number is 9.2% (31 December 2010: 9.3%), and by value is 11.7% (31 December 2010: 11.4%).

During the difficult economic conditions the Group has continued to explore all forbearance options with borrowers in difficulty and our mutual values ensure that repossession is the last resort. Typical activity would include short term arrangements, term extensions, a temporary switch to 'interest only' repayment, capitalisation, repayment holidays and assisted voluntary sale, all of which are subject to predefined criteria.

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for the period ended 30 June 2011**

**17. Financial instruments – credit risk (continued)**

*(b) Commercial*

Loans secured on commercial property are well diversified by industry type with the largest exposure to one counterparty amounting to £38.4m (31 December 2010: £40.6m) or 4.1% (31 December 2010: 4.1%) of gross balances.

Asset quality remains strong with total arrears balances of £1.4m (31 December 2010: £1.8m) and only 8 commercial cases (31 December 2010: 7) three months or more in arrears.

*(c) Treasury*

The Group has a £10.0m (31 December 2010: £10.0m) exposure to Anglo Irish Bank Corporation Ltd due for repayment in June 2012 which currently benefits from a guarantee under the Irish Government Eligible Liabilities Guarantee Scheme. This scheme is approved by the European Commission under EC Treaty state aid rules. The recent agreement between the Irish government, the European Union and International Monetary Fund (IMF) for a restructuring plan in November 2010 contained guarantees for the full repayment of its senior unsecured bonds. In light of the agreement, this exposure is considered not impaired. The Group has no direct sovereign exposure to Greece, Portugal, Spain or Italy as at 30 June 2011.