



REPORT & ACCOUNTS 2012

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CHAIRMAN'S REPORT

Ed Anderson

A REAL MUTUAL ALTERNATIVE – BUILT ON TRUST

As Chairman of Yorkshire Building Society I am delighted to report that the Group has once again performed strongly with robust profits, growing mortgage assets and improving the quality of those assets, in what continues to be challenging market conditions.

The Group has been able to deliver another strong performance thanks to the trust our customers place in us as a real mutual alternative to the retail banks, and because we have maintained our prudent approach to the management of the business.

In 2012 the Group consolidated its position as the UK's second largest independent mutual building society during a period that witnessed an ongoing crisis of trust in many of the UK's leading institutions. As Chris Pilling explains in his Chief Executive's Report, the Group's strong performance in 2012 included robust profits, the delivery of excellent customer service and the initiation of a major transformation programme.

External environment

Trust in the financial services industry is at an all-time low, exacerbated by a range of widely-reported issues including branch closures, failures in IT systems, the mis-selling of payment protection insurance (PPI), the LIBOR-fixing scandal and the poor controls to prevent money laundering overseas. Looking at society generally, trust has been lost in some of our leading institutions as a result of scandals and the perception of how well the institutions involved responded to them. As a building society, with customers at our heart, we regret the impact that these events have clearly had on customers' confidence in the financial services industry, however, we believe that it may raise awareness of the values we stand for.

The Board's view of the UK economy is that conditions remain challenging. There is continuing turmoil in the EU which serves to increase uncertainty, and despite the UK technically exiting a 'double dip' recession in October 2012 overall growth remains weak. Our savers continue to feel the impact of low interest rates, driven

by a record-low Bank of England Bank Rate and, more recently we believe, by the effect on the market of the government's Funding for Lending Scheme (FLS). At present we do not anticipate an increase in the Bank Rate for some considerable time.

The housing market has yet to recover and house price inflation remains flat. The future for house prices is uncertain with a strong pick up unlikely in the foreseeable future. Unemployment is high, especially amongst young adults, labour markets are fragile and there are increased levels of part-time and temporary employment, creating challenges for borrowers and savers alike. One example of how we have observed the challenging economic conditions affecting our customers is in the first time buyer market, which has seen a steady increase in the average age of first time buyers. This is, however, a market we are committed to supporting.

Changes have taken place in the competitive arena as the large retail banks work to address the challenges faced by their business models, including the loss of their customers' trust. Throughout 2012 resurgent consumer interest in alternatives to the big retail banks coincided with the entry into the market of new retail-branded competitors. At the same time, existing mutual challengers increasingly repositioned themselves as alternative providers of current accounts. The Group experienced high levels of customers switching from other providers to our own Norwich & Peterborough (N&P) branded current account during the year.

The pace of regulatory change within the sector remains high, opening up opportunities for us as well as imposing new sets of standards. In 2013 our existing regulator, the Financial Services Authority (FSA), will be replaced by two new regulators, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

The FCA will have the job of making markets work well, and will focus on three objectives: protecting consumers, promoting competition and enhancing market integrity. The FCA is there to ensure that across the spectrum, from the boardroom to the point of sale, firms keep the interests of consumers at the heart of what they do. The PRA, which will be part of the Bank of England, will share with the FCA the responsibility for the oversight of building societies, banks and insurers. The PRA's objective will be to promote the safety and soundness of regulated firms.

We have always prided ourselves on our strong relationship with the regulator and this has been characterised over recent years by:

- Sharing the regulator's goals of protecting the financial system and protecting customers.
- Open and honest communication and dealings.
- Professional completion of regulatory documentation and assessments.
- Proactive reporting on any matters thought to be of interest to the regulator.
- Adopting a positive approach to establishing what matters to address and how.
- Due priority in addressing agreed issues.

During 2012 we reviewed our approach to conduct risk and have embedded this into the Group's risk strategy. This ongoing cultural commitment to behaving in an exemplary manner is a key foundation to ensuring fair customer outcomes and therefore the management of conduct risk.

Further regulatory changes are affecting the savings and mortgage markets and these include:

- The Retail Distribution Review (RDR) which came into effect on 1 January 2013 and which, we believe, will have the effect of restricting the availability of financial advice to the mass market. We are working closely with our partner, Legal & General, to ensure that our sales processes continue to enable us to provide our members with a range of options in how they choose to manage their money and to support them in doing so.
- The Mortgage Market Review (MMR) will come fully into effect in 2014 and will place the full responsibility for ensuring customers can afford the mortgage they request onto the lender. For example, MMR clarifies

the requirements on lenders when mortgage terms extend beyond a customer's expected retirement age. The requirements of MMR have already resulted in a significantly reduced availability of interest only mortgages.

- The FSA's thematic review of interest only mortgage sales (expected in early 2013) will further impact the nature and availability of such mortgages.

During summer 2012 the Bank of England and HM Treasury introduced the FLS, a scheme whose aim is to incentivise banks and building societies to increase net lending to UK households and businesses. FLS is a liquidity programme that provides participating lenders with access to funding at a lower cost than was available in the wholesale markets at the time the scheme was announced. By 31 December 2012, 35 lenders had signed up for the scheme and were eligible to draw down a total of £68bn. The Group has signed up for the scheme but has yet to draw down any funds and is currently reviewing its planned utilisation of the scheme to support its funding strategy. The scheme has, as intended, led to lower mortgage rates and may encourage some lenders to re-enter markets they had previously withdrawn from.

The scheme has already had a significant impact on the retail savings market, reducing average best buy interest rates. We had, by the end of 2012, observed a reduction in average best buy rates in both the mortgage and savings markets. We have had to follow the market and reduce savings rates in 2013, in parallel with reductions in mortgage pricing. These rate reductions have been carried out in as fair a manner as possible whilst maintaining our focus on providing long-term value to our customers.

We are awaiting the outcome of the consultation process on HM Treasury's document 'The future of building societies' which sets out the government's proposals for changes to regulation to our sector. We fully support the government's approach and commitment to the building society sector but have shared our concerns regarding the implementation of any changes, in particular concerning the application of the changes in a balanced and fair way for all without unintended consequences. We are confident that the views and concerns we raised during the consultation process will be listened to.

In summary, the Group closely monitors developments in the economic and regulatory environments.

CHAIRMAN'S REPORT continued

The Board's focus

The Board is responsible for the corporate governance of the Group and for ensuring that best practice is adopted in this area. Our approach to corporate governance and details of the formal committee structures in place to deliver it are set out in detail in the Corporate Governance Report on pages 41 to 47.

The Board directed its focus on a number of critical areas in 2012:

- **Strategy**

We welcomed a new Chief Executive, Chris Pilling, to the Group on 31 December 2011. During 2012 the Board worked closely with Chris and his executive team to undertake a strategic review, with the goal of revitalising the Group's strategy in order to ensure it is optimised for the changing environment and to enable the Group to move forward in a sustainable way.

- **Core business performance**

The Board continued to pay close attention to overseeing the Group's sustainability through achieving a consistent level of profitability and thereby maintenance of its capital strength and its ability to deliver benefits to our customers. Our focus on the quality of new lending has continued to deliver benefits in terms of further reductions in the level of arrears on our mortgages. A comprehensive review of the Group's performance is set out in the Chief Executive's Report and in the Business Review on pages 8 to 29.

- **Integration and transformation**

The Group has undertaken significant merger and acquisition activity in recent years, most recently in 2011 with the acquisition of the Egg mortgage and savings business and our merger with the N&P. I am pleased to report that the integration of the Egg business is complete and the integration of N&P is progressing in line with our plans. During 2012 the Board agreed a major transformation programme which will allow us to simplify our business, become significantly more efficient and deliver market-leading experiences for both our customers and our people.

- **Corporate governance and regulation**

The Board works to ensure that the highest standards of corporate governance are adopted by the Group and that it operates in accordance with both the spirit and letter of all relevant regulation. As noted above, regulatory change continues apace and we will maintain a strong focus on meeting and, where possible, exceeding the high expectations placed on us by our regulators and by our customers.

Board and General Management changes

Richard Davey retired from the Board on 18 April 2012. Richard had been a non-executive director for six and a half years and Vice Chairman for the past five. During this time he made an excellent contribution to the Board and we offer him our sincere thanks.

Lynne Charlesworth was appointed as the new Vice Chairman. Lynne has extensive experience in risk management and the financial services and property industries and currently chairs our Group Risk Committee. Her background of working within the building society sector and the Board oversight role that she held for the Group's Treating Customers Fairly policies (which now falls within the remit of a Conduct Risk Oversight role which is currently held by Kate Barker, Non-executive Director) give her tremendous insight and mean she is ideally suited for this role.

During 2012 the Board initiated a recruitment process to find a new non-executive director as part of the Board's agreed succession planning. This process is well advanced and we hope to make an announcement in the near future. A search has also commenced for a further non-executive director to replace Roger Burden who has decided to retire from the Board after this year's Annual General Meeting. Roger has made an excellent contribution to the Board and I thank him for his commitment and support. Further details of the recruitment process can be found in the Corporate Governance Report.

In support of the Group's strategic priorities, which Chris Pilling outlines on page 9, the Board has approved the creation of a new General Manager role covering our People Experience. I'm pleased to announce that Jane Hanson has been appointed to this role. Jane has a wealth of experience within the Human Resources field in the financial services sector, and most recently was Deputy Regional Director at HSBC, leading their retail banking across Scotland, Northern Ireland and the North. We warmly welcome her to the Group. Rachel Court, currently General Manager - HR and Customer Service, will now take on specific responsibility for leading the Group's customer experience focus and will become General Manager – Customer Experience. These important changes will help the Group to focus on the areas of strategic priority in a way that the increased size, scale and complexity of the business now require.

There were no other changes to the Board or General Management team during 2012.

A complete list of the Board of Directors can be found on page 47 and profiles of each of the Society's Directors and General Managers can be found on pages 34 to 37.

Our people

The Group's workforce now stands at 4,111 employees across our national branch network and the head office sites in Bradford, Cheltenham and Peterborough. In recognition of the importance of our people to the success of our business and the growing family of people working in the Group, one of our strategic priorities for 2013 is, as previously mentioned, centred on the People Experience.

On behalf of the Board, I wish to thank our people for the way in which they worked together with a continued focus on providing excellent service to our customers across all of our brands in 2012. Their continued hard work enabled the Group to deliver another strong performance.

The future

Our vision is 'to be the most trusted provider of financial services in the UK'. Our strategy is to develop our services significantly, to grow and be commercially stronger. In doing so we are aiming to simplify our business model so that we are simpler and easier for our customers to use, leveraging our latent brand assets to appeal strongly to specific customer segments on a national basis. All of this will be reinforced by our investment programme and delivered through effective leadership and amazing people providing an outstanding customer experience in the communities we serve. We look forward to the future with confidence.

Ed Anderson
Chairman

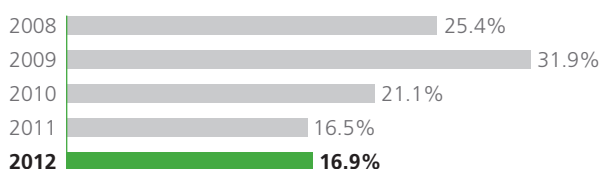
20 February 2013

FINANCIAL PERFORMANCE

TOTAL ASSETS



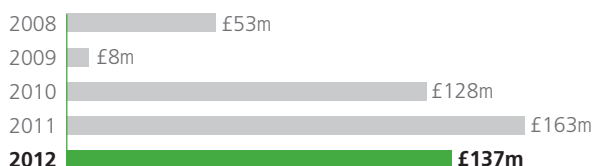
LIQUID ASSET RATIO



STATUTORY PROFIT / (LOSS) BEFORE TAX



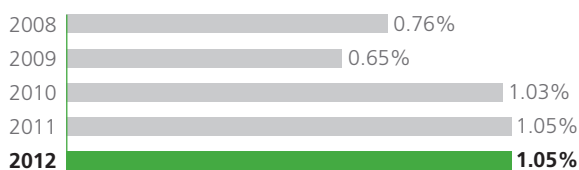
CORE OPERATING PROFIT



COST:INCOME RATIO



NET INTEREST MARGIN



CORE TIER 1 CAPITAL RATIO



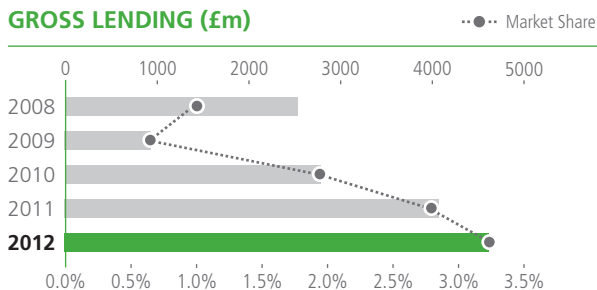
MORTGAGES FUNDED BY RETAIL BALANCES AND RESERVES



*Note: Measures of financial performance are explained in the Business Review on pages 14 to 29.

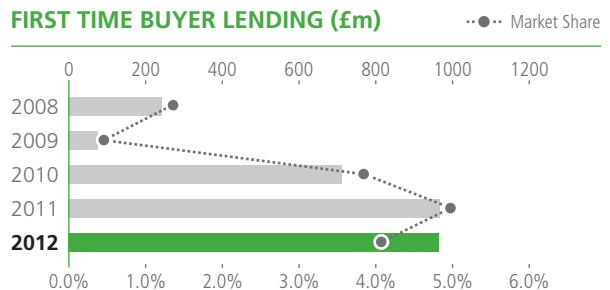
BUSINESS PERFORMANCE

GROSS LENDING (£m)



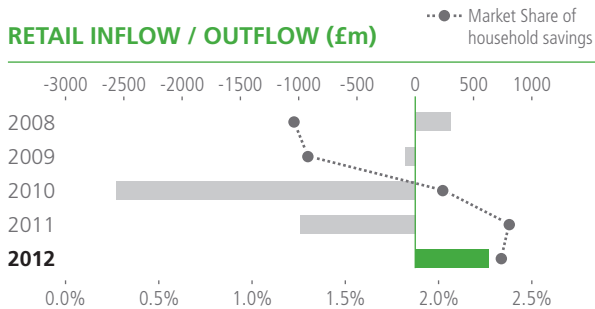
Source: Bank of England secured gross lending to individuals and housing associations.

FIRST TIME BUYER LENDING (£m)



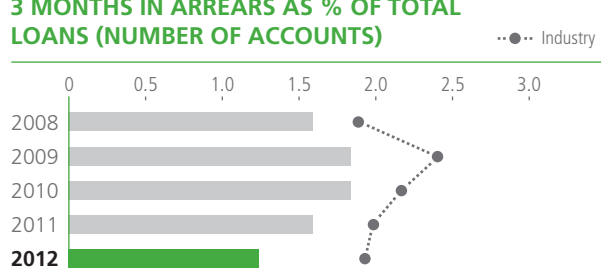
Source: CACI*.

RETAIL INFLOW / OUTFLOW (£m)



Source: Bank of England retail balances outstanding.

LOANS WITH PAYMENTS MORE THAN 3 MONTHS IN ARREARS AS % OF TOTAL LOANS (NUMBER OF ACCOUNTS)



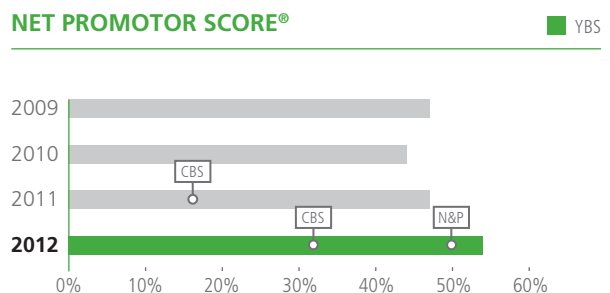
Source: Council of Mortgage Lenders.

FOS OVERTURN RATES



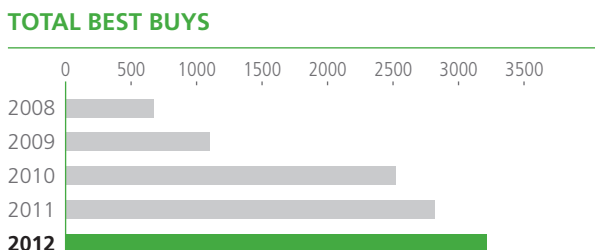
Source: Financial Ombudsman Service.

NET PROMOTOR SCORE®



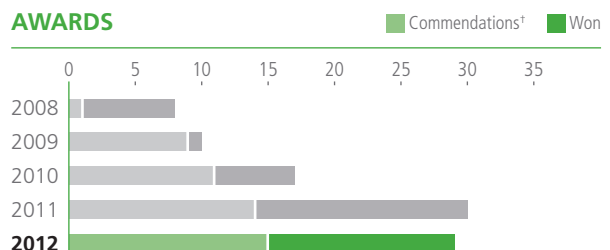
Source: Sametrix 2012 Net Promoter® Benchmark Study of Consumers in France, Germany and the UK.
 CBS - Chelsea Building Society brand.

TOTAL BEST BUYS



Source: PressWatch Financial from Kantar Media.

AWARDS



*includes nominations, commended, highly commended and runners up.

*Market shares based on new lending to first time buyers from CACI's mortgage market database (MMDB), which currently covers 94% of the mortgage market. Data as at the last working day of the calendar month. 2012 figure to the end of November 2012. NB: coverage and membership of the MMDB may vary year on year.



CHIEF EXECUTIVE'S REPORT

Chris Pilling

WITH OUR MUTUAL HERITAGE WE PUT CUSTOMERS FIRST

For almost 150 years we have been bringing savers and home buyers together for the benefit of all. Our mutual heritage means that we are owned by our members – that is our customers - rather than external shareholders. It enables us to do what is right - to invest in the business for the long-term and to plan for future success.

I am proud to report an excellent performance for 2012.

In 2008 my predecessor, Iain Cornish, explained that we entered what we now know to be the global financial crisis in a strong position. I am pleased to report that we are navigating our way through the crisis exactly as we intended, in a much stronger position as a profitable and reliable Group with a great reputation for customer service.

Extract from Chief Executive's Report 2008:
"In summary, the Group is in a robust state of health, despite the conditions in 2008 and their impact on our results. We entered these times in a strong enough position not just to weather the storms, but to emerge from them in an ultimately stronger position."

We have achieved this with skilful and prudent management of the business, particularly in relation to our credit risk management, liquidity management and treasury-related activities in the wholesale markets. During this challenging period we have continued to offer very attractive products at competitive rates that provide long-term value and financial security to our customers.

As a result of its strength the Group has, during the crisis, benefited from being able to take advantage of merger and acquisition opportunities and 2012 represents the first full year of business that incorporates our Norwich & Peterborough (N&P) and Egg businesses. Thanks to the successful way in which the Group took the opportunities open to it over recent years, our strategy is now evolving from acquisition and integration into a journey of transformation.

I have now been in the business for over a year and I am proud to report on an organisation which has:

- Loyal customers and members who trust us.
- Great people who are very committed and passionate.
- A solid financial base.
- Robust governance processes.
- Strong regional brands across the UK, serving the local communities where we are located.

Each of these factors has been crucial in enabling the Group to achieve excellent financial results for 2012 which include organic growth of our mortgage book, an increase in our savings balances and a stable net interest margin reflecting the long-term value of our products. Our overall profits remain at an optimal level and we have maintained robust capital and liquidity positions.

During 2012 the Board undertook a strategic review of the Group which has resulted in a refocused vision. This revised vision is aligned to our belief that trust is critical in our environment and that we genuinely believe it is our trustworthiness that differentiates us from most of the competition. Our vision is:

To be the most trusted provider of financial services in the UK

The vision is underpinned by strategic priorities which will take us to the next stage of the Group's development and will allow us to continue to take and develop opportunities to move forward as a progressive and trusted business.

There are five areas of strategic priority:

- Attract and retain the best talent, with a leading *people experience* built on our cultural foundation of *mutual trust*.
- Deliver a market-leading *customer experience* built on empathy, simplicity and trust.
- Deliver *sustainable financial performance*, that ensures real *financial security* for our customers, within our risk appetite.
- Deliver products, processes and systems for all our channels and brands that are *easy and simple to use*.
- Be *locally famous* and meaningfully engaged in our communities.

Our energies are now focused on a significant £160m transformation agenda, some £60m of which will be invested during 2013. The investment will make our business better and simpler for our customers and our people. This programme will cover product offerings, system re-design, process improvements, physical and systems infrastructure. Also involved are investments in our people and in our risk and financial control systems. The scale of the investment will be reflected in increased costs in 2013, and the likelihood therefore of a reduced level of headline profits in the next few years whilst continuing to meet our sustainability targets. This is a natural consequence of making such an important commitment to building the business for the future and helping to secure the long-term sustainability of the Group.

People matter more in the Yorkshire Building Society Group

We have an amazing team of committed and enthusiastic people who have demonstrated their ability to rise to new challenges. We aim to recruit the best people and train them well to ensure that they can protect and serve our customers' interests. We are a trusted employer and offer excellent benefits which have been enhanced during 2012 by the launch of a SimplyHealth cash plan scheme to all of our people to support their wellbeing.

A recent internal survey showed an impressive 82% of our people are satisfied with the Group as their employer¹. This in turn leads to our lower absence and turnover rates and therefore, as a mutually owned organisation, we can spend less of our members' money

on recruitment. It also means that our customers benefit from the continuity of well-trained people across our branches and service centres, who are able to develop trusted relationships with them in their local communities.

Through the recent merger activity the number of people working in the Group has increased dramatically. We now employ 4,111 people across the organisation, up from 2,327 in 2008. It is important that we continue to develop our supportive and caring culture and we seek to protect and reinforce these aspects through regular face-to-face engagement by me and my senior leadership team with all of our people. We recently engaged with every one of our colleagues in a series of nationwide events, 'Trust on Tour', at which all of our people helped to shape the Group's values. In these challenging economic times we created over 250 new jobs in 2012 across the business, as we seek to grow and develop as a Group.

I would like to take this opportunity to thank all of our people for their continued commitment to providing outstanding service to our customers, without which the Group's excellent performance would not have been achievable.

Record Net Promoter Scores from our customers

Our commitment to delivering a market-leading customer experience can best be evidenced by the fantastic Net Promoter Scores^{®2} we achieved in 2012 across our larger high street brands:

- Yorkshire Building Society - average Net Promoter Score of 54% with a record high score of 61% in March 2012.
- Chelsea Building Society - average Net Promoter Score of 32% with a record high score of 36% achieved consistently since July 2012.
- Norwich & Peterborough Building Society - average Net Promoter Score of 50%.

All these results are well above the 2012 industry average for banking which was just 15%³. However, we are not complacent and understand that our customers want and deserve the best experience every time they transact with us.

¹ Our N&P colleagues were not included in the sample for this survey question due to timing of the survey.

² The Net Promoter Score refers to the net percentage of customers who, when responding to the question "how likely is it that you would recommend us to a friend or colleague?" would either strongly recommend or strongly detract from the organisation.

³ Source: Sametrix 2012 Net Promoter[®] Benchmark Study of Consumers in France, Germany and the UK.

CHIEF EXECUTIVE'S REPORT continued

Our vision is at the heart of our commitment to our members and is at the core of our strategy. We understand that it is ambitious to aspire to be trusted by 100% of people 100% of the time and that we may never achieve it, however, this is the goal we are striving for.

The Group has gained trust by being different from the high-street banks. In contrast with the banks, we have continued to invest in our network of branches and agencies and in 2012 we opened four new branches and increased our agency network to 96, giving us 324 locations to serve our members across the UK. We plan to open four more branches during 2013.

To engender trust, it is very important that we keep our promises and take corrective action if and when we make mistakes, or have inherited issues on merger with other societies. We have reviewed and dealt with the payment protection insurance (PPI) issues we inherited in our Chelsea and N&P brands and will continue to do this for any such issues that arise. We have kept our promise made to members at the time of the merger with the Barnsley Building Society. The Barnsley had invested £10m with two Icelandic banks that went into administration (Kaupthing Singer & Friedlander Ltd and Heritable Bank plc) leading to the merger with the Yorkshire Building Society on 31 December 2008. We made a commitment to pursue recovery of these investments and, if successful, consider an ex-gratia payment from the proceeds to eligible Barnsley members. Having recovered £8.8m, which is the largest possible amount we could reasonably expect to realise, we have kept our promise with a distribution of recovered funds in 2012 to around 28,000 eligible members.

Disappointingly we had to spend a lot of time and money in 2012 administering the high volume of PPI and mortgage payment protection insurance (MPPI) mis-selling claims we received, largely at the hands of aggressive claims management companies. In over 90% of cases referred to the Financial Ombudsman Service they have found no evidence of mis-selling and all of these cases have been overturned in our favour. Despite this, the cost to the Group of administering these claims has reached almost £1m. We feel strongly that this is unfair to our members.

We are proud of the customer experience we offer through all our brands and channels and in 2012 we achieved:

- Exceptional personal service across our branch and agency network and through our internet and phone channels evidenced by continued high scores in our customer satisfaction surveys. In addition an impressive 9 out of 10 of our customers who responded to our regular customer surveys would recommend us to their family or friends.
- Our market shares⁴ have increased to a record 3.2% for new mortgage lending and 2.3% for our share of the household savings market.
- We have a Financial Ombudsman Service overturn rate substantially better than the industry average⁵. We will continue to manage the issues arising through our customers' complaints to the highest standards, ensuring we treat our customers fairly and solve any underlying issues.

We continue to provide value to members and other customers through our product range and commitment to long-term value pricing. As a result, in 2012:

- Our customer base grew by 6% from 3.3m to 3.5m.
- We opened around 340,000 new savings accounts - a record number for the Group. Our savings members get real value from us compared to the banks. The average rate paid in 2012 across our savings range was 2.45% compared to the latest available market average of 1.97%⁶. Customers can take advantage of an in-branch savings comparison tool to see how much better off they could be by saving with us than with all of our main competitors.
- The number of best buy mentions⁷ received continued at high levels with 816 savings best buys and 2,399 mortgage best buy mentions – an overall increase of almost 14% on 2011.
- Our current account offering through our N&P brand saw significantly increased levels of switching from other providers and saw growth during the year.

⁴ Source: Bank of England secured gross lending to individuals and housing associations as at 31 December 2012 and retail balances outstanding as at 31 December 2012.

⁵ Source: Financial Ombudsman Service, latest published complaints data for the six months to June 2012.

⁶ Source: CACI, which covers over 83% of the market (as at end November 2012).

⁷ Source: PressWatch Financial from Kantar Media.

- We helped first time buyers who received 38% of the funds we provided to home buyers. We also lent £0.5bn to borrowers with a loan-to-value of over 85%, supporting those first time buyers with small deposits.
- We demonstrated our commitment to lending prudently to our small and medium enterprise borrowers in local communities by continuing to invest in and expand our N&P commercial lending business with an 82% increase in gross lending on the same period in 2011.
- Through our YBS Share Plans business we brought the benefits of mutuality to an additional 101,000 members and now serve 243 companies.
- We won an impressive number of awards across the Group:

Consumer Moneyfacts Awards

Best High Street Savings Provider

Money.net Awards

Best Overall Mortgage Provider
 Best Offset Mortgage Provider
 Best Fixed Rate Mortgage Provider
 Best Debit Card for use Abroad

Moneyfacts Awards

Best Short Term Fixed Rate Mortgage Provider
 Best Long Term Fixed Rate Mortgage Provider
 Best Building Society Mortgage Provider

Moneywise Mortgage Awards

Best Lender for Fixed Rates
 Innovator of the Year

Mortgage Finance Gazette

Customer Service/Treating Customers Fairly
 Best Overall Lender
 Best National Building Society
 Best Online Lender

In addition there was success with our Share Plan clients, winning five awards at the ESOP Centre Awards and the Ifs ProShare Awards, including Best New Plan for Stagecoach Group plc.

We have achieved this success through listening to our members and tailoring our products to meet their needs through all our brands and channels. We have successfully adopted the leading-edge Egg functionality to bring additional benefits to our customers. Money Manager is now available for all our customers who transact through the Yorkshire Building Society website and Secure Messaging is now available to all our customers. We have also extended our relationship with Legal & General and they are now the sole provider of third-party financial advice, structured deposits and protection products across the Group. We are committed to continue to offer a wide range of financial services to our customers in the new, post-Retail Distribution Review world.

We listen to our members in a variety of ways including our Member Panel, Member Forum, Member Question Time meetings and multiple branch visits, which are held regularly throughout the year. This helps us to develop products and services that meet our customers' needs.

Sustainable financial performance and real financial security

We strive to deliver a sustainable financial performance that ensures real financial security for our customers within our risk appetite. 2012 was no exception with another profitable year for the Group. Key highlights include:

- Increased profit before tax; statutory profit before tax increased to £157m (2011: £130m).
- Core operating profit is down to £137m (2011: £163m), but remains strong.
- Strengthened our capital base with a core tier 1 ratio of 13.6% (2011: 12.6%).
- Positive net mortgage lending of £612m.
- Improved asset quality with arrears levels reduced and remaining well below the industry average.⁸
- Maintaining prudent levels of liquidity well above the regulatory requirement.

As we highlighted in our 2011 Annual Report and Accounts, our costs have increased through 2012 reflecting a full year of running costs for N&P and Egg.

⁸ Source: Council of Mortgage Lenders as at end 2012.

CHIEF EXECUTIVE'S REPORT continued

Our strength is also verified by our external stakeholders. Our ratings position from the three rating agencies - Moody's, Fitch and Standard and Poor's - have all remained stable throughout 2012 and the Group achieved a highly successful issuance of wholesale funding through a £600m securitisation, and a £500m covered bond. The various regulatory processes that periodically assess the Group's financial strength through a series of severe stress tests verified our view that the Group has strong capital and funding positions with robust and successful outcomes in all these processes in 2012.

We strengthened our core capital position by executing a buyback of £235m of our remunerated capital. This does not provide the same quality of capital as retained earnings (and would have matured or become ineligible for regulatory purposes over the next five years). The buyback exercise was positively received by investors and generated £62m of profit for the Society in 2012.

Products, processes and systems that are easy and simple to use

I set out in my report last year that significant investment in many of our systems and processes was planned. During 2012 this included:

- Successful completion of the integration of Egg customers into the Group.
- Ongoing work on our Arrears Transformation Programme, supporting improvements in the management of arrears to help our mortgage customers who find themselves in difficulties.
- Commenced integration of N&P processes and policies to standardise these across the Group.
- Continued investment in improving our mobile and e-commerce technology.

We also sold the legacy business of Norwich & Peterborough Insurance Brokers Ltd. This sale was aimed at simplifying our business whilst ensuring our customers across all of our high-street brands get the best possible products, service and value. We believe they are now getting this across the whole Group through our relationships with Legal & General and RSA.

This was only the start of our transformation journey and we have now embarked on our major investment programme as mentioned earlier. We are continuing on the journey of re-engineering our core systems to make our customers' experience with us easier and simpler. During 2012 we defined and scoped the strategic initiatives that will transform our business over the coming years. The Board's decision to approve these plans confirms our commitment to maintain the momentum of the Group's development and drive towards achieving our vision and strategy for the long term.

Meaningfully engaged in our local communities

As a mutual we care about the communities in which our customers and our people live and work, and we will continue to invest in and be meaningfully engaged in these communities. Our branch revitalisation programme has been a success, with local marketing programmes increasing awareness of our services right at the heart of the communities we are in. We are an employer of choice for many and employ around 2,400 people in our head office sites in Bradford, Cheltenham and Peterborough.

Our people continue to be good corporate citizens and are actively engaged in volunteering activities in their local communities. In 2012, they raised over £170,000 for national and local charities and good causes. We care about the environment and we now recycle around 90% of head office and over 80% of our branches' waste. We have installed smart meters in our branches to monitor energy consumption and are in the process of improving energy efficiency across the network as part of our branch refurbishment programme. In addition to our recycling and energy commitments, we now have a thriving bee community in the grounds of our head office in Bradford – producing our own honey! Details of the Group's Societies Together programme are set out in the Corporate Responsibility Report on pages 30 to 33.

In terms of financially supporting the broader community we remain an active player in the social housing market, and we are also committed to providing commercial mortgages to small and medium enterprises through our N&P Commercial Lending business.

A fantastic opportunity to be a real mutual alternative to the banks

With a number of the major banks still in crisis, now is the time for the Yorkshire Building Society Group to show we are part of a new generation of better financial services providers. With our heritage of financial strength, passion for customers and our mutual heartbeat we are perfectly placed to succeed and to be the most trusted provider of financial services in the UK.

Chris Pilling

Chief Executive

20 February 2013



BUSINESS REVIEW

FUTURE INVESTMENT BUILT ON FINANCIAL STRENGTH

The following section provides a detailed review of the Group's performance in 2012, including analyses of both the Income Statement and the Statement of Financial Position (balance sheet) as well as a look at some of the key performance indicators (KPIs) that the Board and management use to monitor and direct the Group.

Vision and strategy

Chris Pilling, within his Chief Executive's Report, sets out the Group's overall vision and strategy, and in particular some of the work undertaken in 2012 to review and revise these areas. I will not repeat what he has said here, but, as in previous years, would emphasise that our financial strategy is driven by that vision and by our overall mutual ethos. Our financial management of the Group is specifically aimed at achieving a balance between delivering value to members through products and service delivery whilst maintaining solid levels of profitability, growth and financial strength. Within this is our long-standing aim to optimise rather than maximise profits.

This means that our objective is to price our products so that they deliver value to our members and, by being attractive to them, achieve growth for the Group. At the same time products must generate sufficient profits to maintain the Group's strong capital position (since retained profits are our only effective source of capital). This is not always an easy balance to achieve, especially in a market that continues to be subject to stressed and volatile conditions.

Our vision and strategy also mean that we look to provide a service to our customers, whatever channels they choose to use, that treats them fairly and with respect. In doing so we balance what they tell us they value with a need to manage our business efficiently. One example of this is our approach to branches. We

could reduce our costs materially by closing branches, as many institutions are doing, but believe that our branch network lies at the heart of what we do for many of our customers. Therefore we remain committed to our branch and agency networks, whilst also investing in our other channels, such as the internet.

We also seek to control our costs without impairing the service that we deliver. I noted last year that 'within the context of minimising costs over the long term we have recognised that we must incur additional costs in order to deliver strategic deliverables (such as mergers and acquisitions and systems renewals) which will ultimately improve our cost efficiency over the long term'. This continues to be the case, but importantly we have now moved from a phase that saw us complete successfully a number of strategically important mergers and acquisitions to one that will see a major investment in the future of the Group, and most importantly in the service and product offerings that we provide to our customers. During 2012 we undertook a major review of what is needed over this next phase in the Group's history, and the Board have agreed to an ambitious and wide-ranging programme of investments in our systems, networks, people and products that are all aimed at enhancing our service and product delivery. This programme, which involves over £160m of investment, will not be easy, quick or cheap to deliver, but we firmly believe that it is in the interests of our customers to move the Group forward in this way.

The Risk Management Report, on pages 52 to 60 sets out the main risks that the Group faces and how we look to manage them. Strategically, we continue to operate in an uncertain environment. In particular, from a financial perspective:

- The continuation of the financial crisis means that wholesale markets, whilst relatively healthy and stable at present, could return to previous conditions of volatility and/or illiquidity.
- The continued poor health of the UK economy, and the concerns over the timing, speed and length of a recovery, mean that, in particular, the housing market is likely to remain subdued for some time to come, and that many of our borrowers will continue to be financially stressed.
- The introduction of the Funding for Lending Scheme, and the consequent rapid falls in mortgage and savings rates in late 2012 and early 2013, mean that the future margins available in these two core markets remain highly uncertain.
- The changing regulatory environment, which we are fully committed to supporting, means, in particular, that we face uncertainties in our investment and insurance offerings, and hence in the income we earn from these products.
- The ambitious investment programme we have initiated involves over £160m of spend, and close management of both how we spend the money and the realisation of planned benefits will be critical to our future profitability.

It is in this context that the Board assesses the Group's performance in 2012.

Income statement overview

This section looks at our profit before tax on both a statutory and a core operating basis, with commentary that explores the underlying drivers of the Group's performance.

Both measures show an extremely strong financial performance in 2012, building on the successes of the last few years. Our statutory profit before tax grew by over £25m or 21% in 2012, whilst our core operating profit remains extremely strong at £137m. This robust performance is based on a combination of stable core businesses and a number of one-off profits.

Key Performance Indicator explanation:

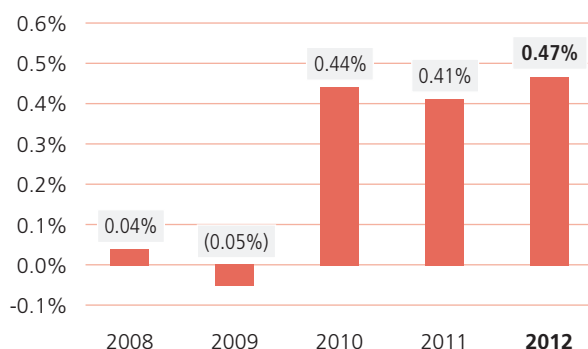
The Board monitors the Group's performance on both a statutory and a core operating basis because it believes that both add value to their oversight of the Group. Statutory profit before tax is the most commonly used comparative definition of profit and is the key contributor to our capital. However, it includes a number of items that the Board believes do not reflect the longer-term, sustainable business performance either because they are pure accounting measures (e.g. negative goodwill), are one-off in nature (e.g. integration costs) or are timing differences that reverse over time (e.g. fair value adjustments). The Board therefore uses core operating profit, which excludes these items, to assess the underlying Group financial performance.

STATUTORY PROFIT BEFORE TAX

	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m
Net interest income	165	148	273	329	346
Fair value movements	(29)	(10)	(10)	(10)	(12)
Profit from sale of assets	(1)	11	15	3	16
Profit on capital repurchase	-	-	-	-	62
Other income	31	31	43	47	48
	166	180	321	369	460
Negative goodwill	3	-	17	6	-
	169	180	338	375	460
Management expenses	(122)	(131)	(173)	(209)	(250)
	47	49	165	166	210
Provisions	(39)	(61)	(50)	(36)	(53)
Profit / (loss) before tax	8	(12)	115	130	157

BUSINESS REVIEW continued

STATUTORY PROFIT BEFORE TAX AS % OF MEAN ASSETS



The growth in statutory profit before tax was driven by steady performances across the main income and expense categories and a number of exceptional one-off items. As a percentage of mean assets it increased from 0.41% to 0.47%.

Within this rise, the core business performance was robust, and included:

- Rising net interest income (up £17m) driven by the inclusion of a full year's income from the N&P and Egg businesses offset by a tightening of margins in the savings market.
- Broadly stable fair value movements.
- £16m of profits from the normal turnover of our liquid assets, up by £13m from 2011.
- No negative goodwill in the year (since no mergers took place) meaning a £6m fall relative to 2011.
- A £41m increase in management expenses largely because of the inclusion of a full year's expenses for the N&P and Egg businesses.
- Provision charges rose by £17m, driven by charges against non-core portfolios and other items, whilst charges on our core portfolios fell.

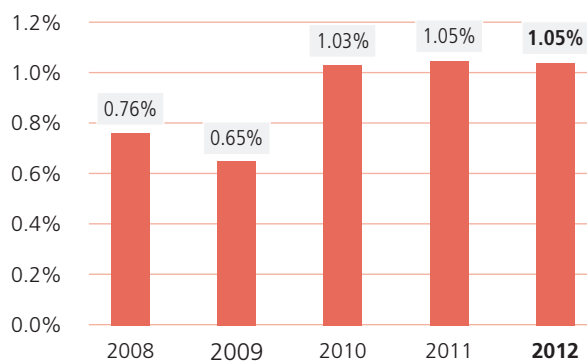
Boosting this solid underlying performance was a one-off profit from a major capital buyback exercise undertaken towards the end of the year to capitalise on an opportunity to retire capital, that for us was largely redundant, at a material profit (£62m in 2012).

This represents another extremely strong performance by the Group. Looking at the individual components:

Net interest income

Key Performance Indicator explanation: The Board monitors the Group's net interest margin, a measure that calculates net interest income as a percentage of mean assets. This measure tracks how effective an institution is in earning income on its assets, and in managing the interest paid for its funding. The cheaper an institution can raise funding, and the more effectively it can invest its assets, the higher this ratio will be. Because the majority of our assets and liabilities are in the form of mortgage loans to, or savings deposited by, our members, our policy is to optimise rather than maximise this ratio since the product rates that underly this ratio are our key mechanism for delivering value to our members. As such we have a lower margin than many of our non-mutual peers. The challenge is to achieve the appropriate balance, within a competitive marketplace, between providing value to members, achieving adequate levels of asset growth, taking only sensible levels of risk and making sufficient profits to maintain a strong capital position.

NET INTEREST MARGIN BEING NET INTEREST INCOME AS % OF MEAN ASSETS



2012 saw a stable position on net interest margins, remaining unchanged at 1.05%, although if the distorting impact of the merger and acquisition activity in 2011 is taken into account it was actually a fall from 1.07% to 1.05%. The absolute levels of income rose by £17m but this largely reflected the inclusion of a full year of N&P income.

Most of the year was characterised by:

- Higher than planned mortgage margins as the market continued to see relatively low levels of activity. Within the confines of the market, we continued to offer competitive products to support both our existing borrowers and to attract new borrowers to grow our mortgage books.
- A continuation of the larger than normal, in historic terms, standard variable rate position.
- A continuation of the competitive conditions in the savings market (albeit against an historically low Bank Rate background), with some players offering highly attractive but, in our view, unsustainable products to attract new business. We continued to focus on offering the fairest rates possible across our portfolios, and this resulted in a steady rise in the cost of our balances for most of 2012.
- A more settled year on the wholesale funding front, with repayment of the last of our government guaranteed issues and further issuance of both covered bonds and securitised funding. These new issues were achieved at an attractive cost, meaning that this element of our funding strategy continues to perform well and contribute positively to our overall margins.

Throughout the year, and within the context of these trends, we continued to look to balance the needs of our savers in a historically low interest rate environment, the pressures on those of our borrowers who are economically stressed and our overall duty to safeguard the financial strength of the Group.

Our liquidity management throughout most of the year continued to focus on balancing the need to maintain prudent levels of high quality assets and the need to do so in an efficient, margin optimising manner. This meant that through most of the year we steadily managed down our levels of liquidity (whilst enhancing the quality), and hence reduced the negative impact that these holdings have on margins.

The last few months of 2012 then saw a marked shift in the savings, mortgage and wholesale funding markets. These changes are yet to fully emerge, but appear to have been largely precipitated by the introduction of the Government's Funding for Lending Scheme (FLS). This scheme offers low-priced funding to lenders with the price driven by whether or not those lenders are growing

or shrinking their lending books. The reaction so far of lenders has varied, with some seeming to use the scheme to re-finance their existing books and others (including ourselves) intending to use the scheme to increase their net lending levels.

Whichever motivation has driven participation the impact on markets has been marked, with:

- Sharp falls in savings rates being offered to new and existing customers across the market. By the year end, best-buy rates on some products had fallen by over 1%.
- Mortgage pricing for new products followed suit, albeit more slowly and, by the year end, to a lesser degree with best-buy products down by over 0.5% and still falling.
- Wholesale costs fell sharply as the markets reacted to the availability of cheaper, government-backed funding in both the UK and the eurozone and likely reductions in future levels of issuance.

Because the Group did not want to immediately reduce rates paid to savers, this meant that the last few months of the year saw stronger than anticipated inflows at lower than planned margins as more of our products were offering best-buy rates than we anticipated. This meant that we ended 2012 with higher levels of liquidity than we planned (since it is not possible to sensibly lend the increased funding at short notice).

Going forward, we will have to see how the markets settle. We always aim to protect our savers from falling rates, but cannot prudently go against the market as a whole without attracting unusable levels of unsustainably priced funding and seriously damaging the Group's financial strength. We have already been compelled to follow the market and lower rates in early 2013 and whilst our mortgage customers will have benefitted from this decrease, we are acutely aware of the impact this will have on our saving members.

Our customer relationships are built on trust which means we maintain our focus on providing long-term value. However it also means that we must protect our financial stability in order to provide protection to all our customers. If it proves impossible to resist further rate changes we will continue to maintain our focus on balancing our customers' need for value with our duty to maintain financial security.

BUSINESS REVIEW continued

Fair value movements

Key Performance Indicator explanation: The Board monitors the Group's fair value movements in absolute terms. These movements represent adjustments to the value of a number of assets and liabilities to reflect their current market value. However, since the Group generally retains these assets and liabilities to their normal maturity dates (when the full face value is generally expected to be realised) these mark to market adjustments are in effect timing differences, which will in time usually reverse out.

The 2012 movements analyse between:

- £13m loss relating to hedge accounting (2011 £5m loss) – these continue to be viewed as timing differences which reverse over time. The Group's aim is to minimise their year-on-year impact on our results, and the 2012 movement is considered to be high but still within acceptable tolerances.
- £1m gain relating to our historic, inactive, portfolio of structured asset investments (2011 £5m loss). The total current value of the portfolio is £54m compared to £57m in 2011, with the remaining movements due to a scheduled maturity in the year.

Overall the fair value movements for the year are within an acceptable range.

Realised profits

2012 saw a higher than usual level of activity in this area, in particular a major buyback of capital and routine sales of liquid assets.

Looking at each of these:

- Under new regulatory rules now in place our remunerated capital (Permanent Interest Bearing Shares and Subordinated Liabilities) will cease to be effective as regulatory capital over the next five years. This means it would, in the main, just become relatively expensive funding. Because of recent market conditions, an opportunity arose to offer to buy the majority of this capital back at less than face value i.e. at a profit to the Group. This process, which was conducted openly and with the full co-operation of the institutions and individuals holding the underlying instruments, realised a profit of £62m for the Group. This is clearly a one-off event, but means we have boosted our core capital (made up of accumulated profits) whilst removing non-core capital that would otherwise become redundant. That we were in a position to do so, with our regulator's approval, reflects our position of financial strength.

- As part of our routine management of liquid assets we periodically sell a proportion of our portfolios. The decisions on when to sell are not primarily profit driven, and so, year on year, this income is highly variable. The prevailing market conditions in 2012, and the timing of actual sales, delivered a profit of £16m compared to £3.5m in 2011 and £15m in 2010.

Other income

Key Performance Indicator explanation: The Board monitors the Group's other income in absolute terms. This figure principally represents the income we earn from selling non-mortgage and non-savings products (such as home and contents insurance, investment products and other insurances), combined with that which we earn from a number of smaller business divisions (being our YBS Share Plan and Yorkshire Key Services operations). This measure indicates how successful we have been in:

- Providing appropriate and competitively-priced products to our members through our partnerships with other financial institutions.
- Running our smaller business divisions.

In 2012 our non-interest income (net of charges) rose marginally to £48m (2011: £47m). As a percentage of mean assets it was steady at 0.15%.

Income from the sale of products to our customers fell marginally from £37m to £36m. This fall largely reflects the overperformance in some areas during 2011, and our decision to withdraw and re-design a number of products at times during the year.

Other non-interest income rose by over £2m due to a range of factors including:

- The inclusion of a full year of income (£7m) from N&P subsidiaries and from its current account operation.
- The removal of government funding fees compared to 2011 (£2m).
- The write off of a number of intangible assets taken on with the mergers (£4m).
- The sale of the insurance broking business acquired as part of the N&P merger (Norwich & Peterborough Insurance Brokers Ltd) as part of our continued drive to focus ever more clearly on our core businesses. A successful sale was completed to Towergate Underwriting Group Limited that looked to safeguard the ongoing interests of the customers and staff of the business. The sale realised a profit of over £2m for

the Group. Going forward products are now provided through our group wide partnership with RSA.

Overall, in a competitive market and with a changing regulatory landscape, we are satisfied with the performance in this area, and that, critically, we continue to provide our customers with insurance and investment products that meet their needs.

Negative goodwill

In 2010 and 2011 negative goodwill arose from the mergers with the Chelsea and the N&P. As there were no mergers in 2012, no equivalent amount arose.

Management expenses

Key Performance Indicator explanation:

The Board monitors the Group's cost efficiency using two measures:

- Management expenses ratio – (management expenses as a percentage of mean assets) looks at how much it costs us to manage every £100 of assets. This provides a broad measurement of how well the Group manages its costs to remain efficient whilst still delivering effective service, and how growth, inflation and efficiency are being balanced. Put simply, the lower the ratio the more efficiently an organisation is being managed.
- Cost:Income ratio – (management expenses as a percentage of total income) looks at the relationship between our income generation and our costs. In some cases an institution may well have higher costs than its peers, but if these costs are generating additional income and hence profits then such a structure makes sense. The lower the ratio the less an institution is spending to generate every £1 of income.

In absolute terms our management expenses rose from £209m to £250m in 2012, with the majority of this increase relating to:

- The inclusion of a full year of N&P expenses – the running costs of N&P are high and will continue to be so until completion of the relevant integration projects. Even then the N&P current account operation has inevitably introduced a more expensive (albeit profit making) business unit into the Group.
- The transitional costs for the Egg business – during most of 2012 a transitional services arrangement was in place with Citibank under which they continued to administer

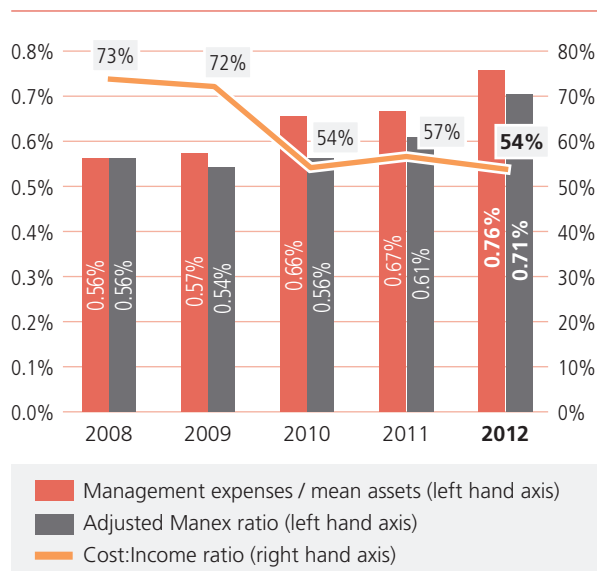
the portfolios until integration was successfully completed in September 2012. This introduced over £10m of additional cost which will not be present going forward.

At the same time, the Group continued to spend material amounts on integrating businesses acquired through recent mergers and acquisitions. Along with the Egg transitional costs these totalled £16m in 2012 (in 2011 deal and integration costs totalled £24m).

The impact of all of this was that our simple mean asset ratio (including all expenses and ignoring the distorting effect of when mergers and acquisitions took place in 2011) rose sharply from 0.67% to 0.76%. The adjusted ratio (excluding one-off costs and adjusting for the timing of mergers and acquisitions) rose from 0.61% to 0.71%.

The Group's Cost:Income ratio improved from 57% to 54%. This reflects the factors noted above offset by the high level of one-off income from our capital buyback. If the exceptional costs associated with mergers and acquisitions and integrations, and the capital buyback income, are adjusted for then our core ratio increased from 46% to 57%.

MANAGEMENT EXPENSES AND COST:INCOME RATIOS



As noted earlier, the Board has taken the decision to invest materially in the business across a broad spectrum of areas including systems and processes, product offerings and distribution channels (including our branch and agency network). This means that we will continue

BUSINESS REVIEW continued

to run with inflated cost ratios for some time to come, with the inevitable pressure this will bring on overall profitability. We remain convinced, however, that this is the right approach to ensure that we can continue to deliver an enhanced product and service offering to our customers in the ways, and places, that they value. We can continue to follow this route because of our financial strength and stability, and because of our mutual, long-term perspective.

Provisions

Key Performance Indicator explanation: The Board monitors the Group's provisions charge in absolute terms. This measures how far our assets have failed to perform from a credit risk perspective. It includes both actual losses incurred as a result of defaulting borrowers, and our estimate of potential losses on mortgages and other assets that, based on our portfolios' current behaviour, we believe are already impaired (whether or not they are actually in arrears). Whilst clearly heavily influenced by factors such as the wider economy (in particular unemployment levels) and the housing market (in particular house prices) this measure gives the Board a clear view on whether the risks taken on our lending and investments are in line with expectations.

The breakdown of the provisions charge in recent years is as follows:

The main provisions charge against our, principally residential, loan portfolios rose in 2012 by £9m. As noted last year, 2011 included a one-off recovery of £5m in relation to losses suffered by the Chelsea prior to merger, so that the like-for-like rise was in fact £4m.

	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m
Provisions against loan portfolios	25.0	59.0	40.8	30.1	39.3
Provisions against impaired investments	-	0.9	5.1	-	-
Provisions for other items	(1.0)	(1.4)	-	-	7.9
Internally generated provisions	24.0	58.5	45.9	30.1	47.2
FSCS charges	14.7	2.7	3.6	5.6	6.1
Total provisions	38.7	61.2	49.5	35.7	53.3

This rise in provisions is largely driven by charges against loan portfolios (including equity release portfolios) taken on with the Chelsea and N&P mergers as we adjust our initial estimates. We are satisfied that provisions for these books are adequate. Provisions charges on our remaining portfolios fell, driven by two main factors:

- The continued improvement in our arrears performance, with arrears over three months (excluding possessions) falling again, from 1.9% at the end of 2011 to 1.4%, and our stock of possessions falling from 0.21% to 0.18%.
- The relatively modest level of house price falls in 2012 when compared to the levels predicted at the end of 2011 (and therefore built into our provisions at that time).

The fair value adjustments relating to the Chelsea and N&P mergers enabled us to provide additional protection from future losses over and above what can be provided through standard 'incurred loss' provisioning. When calculating the fair value of the mortgages we effectively provided for expected lifetime losses on those loans when they were brought onto our balance sheet. Any losses on these books that are in line with our original expectations are set against those fair value adjustments rather than being charged through the Income Statement. Losses during the year so charged were in line with expectations. In total £22m of losses were treated in this way (2011: £21m).

The following table shows the overall 'protection' provided against the Chelsea and N&P loan books being the combined impairment provisions previously carried by the merged entities and the fair value adjustment made on merger.

PROVISIONS AND FAIR VALUE ADJUSTMENTS FOR CREDIT RISK

	2010 £m	2011 £m	2012 £m
Brought forward	-	213	244
Previously carried by Chelsea / N&P	53	13	-
Fair value on merger Chelsea / N&P	176	39	-
Utilised losses	(16)	(21)	(22)
	213	244	222

The reduction in provisions charges against our core portfolios is clearly a further step in the right direction. We remain, however, cautious about the state of the UK economy and the housing market in particular and the resulting danger of a future rise in arrears levels.

This caution is reflected in our continued conservative approach to provisioning and to arrears management. In particular, we have continued to invest material sums in our arrears management processes in 2012, and will continue to do so during 2013.

The Group continues to exercise a certain degree of 'forbearance' to borrowers who may face difficulties in making their mortgage payments:

- Our initial objective is to engage the customer in constructive dialogue with the aim of clearing existing arrears and re-establishing a sustainable, regular payment pattern. In doing so we will use a variety of approaches ranging from forbearance facilities through to ending the customers' relationship with the Group. This includes taking possession and selling mortgaged properties since in some cases this will be a better option for both the borrower and the Group than allowing the position to deteriorate further.
- Forbearance tools are only used where deemed appropriate for an individual borrower's circumstances, and are used in line with industry guidance. Tools used include capitalisation of arrears (adding them to the underlying loan), temporary interest-only concessions, payment arrangements (to make regular but reduced payments for a limited period), payment holidays and term extensions. The use of account management tools are either fully recognised within provisioning or are low in materiality. Further details can be found in Note 39.
- In applying forbearance to borrowers in trouble we seek to maintain a balance. Firstly we have to establish what is fairest for the customer in question and balance a desire to help them in the short term with our responsibility to ensure that whatever measures we agree to are realistic and affordable, and are not just delaying and exacerbating the underlying issue. Secondly, we have to balance our responsibility to individual customers with our duty to all our members to manage our risks responsibly to maintain our financial strength and stability.

The Group also took the opportunity to make provisions against a number of other items including additional provisions of £9m following further reviews of the likely mis-selling claims arising from sales of payment protection and financial advice within our Norwich & Peterborough (N&P) brand. Netting against this was a £1.1m release of other non-customer-related provisions.

The final element of the provisions charge in 2012 was the Financial Services Compensation Scheme (FSCS), which rose marginally from £5.6m to £6.1m. As highlighted

in previous years, the Group continues to pay a material contribution to the FSCS following the failure of institutions such as Bradford & Bingley and the Icelandic banks. We do not believe that the levy is right, since it places greater financial onus on those institutions with proportionately higher retail funds, thereby punishing the structurally safer organisations. It will continue to represent a significant charge to our Income Statement for the foreseeable future.

Core operating profit

A number of Income Statement components do not reflect our underlying performance and are reversed when calculating core operating profit. This measure gives the Board a clear view of our ongoing performance without shorter-term distortions, both positive and negative:

	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m
Statutory profit before tax	8	(12)	115	130	157
Reverse out the following items:					
Fair value movements	29	10	10	10	12
Debt buyback	(2)	-	-	-	(62)
Sale of assets / other income	-	1	1	(1)	2
Non core provisions:					
• Structured credit	7	1	5	-	-
• FSCS	15	3	4	6	6
• Other liabilities	(1)	(2)	-	-	6
Negative goodwill	(3)	-	(17)	(6)	-
Mergers, acquisitions and closures	-	7	10	24	16
Core operating profit	53	8	128	163	137

2012 saw a fall in our Core Operating Profit, from £163m, to £137m. As a percentage of mean assets this represented a fall from 0.52% to 0.41%. This fall was principally driven by the additional provisions against our equity release portfolio and the increased costs for N&P. This remains a healthy level of profit and, most importantly, represents a sustainable financial performance that is generating sufficient capital (in the form of retained profits) to allow the Group to continue to invest in its products, services and infrastructure, and to grow balances in the coming years. We continue to look to optimise rather than maximise this figure, generating sufficient profits to achieve long-term sustainability rather than short-term performance.

BUSINESS REVIEW continued

Balance Sheet overview

The growth in the Group's business seen in recent years has continued and gross assets now stand at £33.5bn.

GROUP BALANCE SHEET

	2008 £bn	2009 £bn	2010 £bn	2011 £bn	2012 £bn
Liquid assets	5.3	6.7	5.9	4.9	5.2
Mortgage and other loans	16.3	15.0	23.4	27.0	27.6
Other assets	1.4	1.0	0.8	0.7	0.7
Total assets	23.0	22.7	30.1	32.6	33.5
Retail savings	13.7	13.8	21.4	26.0	26.8
Wholesale funding	7.3	7.2	6.3	3.9	4.2
Other liabilities	0.8	0.5	0.7	0.7	0.8
	21.8	21.5	28.4	30.6	31.8
Remunerated capital	0.3	0.3	0.4	0.4	0.1
Reserves	0.9	0.9	1.3	1.6	1.6
Total liabilities	23.0	22.7	30.1	32.6	33.5

2012 saw a return to organic growth with total assets growing by 3%:

- On the asset side this growth was driven by £0.6bn, or 2%, of net growth in mortgage balances and £0.3bn of growth in liquid assets.
- The growth in liquidity was driven by a strong retail performance in late 2012 as pricing in the market shifted rapidly and the Group took the decision to delay reducing its savings rates whilst the market continued to be unsettled. As referred to earlier, 2013 has already seen the Group being compelled to fall more in line with the market by reducing our product rates. This has been done by balancing our desire to deliver customer value with our duty to maintain financial stability and security.
- Retail savings saw a net inflow of £0.8bn whilst wholesale funding also grew, by £0.3bn.
- Overall capital, constituting remunerated capital and reserves, shrank by £0.3bn driven by the buyback of soon to be redundant remunerated capital. This was done while strengthening, materially, our core capital strength.

Looking in more detail at the principal balance sheet items:

Liquidity and funding

The Group continues to have resilient and diverse funding. Our funding is, and will continue to be, dominated by retail savings backed up by a strong wholesale programme. We continue to focus our management of funding on balancing the benefits and risks of these two forms of funding against the shifting market conditions that continue to prevail. In achieving this we focus on a number of key factors, namely that:

- One of our principal purposes is to provide our members with a secure home for their savings. We would, therefore, not move away from having retail savings as our predominant funding source.
- We raise funding in order to lend residential mortgages, and therefore the pricing of all of our funding must be set against the rates at which market conditions allow us to lend.
- Under the new liquidity regime shorter-term, or shorter-notice period, funding logically carries a higher liquidity requirement which translates directly into a financial cost for the Group. It is therefore sensible to avoid focusing too heavily on shorter-term products.
- It is not prudent to have too great a proportion of our funding maturing, and therefore requiring replacement, within a short time period.

In parallel with its funding strategy, the Group always maintains a prudent level of liquid assets. At the same time it is sensible to manage the impact of holding highly liquid (and therefore low yielding) assets on our income levels. The regulatory regime rightly requires us to hold certain levels of the highest quality, or 'buffer', liquid assets i.e. those that are most readily converted into cash. The level is driven by the nature and maturity profile of our funding. During 2012 we have continued to re-focus on our funding profile and hence to optimise the absolute and relative level of buffer liquidity that we are required to hold. This means that whilst a high proportion of our liquid assets are held in very low earning assets, we can hold lower overall levels of liquidity that would otherwise be the case.

Members should be in no doubt that, should there ever be a conflict between these two factors, then holding prudent levels of liquidity will always win out. We monitor our required level of liquidity in a number of different ways, not least by calculating the absolute level we should be holding on a daily basis. This is done by using stress

testing models that use a number of different sets of assumptions – including one set by our regulator and a number that we, independently, consider appropriate. Our policy is to aim to hold 10% above whichever of these two is higher at any given point in time. If our forecasts, which extend several years into the future, indicate that we will fall below this 10% safety limit then remedial action is initiated.

Adherence to these funding and liquidity policies is monitored on a continuous basis using an extensive framework of cashflow analyses, modelling tools and exposure/maturity limits. These processes involve, in particular, our independent Risk function, the Group's Finance Director, our various risk committees and the Board. The Group also has in place a Contingency Funding Plan which details the actions we would take in the event of a funding and/or liquidity stress.

At an overall level, 2012 saw a stable balance between our two main sources of funding. We are satisfied that the balance we currently have sensibly mixes the benefits and risks associated with these two types of funding. We are also satisfied that we could accept a slightly higher level of wholesale funding given the renewed stability that we are seeing in that market. The next few years are likely to see the balance shift moderately towards wholesale although we will, naturally, keep market conditions under review.

	2008	2009	2010	2011	2012
Funding ratio	33.0%	32.5%	21.4%	12.9%	13.5%
Wholesale ratio	31.8%	31.3%	20.7%	11.8%	12.1%

Retail savings now account for 88% of our total funding meaning that they fund 99% of our mortgages (2011: 97%).

During 2012 we continued our policy of converting a higher proportion of our liquidity into 'buffer' liquidity through disposals and scheduled maturities. We remained well above our regulatory minimum, and above the levels that we, independently of the regulator, consider prudent. The retail inflows in the last quarter, driven by our delaying of the rate cuts seen in the rest of the market, meant liquidity rose slightly year on year to £5.2bn.

Liquidity portfolio

Key Performance Indicator explanation: The Board monitors the Group's liquidity position in a number of ways, including by continually running potential stress scenarios against our current balance sheet to test that adequate liquidity is in place, and by monitoring the make-up of our funding and liquidity portfolios. One of the key measures is to monitor the total level of 'buffer liquidity' against our regulatory requirement (set by the FSA). Buffer liquidity constitutes cash and investments with the UK government (deposits with the Bank of England or holdings of UK Gilts and similar investments) and with supranational institutions. As such it represents the most liquid and safest form of holding.

Almost 85% of our liquidity is now in 'buffer' liquidity.

	2009 £bn	2010 £bn	2011 £bn	2012 £bn
Buffer liquidity	3.2	4.4	3.3	4.4
Bank of England eligible securities	1.1	0.4	0.6	-
Other securities	1.9	0.7	0.3	0.1
Total core liquidity	6.2	5.5	4.2	4.5
Subsidiary / other liquidity	0.4	0.3	0.6	0.6
Structured investment	0.1	0.1	0.1	0.1
Total liquid assets	6.7	5.9	4.9	5.2

2012 saw a continued move into 'buffer' liquidity and away from other classes of asset. 'Buffer' liquidity consists principally of deposits held at, and securities issued by, the Bank of England or by supranational institutions.

Other items within our Liquidity portfolio at the year end included:

- Small (<£0.1bn) portfolio of Mortgage Backed Securities.
- £0.6bn portfolio within subsidiary funding vehicles and balances held under Collateralised Swap Agreements (where liquidity is positioned to mitigate credit risk on derivative contracts).
- Our remaining portfolio of structured asset investments.

BUSINESS REVIEW continued

The Group's portfolio of structured assets which now stands at just £54m, continues to be monitored very closely and managed down as quickly as is commercially sensible. Nevertheless, the nature of these investments means that their values remain susceptible to the kind of market upheaval we continue to see. At the end of 2012 the total value of the portfolio had reduced by £3m as a result of a maturity (which we received in full) and increases and decreases in individual investment's market values.

2012 saw the continuation of the difficulties affecting a number of eurozone countries, and concerns persisting about institutions based in these countries. Whilst the situation appears to have stabilised there remains a considerable level of concern and uncertainty. Following the maturity during 2012 of our remaining exposures to institutions based in Ireland, the Group now has no direct exposure to institutions in Ireland nor to institutions in any other eurozone country.

Retail and wholesale funding

Key Performance Indicator explanation: The Board monitors the Group's retail savings performance by tracking its net retail inflow in absolute terms, being the net amount by which its retail savings balances grow in any period. Any portfolio of retail savings products will, at any point in time, have some products where balances are growing and others where the balances are reducing, reflecting the relative attractiveness of those products against the market. It is, in our view, not a sustainable strategy to offer market-leading rates on all savings products at all times, but neither do we look to offer eye-catching introductory rates and then quietly reduce product rates to de minimis levels once the introductory period is past. Instead we look to compete fairly, offering competitive rates on new products whilst maintaining fair rates on existing balances. This means that, at times when the savings market is overheated, we will inevitably see some outflows on some of our products.

The majority of 2012 saw competition for retail savings remain fierce, with many institutions prepared to continue to pay unsuitable rates for funding as they sought to re-finance their balance sheets. We remain committed to offering our savings members good-value products, but equally determined not to be drawn into offering unsustainable rates which we would then have to reduce sharply. We believe that this is not in the long-term interests of our members or the Group, and so we have continued to focus on products that offer good

value over the medium and long term rather than short-term products.

For most of 2012 this meant that we were slowly shrinking our retail portfolios, whilst also managing down our liquidity requirements as discussed earlier. This trend was reversed in the last quarter of the year and the Group ended the year with net inflows of £0.8bn.

The Group's wholesale funding portfolio was as follows at the end of the year:

	2011 £m	2012 £m
Cash/CDs	688	764
Covered Bonds	1,350	1,897
Government guaranteed issuance	747	-
Medium Term Notes	116	40
Residential Mortgage Backed Securities	347	846
Other	619	624
	3,867	4,171

During the year the Group:

- Repaid the last of its funding under the old government guarantee schemes.
- Launched very successful issues under both its Covered Bond and Securitisation programmes. In both cases demand for the issues was high and as a result pricing was very beneficial to the Group.

Key Performance Indicator explanation: A key measure for the Group in monitoring its wholesale funding position is the weighted average maturity of its outstanding funding. This metric provides a measure of how long the Group has funding in place for, since it reflects the average remaining term (weighted by balances) of outstanding wholesale funding. It is important to achieve a balance here – since too long an average maturity suggests a preponderance of more expensive long-term funding, whilst too short an average maturity suggests that the Group will have to constantly issue and re-issue funding.

The Group's weighted average maturity at 31 December 2012 was 36 months, which is consistent with our funding strategy and represents an extremely healthy funding position. Within this we also manage the maturity profile of our funding to ensure that we do not have to re-finance too much within a concentrated time period.

Some elements of our wholesale funding portfolio are secured on the assets of the Group. In particular, our Covered Bond and Securitisation issues are secured on elements of our mortgage portfolios. This means that, should the Group ever be unable to repay funding under these schemes as it fell due, then independent trustees would be able to take control of certain mortgages and either manage or sell them to repay the monies owed. Whilst we consider such an outcome extremely remote, we monitor closely and control the level of assets that are 'encumbered' in this way. The benefit of issuing such funding is that, because they are backed by good quality mortgage assets, the interest rates we pay are lower. As at the end of the year 13.9% of our mortgage assets were so encumbered. We consider this to be a sensible and secure level, and indeed would expect to see it increase in the coming years as we continue to use both of these funding programmes and to participate, as we intend to do, in the Government's Funding for Lending Scheme.

Mortgage assets and new mortgage lending

The make up of the Group's loan portfolios is set out below:

	2010		2011		2012	
	£bn	%	£bn	%	£bn	%
Prime mortgage lending	19.0	81%	22.6	84%	23.6	85%
Buy-to-let lending	2.2	9%	2.2	8%	2.1	8%
Non-prime lending	2.1	9%	1.8	7%	1.6	6%
Total residential	23.3	99%	26.6	99%	27.3	99%
Other lending	0.0	<0.1%	0.0	<0.1%	0.1	<0.3%
Retail lending	23.3	99%	26.6	99%	27.4	99%
Commercial lending	0.1	<0.5%	0.4	1%	0.4	1%
Total loans	23.4	100%	27.0	100%	27.8	100%

2012 saw:

- £1.0bn net growth in our prime residential portfolios, which now constitute 85% of our loan balances.
- Our buy-to-let book shrank by £0.1bn as redemptions on our inactive Chelsea portfolio outweighed new lending in our Accord business. We are taking a cautious approach to our entry into buy-to-let lending in Accord, and expect the rate of lending to increase in 2013.

- Non-prime lending portfolios shrank by £0.2bn, with these portfolios in run-off and representing lending in areas where we are no longer active.
- Overall residential lending continues to represent 99% of our total loan book.
- Commercial lending overall was stable at £0.4bn. Within this our inherited Chelsea loan portfolio reduced to just £57m whilst the high quality N&P branded portfolio of lending to small businesses across the country grew to £382m.

The Group remains comfortable with its overall portfolio mix.

The make-up of our mortgage portfolio, and the potential risks that are contained within it, are monitored closely across a wide range of characteristics. These include, for example, the geographic make-up of the portfolio, its indexed loan-to-value position and its ongoing arrears position.

Taking these in turn:

- Our geographic mix, following several years of change as we took on the Chelsea and N&P portfolios, was stable. Our highest exposure, in line with the whole of UK market, continues to be in the South East and London.

GEOGRAPHIC DISTRIBUTION

	2008	2009	2010	2011	2012
Yorkshire & Humberside	17%	17%	13%	11%	11%
South East	15%	15%	18%	20%	20%
North West	14%	14%	9%	11%	11%
Midlands	11%	12%	13%	12%	13%
Greater London	11%	11%	16%	17%	19%
Scotland	12%	11%	8%	8%	7%
North East	6%	6%	7%	4%	4%
Wales/N Ireland	6%	6%	5%	5%	4%
South West	5%	5%	7%	6%	6%
East of England	3%	3%	4%	6%	5%
	100%	100%	100%	100%	100%

BUSINESS REVIEW continued

- 2012 saw further reductions in the highest loan-to-value segment of our portfolio, driven by a combination of relatively risk averse new lending and beneficial house price movements. Our lending is strongly focused in the 50-90% loan-to-value segment, with over 60% of our lending in this segment.

INDEXED LOAN-TO-VALUE

	2008	2009	2010	2011	2012
Greater than 90%	23%	27%	22%	18%	16%
75% to 90%	19%	19%	24%	25%	26%
50% to 75%	27%	26%	30%	33%	36%
Less than 50%	31%	28%	24%	24%	22%
	100%	100%	100%	100%	100%

Key Performance Indicator explanation: The Board monitors the Group's arrears performance using a range of different measures and analyses. It does this because the current arrears performance and its trend gives a direct indication of how well borrowers are, or are not, coping with current economic conditions and therefore how exposed the Group may be to borrower defaults and hence loan losses. A range of arrears measures are used because they may each provide a slightly different perspective on current and prospective conditions. However the key measure used by the Board is the number of borrowers whose loans are in arrears by three monthly payments or more.

LOANS WITH PAYMENTS MORE THAN THREE MONTHS IN ARREARS AS % OF TOTAL LOANS

	2008	2009	2010	2011	2012
Number of accounts	1.59%	1.84%	1.84%	1.58%	1.25%
Balances outstanding on accounts	1.99%	2.46%	2.26%	1.90%	1.39%

Throughout 2012 we have maintained our strong focus on managing arrears and are pleased that again this has borne fruit with significant falls in all arrears measures. This includes significantly widening the gap between ourselves and the industry average provided by the Council of Mortgage Lenders – such that for the last available figures (at 31 December 2012) the Group's three month arrears (excluding possessions) were 0.66% below the industry average, against 0.40% at the end of 2011.

The Group's approach to forbearance in cases where borrowers face difficulties in making their contractual repayments is explained in Note 39 to the accounts.

Key Performance Indicator explanation: The Board monitors the Group's new lending performance across a range of measures, and between different channels and portfolios, with the over-arching metric being net new lending in absolute terms. This figure is used because it provides a measure that includes all portfolios and channels, and measures our effectiveness in gross mortgage lending, the rate at which existing borrowers are redeeming their mortgages and how effective we are being in retaining borrowers whose original loan deals are maturing. As such it gives a good guide to how well we are performing both in terms of offering the type of competitive mortgage products that our customers want, and of meeting our growth aspirations.

The Group's gross lending increased by 12% to £4.6bn (2011: £4.1bn) in 2012. This represents a market share¹ of 3.2% against 2.9% in 2011, and is significantly ahead of our 2.1% market share of mortgage balances.

Redemptions for the year also increased to £4.0bn, meaning our net lending decreased to £0.6bn (2011: £0.7bn). This level of net lending reflects our continued commitment to being an active mortgage lender providing our customers with good-value products. All of this has been achieved within our relatively low risk appetite and our continued approach of funding first and lending second. It is something we intend to continue in 2013.

¹ Source: Bank of England secured gross lending to individuals and housing associations as at 31 December 2012.

Capital

The Group's capital ratios continue to echo its core strength, with all ratios reflecting our very strong standalone and comparative position.

Key Performance Indicator explanation:

The Board looks at two key measures to monitor the Group's capital strength, which is important since it represents the money held to protect investors against ever losing any of their money with the Group. The higher these ratios the more capital an institution has in place, relative to the riskiness of its assets, and therefore the stronger its position:

- Core Tier 1 ratio – core tier 1 capital represents the very strongest form of capital for any financial institution, and for the Group is essentially its accumulated profits built up over time. The ratio compares this to its assets weighted according to how much risk they carry - all financial institutions, by their very nature, take some degree of risk in investing their assets, but differing assets carry differing degrees of risk.
- Capital excess – as a part of the Internal Capital Adequacy Assessment Process the FSA sets minimum capital requirements for the Group, based on its view of the Group's own assessment of the risk profile of its assets and wider business activities. The Board monitors closely the degree to which the Group carries capital above this requirement.

The table below sets out the Group's capital resources and ratios:

£m	2008	2009	2010	2011	2012
Total Capital Resources	1,161	1,238	1,778	1,892	1,735
Tier 1 Capital Resources	1,104	1,123	1,562	1,679	1,629
Core Tier 1 Capital Resources	937	964	1,394	1,502	1,622
Risk Weighted Assets	7,832	7,927	11,205	11,965	11,905
Tier 1 Ratio	14.0%	14.2%	13.9%	14.1%	13.7%
Core Tier 1 Ratio	12.0%	12.2%	12.4%	12.6%	13.6%

As can be seen, our key Core Tier 1 ratio has increased from 12.6% to 13.6%. This is after having undertaken a major capital buyback exercise during the year which:

- Was possible because of our extremely strong capital position.
- Anticipated the fact that, under the new regulatory rules, over the next five years subordinated liabilities and PIBS ('remunerated capital') will gradually become redundant as regulatory capital.
- Also recognised that, because of current market conditions and, in particular, current interest rates against those paid on our issues, the market price of our remunerated capital was less than its face value. As a result the holders of that capital would be willing to sell it back to us for less than the debt we were showing on our balance sheet.

Overall the Group bought back £235m of remunerated capital, realising a net profit of £62m for the Group. In effect we have replaced £235m of capital that would be redundant in five years with £62m of permanent, Core Tier 1 capital. The Group improved the overall quality of its capital base whilst also providing liquidity to the holders of the capital securities.

This means that whilst our Total Capital Resources reduced by £157m in the year, our critical Core Tier 1 Capital Resources grew by 8% or £120m. It also meant that whilst our Tier 1 Capital ratio fell slightly to 13.7% our more important Core Tier 1 ratio rose by 1% to 13.6%, remaining among the strongest in the UK.

The Group remains committed to maintaining strong capital ratios as these are the most fundamental measure of the security we offer our members. Once again our Capital Excess has grown year on year and we continue to hold what we believe to be a sensible but not excessive amount over and above what the FSA requires us to hold.

Customer satisfaction measures

In addition to financial indicators the Board monitors a range of measures designed to reflect how well the Group is meeting our members' and customers' needs for high quality products and services.

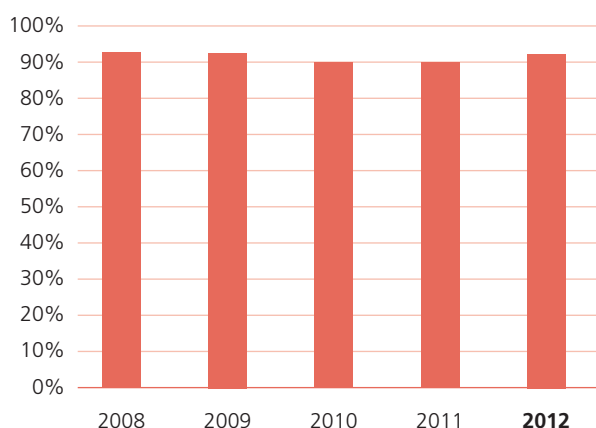
BUSINESS REVIEW continued

Key Performance Indicator explanation: The Group looks at a range of customer metrics, with the key ones being:

- Customer satisfaction – which shows the proportion of our customers who say that they are satisfied or more than satisfied with the service they received.
- Net Promoter Score® – which shows the percentage of customers strongly prepared to recommend our products and services to others less those who are not prepared to do so and excluding those who are neutral towards us i.e. it is the net proportion of our customers with a positive perspective on us, and not just the gross number.
- Complaints – a range of data is monitored including the number and type received, the speed with which complaints are resolved, the proportion that are accepted or rejected, how many are referred to the Financial Ombudsman Service and how many of those are found in our or the customer's favour. The Board also monitors the absolute level of complaints received.

Our customer satisfaction measure is based on a continuous survey of customers after they have transacted with us. During the year it has continued at around 90% (92% for the Yorkshire brand, and 88% for the Chelsea brand).

CUSTOMER SATISFACTION



The Net Promoter Score® is an extremely hard but powerful measure since it represents those who are willing to actively promote the Group minus those who would actively advocate against us. 54% for the Yorkshire brand and 50% for the N&P are both exceptionally strong scores, and ones we will continue to work hard to maintain. Equally pleasing is the improvement in the year in the Chelsea brand measure which has risen from 16% to an average of 32% for the year, and 36% since July.

NET PROMOTER SCORE®

Yorkshire brand	54%
Chelsea brand	32%
N&P	50%

The Board reviews a number of measures in relation to customer complaints, including Financial Ombudsman Service (FOS) 'complaint overturn' rates. This measures (as a percentage) how many times the FOS has decided cases referred to it in the customer's favour. In other words, a low figure shows that the FOS finds fewer mistakes in how an individual firm has dealt with customer complaints.

The latest table, published on 30 June 2012, showed:

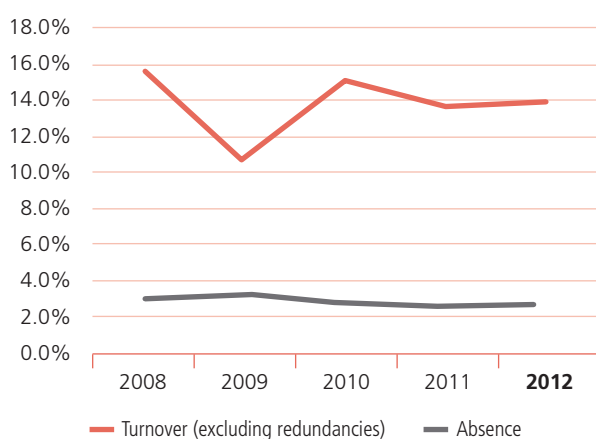
- That Yorkshire (including Chelsea) once again had one of the lowest published rates with an FOS overturn rate of 13%, up marginally from the same period in 2011 but still extremely strong against an industry average of 51%.
- Results for N&P which were unacceptably high at 92% in 2011 are now included in our Group figures – meaning that maintaining a low combined score is an even more pleasing result.
- Results for the part of Egg acquired by the Group remain higher than we would have liked at 36%, but are down from 42% in 2011 and remain below the industry average. Since this data was published we have completed the integration of Egg into our business and believe that the rates will have reduced further.

Staff metrics

Key Performance Indicator explanation: The Group looks at two staff metrics on a monthly basis, as well as undertaking periodic detailed staff surveys:

- Turnover – this measures how many of our staff are leaving the organisation. Whilst this inevitably includes a number of retirements and similar leavers, movements in the ratio will give a broad indication of our staff's satisfaction with the Group as an employer. It excludes redundancies as these represent specifically merger-related short-term anomalies.
- Absenteeism – this measures the percentage of working days lost through sickness and other forms of absenteeism. Generally a lower ratio will suggest a more committed, healthy and satisfied workforce.

	2008	2009	2010	2011	2012
Staff turnover	15.6%	10.7%	15.1%	13.6%	13.9%
Staff absenteeism	3.1%	3.2%	2.8%	2.6%	2.7%



The results for both these measures continue to be better than target. Staff turnover is up modestly to 13.9% from 13.6% but remains good, whilst absenteeism remained firmly below 3%, which is an excellent position reflecting the enthusiasm and commitment of all of our people.

Major projects

We continued to deliver against our ambitious project agenda during 2012, with:

- The successful integration of the Egg savings and mortgage portfolios onto our systems, and into our call centres.

- On the back of the Egg integration, the provision of new Money Manager and Secure Messaging services across our wider customer base.
- Continued investments in our arrears management processes, and in our retail sales processes to both improve customer experience and comply with the new regulatory framework.
- Introduction of Faster Payments across all of our brands and products.
- The delivery of new desktop infrastructure across the majority of our branches and head office departments, providing more efficient hardware and software to enhance customer services.

A number of these projects will continue into 2013 in parallel with our ambitious, £160m and five year investment programme that will cover product offerings, systems re-design, process improvements and underlying physical and systems infrastructure. Also involved are investments in our people, and in our systems of risk and financial control. This is an ambitious programme that will take more than five years to deliver, and which is aimed at making our products, processes and systems simpler and, most importantly, easier for our customers and our colleagues to use. Whilst the Board has signed off on the overall programme, every investment will continue to be subject to strict re-appraisal and monitoring of both their costs and benefits.

Conclusion

2012 saw the Group deliver an exceptionally strong set of financial results based on solid core performances enhanced by a number of one-off opportunities. In doing so we have retained exceptionally strong capital, funding and liquidity positions that allow us to commit to extensive future investments in how and what we deliver to our customers. This performance was achieved whilst maintaining our high levels of customer satisfaction and trust as evidenced by our Net Promoter and FOS overturn rates in particular, and high levels of staff engagement and satisfaction. Whilst the environments in which we operate continue to be uncertain and volatile, we enter 2013 in very good shape.

Robin Churchouse

Finance Director

CORPORATE RESPONSIBILITY

BUILDING STRONGER COMMUNITIES TOGETHER

As a mutual building society, we are committed to playing an active role in the communities we serve. That's why our community programme, Societies Together, works to inspire our members, colleagues and people from the local community to play their part in activities that make a real difference to the lives of those around us.

The programme encompasses all the community, charity and volunteering work carried out by the Yorkshire Group and Yorkshire Building Society Charitable Foundation. In 2012 that added up to over £1.23m donated to charities, good causes and community groups, as well as more than 5,000 volunteering hours by colleagues. Here are some of the highlights.

Come Rain or Shine we're there for the RNLI

Our members and colleagues voted the Royal National Lifeboat Institution (RNLI) as our Charitable Foundation's Charity of the Year in 2012, and so our 'Come Rain or Shine' campaign was born.

All the funds raised will be used by the RNLI to train its volunteer lifeboat crew and lifeguards - turning them into the extraordinary individuals who save lives at sea.

Our colleagues took part in over 120 activities to raise money over the year, from sponsored runs to mountain climbs and cake sales. Twenty five brave members of staff cycled the 152 miles from Yorkshire Building Society's head office in Bradford to Norwich & Peterborough's (N&P) office in Peterborough, and raised over £2,000 in the process.

In 2012, Come Rain or Shine raised over £106,000, and with a boost from Yorkshire Building Society Charitable Foundation, a total donation of £200,000 was made. We are really pleased that in 2012 we were awarded the RNLI Corporate Supporter of the Year Award. In 2013 we will continue to raise money for the RNLI as employees and the Member Panel voted in favour of extending our partnership with the charity for another year.





Afghan Trust

Sergeant Paddy Caldwell, from the Parachute Regiment injured on duty in Afghanistan, received a new multi-terrain wheelchair thanks to a £2,000 donation.



Registered Charity No: 1069082

Small Change, Big Difference™

Since its launch in 1999, the Yorkshire Building Society Charitable Foundation has given over £5m to more than 15,000 good causes. In 2012 it donated over £721,000 to more than 2,000 causes, almost 90% of them recommended by our members.

This is only possible thanks to our innovative Small Change, Big Difference™ scheme, whereby our members agree to donate the annual pence of their interest from their accounts to the Charitable Foundation.

There are currently over 860,000 accounts participating in the Small Change, Big Difference™ scheme. The scheme has raised over £2.5m - turning pennies into millions of pounds for local good causes.

Below you can see some of the causes the Charitable Foundation supported in 2012.

Martin House Hospice

Martin House Hospice in West Yorkshire provides invaluable support to children with life limiting illnesses. Yorkshire Building Society's new Bingley branch, which opened in 2012, recently helped local resident Tom Bairstow organise a charity dinner to celebrate the 25th anniversary of the hospice's opening. The Yorkshire Building Society Charitable Foundation made a £600 donation to the charity and colleagues from the Bingley branch all bought tickets to attend the dinner. Tom said: "I've lived and worked in Bingley for many years and was very pleased to see the Yorkshire open in the town, but I was even more pleased when I approached them for support. The help they gave surpassed all my expectations."

Autism Anglia

Autism Anglia benefitted as a result of a colleague from Norwich & Peterborough's Watton branch going the extra mile – vertically! Caroline Wheeler, along with her nephew Joe, sister-in-law Lois and 79 year-old mother Vera Amys, completed a sponsored skydive at Beccles airfield to raise money for the charity. Once safely back on the ground, Caroline explained: "My sister Helen is autistic and has received absolutely brilliant support from the charity for many years. Autism Anglia have also been there to give my family guidance and I think we all felt we should do what we can to give something back to show our gratitude."



Make a Difference Week

This is an annual event when we invite our members, colleagues and the general public to recommend a local good cause or charity to support. In 2012 we made a difference by giving 1,118 causes a donation of £100 each.

CORPORATE RESPONSIBILITY continued



Every year all Yorkshire Building Society colleagues are given two days paid leave to get out into their communities and work on local projects, as we know that time can be just as important as money to charities and community groups. We call it Actionteering.

In 2012 our people gave a total of 5,467 hours to 124 different activities and challenges. These ranged from helping local primary school children with reading and numeracy to creating nature trails and sensory gardens for the entire community to enjoy.

Since Actionteering was launched in September 2007, 1,874 days have been completed, that's a total of over 13,000 hours. Proof that we always have time to help our local communities.

Here are details of just a couple of the Actionteering activities completed in 2012.

Miriam Lord Primary School

Employees from our head office in Bradford visited the Miriam Lord Primary School to mentor the pupils in an Apprentice-style challenge. By becoming business leaders, they created 16 events that taught the children valuable business skills, including marketing and budget planning. The event culminated in the top three teams visiting our head office for their final boardroom interview. The winning team was presented with the Yorkshire Building Society trophy and there were medals for the runners-up.



Cheltenham Animal Shelter

Colleagues from the Cheltenham office of Chelsea Building Society proved themselves to be true animal lovers in 2012. They raised £2,000 for Cheltenham Animal Shelter and spent a total of 134 volunteer hours feeding and exercising the animals, cleaning out kennels and walking dogs. The shelter cares for approximately 1,000 lost, unwanted or abandoned animals each year, with annual costs reaching £500,000. The £2,000 donation paid for blankets, toys and bedding to see the animals through the winter.

Barnsley branches get involved

Eight Barnsley Building Society branch managers took a day out of their branches to help renovate a small run-down children's park. They spent the day clearing the area of grass and weeds, also planting bulbs which will flower in spring 2013, making the park colourful for parents, grandparents and improving children's facilities in the Barnsley area.

Caring for our environment

Caring for our local communities means caring for our environment. We believe that responsibility falls on all of us, and are continually looking at ways to reduce our impact as individuals and as a business.

Thanks to our extensive programme we now recycle around 90% of head office waste and over 80% of branch waste. This includes paper, cardboard, aluminium cans, glass, plastic and food waste.

We also support a very special kind of community at the head office, our own honey bees. Thanks to a donation from the Yorkshire Building Society Charitable Foundation, they moved into their new hives last year. Honey bees play a vital role in our ecosystem, without bees to pollinate our essential

crops there would be no more plants, no more animals and no more us. That's why this is a project we're proud to be a part of.

Another way we're making a difference to the environment is through our branch refurbishment programme. As we upgrade and improve, we're taking the opportunity to increase our energy efficiency by installing more efficient boilers, insulation, low-energy lighting and presence detectors in low-use areas.

We're also helping our people find greener ways to get to work, by supporting National Bike to Work Week, Lift Share Week and the Metrocard Scheme, which provides colleagues with discounted public transport.



Our Actionteering volunteers exercise Cheltenham Animal Shelter's residents



Our 152 mile sponsored cycle raised over £2,500 for the RNLI



The Charitable Foundation trustees welcome the Yorkshire bees!



Mr Bairstow shares afternoon tea with the Bingley branch

Building on strong foundations

2012 has seen our community activities go from strength to strength. More colleagues, branches, and members have been involved in fundraising and local initiatives than ever before.

The 'Societies Together' programme lies at the very heart of what we stand for. It is a reflection of our local roots and our commitment to helping our communities grow, develop and succeed. In 2013 that commitment will grow further still.

NON-EXECUTIVE DIRECTORS



Ed Anderson

Ed Anderson, BSc, CPFA (age 62) Chairman

Ed Anderson joined the Board in 2003 and was appointed Chairman on 1 January 2007. He is a member of the Group Risk Committee and the Board Governance and Nominations Committee.

Ed is an accountant by training and divided his executive career between airport management and local councils. He is Chairman of the Airport Operators Association and was the Managing Director of Leeds Bradford International Airport for 10 years until his retirement in 2007. Prior to that, he was an executive director at Leeds City Council. Ed is a member of the Council of the University of Leeds and Chair of Governors of Leeds Trinity University. He is also involved in various other local organisations.

Kate Barker, CBE (age 55) Non-executive Director

Kate Barker joined the Board in November 2010 and is a member of the Group Risk Committee and the Board Governance and Nominations Committee. She is also a trustee of the Norwich & Peterborough Building Society Pension Scheme and holds the Society's 'Conduct Risk' oversight role on behalf of the Board.

Kate was previously on the Board of the Society and stepped down when she became a member of the Bank of England's Monetary Policy Committee in 2001.

Kate also has a background in housing and is the author of major policy reviews on housing supply and planning for the previous government. In 2006 she was awarded a CBE for services to social housing. She is a non-executive director of Electra Private Equity Plc and Taylor Wimpey plc and a senior adviser to Credit Suisse.



Kate Barker



Roger Burden

Roger Burden, PhD (hon), FCIB, MBCS, FRSA (age 66) Non-executive Director

Roger Burden joined the Board in April 2010, following the completion of the merger with Chelsea Building Society, and is a member of the Remuneration Committee. He also oversees the 'People Strategy' on behalf of the Board. He joined the Chelsea's Board as a non-executive director on 1 November 2009 when merger discussions between the two societies were well advanced.

Roger has extensive experience at a senior level within the financial services sector. He is a former Chief Executive and Chairman of Cheltenham & Gloucester Plc as well as a former Chairman of the Council of Mortgage Lenders. Roger is also a director and Vice Chairman of the Football Association. Roger has decided to retire from the Board immediately following the Annual General Meeting to be held on 17 April 2013.

Lynne Charlesworth, BA, MBA (age 56) Vice Chairman

Lynne Charlesworth joined the Board in 2006 and was appointed Vice Chairman of the Society on 18 April 2012. She is Chairman of the Group Risk Committee and a member of the Board Governance and Nominations Committee and a trustee of the Society's Pension Scheme.

Lynne has a background in risk management, particularly within the financial services and property sectors. She has worked within the building society industry and became Group Risk Manager of Abbey National Plc when it took over the former National & Provincial Building Society. In the 1990s, Lynne founded a successful property and asset management business and is now joint Managing Director of a private investment company, St. James Investments Limited.



Lynne Charlesworth



Philip Johnson

Philip Johnson, FCA (age 66)
Non-executive Director

Philip Johnson joined the Board in 2007 and is Chairman of the Audit Committee.

Philip retired as a partner at Deloitte LLP in 2007 where he was Head of Audit Quality and Risk Management for the UK, a member of the Deloitte Board of Partners and Chairman of the Deloitte Audit Committee.

During his 30 years as a partner with Deloitte, Philip specialised in providing advisory and assurance services to large corporate clients. He has considerable experience of financial services through leading some major investigations in the sector. Philip is a member of the Audit Committee of the Wellcome Trust and until recently, he was President of the Federation of European Accountants.

David Paige, BSc, FCA (age 61)
Non-executive Director

David Paige joined the Board in 2006 and is a member of the Audit, Group Risk and Remuneration Committees. He is also a trustee of the Society's Pension Scheme.

David is a chartered accountant and has considerable experience within the financial services industry on the risk, financial and audit sides. He was a partner at Coopers & Lybrand in their financial services division before moving into senior executive positions with NatWest Bank Plc, Zurich Financial Services, Aviva Plc and Royal & Sun Alliance Insurance Group Plc where he was Executive Director (Risk).

David is a non-executive director of Willis Ltd and the IFG Group Plc.



David Paige



Simon Turner

Simon Turner, BSc (age 61)
Non-executive Director

Simon Turner joined the Board in 2005 and is Chairman of the Remuneration Committee and a member of the Audit Committee.

Simon has extensive experience in marketing, sales and general management in a variety of roles in the electrical and publishing markets. He was Managing Director of Philips in the UK and Ireland until 1999 when he joined DSG International Plc where he was Group Managing Director of PC World, and all PC City operations in Europe. He was also responsible for the service business of the DSG Group and chaired their pan-european internet business prior to his retirement at the end of 2008. Since then Simon has worked in a variety of roles in the electronics industry and is now a senior executive within the European Division of the Acer Group.

EXECUTIVE DIRECTORS



Chris Pilling

Chris Pilling, MA (Age 47) Chief Executive

Chris Pilling joined the Society on 31 December 2011. He has a wealth of experience in delivering exceptional customer service both within the financial services sector and elsewhere. Prior to joining the Society, Chris was with HSBC Bank Plc for six years, most recently as Head of Branch Network. His previous roles with HSBC also included Chief Executive of First Direct, which is its telephone and internet-based retail bank. Prior to HSBC, Chris held a number of senior marketing positions in various sectors including Marketing and Customer Services Director at ASDA.

Chris is also a non-executive director of The Department of Health.

Ian Bullock, BSc, FIA (age 52) Sales and Marketing Director

Ian Bullock is a qualified actuary and joined the Society in 2003 as Head of Insurance and Financial Services, soon acquiring responsibility for other functions. He was promoted to the General Management team in 2004 and became Sales & Marketing Director in April 2007. Ian has the responsibility for Product Development, Marketing and the Society's distribution network, including our branches, agencies and online business. He is also Chairman of Accord Mortgages Ltd, the Society's intermediary lending subsidiary.



Ian Bullock



Andy Caton

Andy Caton, BA (age 49) Corporate Development Director

Andy Caton joined the Society in 1991 as an economist and was appointed to the General Management team in 1998. In 2004 he was appointed Corporate Development Director and is responsible for the Treasury, Corporate Affairs and Legal & Secretarial functions.

Andy is a trustee of the Yorkshire Building Society Charitable Foundation and a trustee of the Norwich & Peterborough Building Society Pension Scheme. He is also a non-executive director of the Bradford Chamber of Commerce.

Robin Churchouse, MA, ACA (age 47) Finance Director

Robin Churchouse joined the Society in 2004 as Head of Finance. He was promoted to the General Management team in June 2006 and was appointed Finance Director in June 2010. He now has responsibility for the Corporate Planning, Finance and Group Internal Audit functions. Before joining the Yorkshire, Robin gained a wide range of experience across a number of financial services organisations, including roles in finance, planning and strategy, management consultancy, corporate finance, risk management and prudential regulation.



Robin Churchouse

GENERAL MANAGERS



Rachel Court

Rachel Court, BA (age 46)

General Manager - Human Resources and Customer Service

Rachel Court was appointed to the General Management team in 2006 and is currently responsible for the Human Resources and Customer Services functions. In early March 2013 Rachel's role will change to General Manager - Customer Experience to focus on maintaining our excellent customer service.

Having joined the Society in 1991, Rachel has gained a broad experience across the Group starting in the Customer Service functions of Mortgage Arrears, Mortgage Administration and Investment Services. She then spent a period as Sales Director of Accord Mortgages Ltd before becoming the Society's Head of Mortgages prior to her appointment as a General Manager.

David Henderson, BSc (age 52)

General Manager - Group Change and Chief Information Officer

David Henderson joined the Society in 2007 as Chief Information Officer and now has responsibility for the Group's IT, Information Security and Change Management functions. David is leading our business transformation programmes as part of our strategic plans to invest substantially in improved business processes and technology. He is also Chairman of Yorkshire Key Services which provides IT services externally. David started his career in the building society sector and, prior to joining the Yorkshire, he held a range of senior IT positions within a major UK banking group.



David Henderson



Mark Jenkins

Mark Jenkins, BA, FCA, DipL (age 50)

General Manager - Commercial Services

Mark Jenkins joined the Chelsea Building Society in September 2009 and was a member of the Chelsea Board from October 2009. Following the merger of the Chelsea with the Yorkshire in April 2010, Mark was appointed a General Manager and is now responsible for commercial and social housing lending and the Facilities and the Corporate SharePlan functions.

Before joining the Society he spent 10 years with Price Waterhouse and a further 15 years with the Nationwide Building Society. A chartered accountant by profession, he has a wealth of corporate finance and commercial lending experience. Mark is a trustee of the Guide Dogs for the Blind Association and chairs its Audit Committee.

Richard Wells, FCIB (age 49)

General Manager - Risk

Richard Wells joined the Society in 2010 as General Manager, Risk. He is responsible for managing all of the risks planned or encountered by the Group. Richard has extensive experience of risk management within the financial services industry including senior risk management roles at a number of the UK's major banks and building societies.



Richard Wells

DIRECTORS' REPORT

The directors have pleasure in presenting their annual report, together with the Group Accounts and Annual Business Statement, for the year ended 31 December 2012.

Business objectives and activities

The Group's vision is 'to be the most trusted provider of financial services in the UK'.

Further information on the Group's vision and strategy is given in the Business Review on pages 14 to 15.

Principal risks, uncertainties and going concern

The principal risks and uncertainties faced by the Group and our approach to managing them are set out in the Risk Management Report on pages 52 to 60.

As set out on page 69, the directors are required to prepare these financial statements on the going concern basis unless it is inappropriate to presume that the Group and the Society will continue in business.

In accordance with best practice, the Board undertakes regular rigorous assessments of whether the Group is a going concern in the light of current economic and market conditions and all available information about future risks and uncertainties.

The future risks considered in the latest review, performed in January 2013, included:

- The impacts of the continuing financial crisis, principally around the eurozone, on the outlook for a recovery in UK economic growth.
- The Group's exposure to retail credit losses in the light of the outlook for the UK economy.
- Further changes to the regulatory framework.
- The outlook for interest rates and house prices.
- Risks associated with the Group's major projects, further details of which are shown on page 29 of the Business Review.

Factors addressed when considering the Group's ability to manage future risks and uncertainties included liquidity, funding, capital resources, future profitability and risk management processes. Stress testing was used to assess the Group's ability to withstand a variety of extreme circumstances and conditions.

As a result of the detailed assessment performed in January 2013 the Board concluded that the Group has sufficient resources to continue in operational existence for the foreseeable future and as a result that it is appropriate to prepare these financial statements on the going concern basis.

One key tool for mitigating risk is the requirement for all institutions to hold minimum levels of capital. In this regard, the Group uses the standardised approach under the Capital Requirements Directive (Basel II), and holds well in excess of its regulatory requirement. The disclosures required under Basel II Pillar 3 will be published on the Society's website.

Another key tool is the requirement to hold a sufficient level of high quality liquid assets to meet potential stress scenarios. The Group holds such liquidity in line with our risk appetite which ensures we are consistently well above the regulatory requirement.

Business review and future developments

Key developments and the future outlook are reviewed by the Chairman and Chief Executive on pages 2 to 13 and in the Business Review on pages 14 to 29. The Business Review identifies and explains the Group's Key Performance Indicators and sets out how it has performed against each during 2012.

Profit and capital

Profit before tax for the year was £157.1m (2011 – £129.7m) and after tax the amount transferred to Group general reserves was £122.9m (2011 – £106.2m).

Total Group reserves at 31 December 2012 were £1,632.9m (2011 – £1,557.6m). Details of reserves movements are given in the Statements of Changes in Members' Interest on page 74.

Gross capital at 31 December 2012 was £1,763.0m (2011 – £1,965.5m) including £122.8m (2011 – £230.9m) of subordinated liabilities and £7.3m (2011 – £177.0m) of subscribed capital. Expressed as a ratio to shares and deposits gross capital was 5.69% (2011 – 6.59%) and free capital was 5.18% (2011 – 6.06%). These ratios are explained on page 131.

One of the Group's principal measures, to monitor the level of capital within the business, is the solvency ratio, the calculation of which is in Note 31 on page 107. The Group's solvency ratio has decreased to 14.6% (2011 – 15.8%).

Further information about the Group's capital strength is outlined in the Business Review on page 27.

Mortgage arrears

Details of the Group's mortgage accounts which were 12 months or more in arrears at 31 December 2012 were as follows:

	2012	2011	2012	2011
			% of mortgage	
			accounts/balances	
Number of accounts	593	814	0.23	0.30
Balances outstanding on accounts	£84.0m	£113.1m	0.31	0.42
Amount of arrears included in balances	£9.4m	£11.8m	0.03	0.04

Further details of the Group's arrears position and the various provisions made against potential losses are set out in the Business Review on pages 14 to 29. Note 39 on page 121 describes the various forbearance measures offered by the Group to borrowers experiencing difficulties in meeting their repayments.

Staff

Our staff are key to our operations.

The Group's management meet staff representatives regularly to discuss a wide range of topics. Communication with and between all staff is subject to regular review and includes regular 'Pulse' staff opinion surveys, team briefings, an intranet site, in-house magazines and bulletins.

An equal opportunities policy is followed and the Group gives full consideration to applicants and staff with disabilities. In 2010 the Group had its Investor in People (IIP) accreditation reaffirmed and has been recognised as going beyond the required IIP standard to meet the higher 'bronze' rating.

The Group supports the continued learning and development of its staff through regular analysis of training needs and by the provision of a broad range of training opportunities.

Directors

The names of the directors of the Society who served during the year, their roles and membership of Board committees are described in the Corporate Governance Report on pages 41 to 47.

At the 2013 Annual General Meeting (AGM), Ed Anderson, Philip Johnson, David Paige and Ian Bullock will retire as directors and, being eligible, offer themselves for re-election. Biographical details of all directors are outlined on pages 34 to 36.

None of the directors had an interest in, or share of, any associated body of the Society at any time during the financial year.

The directors in office at the date of approval of this Directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Group's auditor is unaware.

DIRECTORS' REPORT continued

Charitable donations

In 2012 Yorkshire Building Society's Charitable Foundation donated over £721,000 to more than 2,000 causes, of which almost 90% were suggested by members, maintaining the Foundation Trustees' desire to support causes across the UK with the assistance of member nominations. The funds were primarily raised through the 'Small Change, Big Difference™' scheme. Further details can be found in the Corporate Responsibility Report on pages 30 to 33.

Supplier payment policy

The Group pays supplier invoices in accordance with the terms agreed at the start of trading.

The creditor days were one day at 31 December 2012 (2011 – six days).

Auditor

The re-appointment of Deloitte LLP as auditor is to be proposed at the AGM.

On behalf of the Board

Ed Anderson
Chairman

20 February 2013

CORPORATE GOVERNANCE REPORT

Chairman's statement

In my Chairman's Report on pages 2 to 7, I comment on the main areas that the Board focused on in 2012, the impact of the new regulatory regime and the delivery of the strategy that we will be concentrating on in 2013 and in the years ahead. However, good corporate governance, which provides a framework of how the Board (and the rest of the Society) operates, is also vital in assisting the Society to continue as a successful organisation run for the benefit of its current and future members in a legal, ethical and transparent manner.

The Board's approach to corporate governance is influenced by the following:

- That the Board is accountable to the Society's members for the conduct and performance of the business.
- That the interests of members are at the heart of the Board's decision-making.
- That the interests of other parties, such as employees and the communities in which we operate, are also taken into account.
- That the Society should be managed in a prudent and effective manner with effective decision making and robust management of the risks that the Society may face.
- That the effectiveness of the Board is vital to the financial strength and future success of the Society.

The approach is based on the principles and provisions of the UK Corporate Governance Code (the Code) published by the Financial Reporting Council (the FRC) in June 2010, which applies to listed companies, to the extent that they are relevant to a building society. A copy of the Code is available at www.frc.org.uk. In the interest of transparency, the Financial Services Authority (FSA) also encourages each building society to explain in its Annual Report and Accounts whether, and to what extent, it adheres to the Code. An updated version of the Code (the New Code) was published in October 2012 and applies to financial years commencing on or after 1 October 2012.

This Report sets out how the Board operates and whether it complies with the Code. It also takes into account those revised provisions in the New Code with which we already comply.

Ed Anderson
Chairman

Does the Society comply with the Code?

The Board is committed to complying with best practice in corporate governance but it does not consider that this should be a 'box ticking' exercise and where it believes that there is a justifiable reason to depart from the Code then it will do so, the key consideration being that such a departure is believed to be in the best interests of members and that the governance of the Society is not compromised.

The Board considers that the Society complied in 2012 with the guidance issued by the Building Societies Association on the Code with the exception of the Code provision that all directors should be subject to annual election by shareholders (that is the Society's members). This would take place at the Society's Annual General Meeting (AGM). As reported in the 2011 Corporate Governance Report, the Board considered this provision in respect of the Society's AGMs held in 2011 and 2012 and agreed that this should not be brought in at that time. The Board was concerned that in extreme circumstances this provision could have implications for the financial stability of the Society which would not be in the best interests of members. The Board has given careful consideration to the adoption of this provision at the 2013 AGM, being mindful of the Board's stated commitment to comply with best practice in corporate governance and its duty to act in the best interests of its members. The Board has concluded that the current policy should continue and, as a result, not all the directors should be put forward for re-election at the AGM to be held in April 2013.

The Society's Rules, which set out the constitution of the Society, state that only those directors who are due for election or have not been re-elected within the previous three years should be put forward for election/re-election by members. However, the Rules do enable re-elections to be brought forward. In normal circumstances there would be one re-election at the 2013 AGM being David Paige, Non-executive Director. However, to allow members a greater say, the re-election of three directors have been brought forward to the 2013 AGM, namely Ed Anderson (Chairman), Philip Johnson

CORPORATE GOVERNANCE REPORT continued

(Non-executive Director) and Ian Bullock (Sales and Marketing Director). This is in line with the Board's policy that if annual elections of all directors are not adopted then members should be able to vote on at least one third of the directors, including at least one executive director. As mentioned on page 34, Roger Burden, Non-executive Director is to retire immediately following the 2013 AGM. Based on the current number of directors, this will mean that out of 10 directors on the Board immediately after the AGM, members will have had the opportunity to vote on four of them. The Board has considered (in the absence of each relevant director) that the performance of those directors to be voted upon at the 2013 AGM continues to be effective and they demonstrate the necessary commitment to the role.

The role of the Board

The Board's principal role is to:

- Focus on the Group's strategy.
- Ensure that the necessary resources are in place for the Group to meet its objectives.
- Ensure that financial and internal controls and systems of risk management are robust.
- Provide general direction to the organisation.
- Monitor the performance of the senior management team.
- Safeguard the interests of members, ensuring the long-term success of the Society.

Reserved matters to the Board

The Board maintains a schedule of reserved matters (which is reviewed at least annually) in order to ensure that it exercises control over the Group's affairs. These include the approval of the annual results and strategic aims of the Group, including mergers and other acquisitions and disposals, as well as the approval of policies and matters which must be approved by the Board under legislation and the Society's Rules. The Board is also responsible for the recruitment and terms of employment of the executive directors and other General Managers (collectively known as the General Management team). Other matters are delegated to the General Management team or to other specified members of staff or committees, including the Board committees referred to on pages 44 to 45. Details of all the directors and other members of the General Management team are set out on pages 34 to 37.

Composition of the Board

As at the date of this report, the total number of directors on the Board is 11, consisting of four executive directors and seven non-executive directors. Their details are set out on pages 34 to 36. However, the Board accepts that there needs to be flexibility in this number (particularly in the number of non-executive directors), to take into account any future skills or experience gaps, either due to changes in the Group's business activities or as part of succession planning and recruitment.

The size and composition of the Board and the Board committees are kept under constant review by the Chairman and are reviewed formally by the Board Governance and Nominations Committee at least annually. This is to ensure that there is adequate succession planning for executive and non-executive directors and that there is the optimum mix of skills and experience on the Board for the direction of the Group's activities and to populate and chair the Board committees.

Appointments to the Board

The appointment of new directors is initially considered by the Board Governance and Nominations Committee which is made up of Ed Anderson (Chairman), Lynne Charlesworth (Vice Chairman), Kate Barker (Non-executive Director) and Chris Pilling (Chief Executive). The committee is responsible for considering matters relating to the composition of the Board, including nominating candidates for the position of director, taking into account the balance of skills, knowledge and experience of directors, and making recommendations to the Board as appropriate.

A review of the succession planning for non-executive directors was agreed by the Board in 2012 and was shared with the FSA. This succession plan takes into account a phased recruitment to ensure that there continues to be relevant skills and experience on the Board during the period of change to the Board membership. In the latter part of 2012, recruitment commenced for the replacement of Simon Turner, Non-executive Director, who will retire at the 2014 AGM with the aim of allowing a considerable period of overlap.

An independent external search agency, The Zygos Partnership, has been engaged to assist in the candidate search and administration of the recruitment process. Zygos has no other connection with the Society. In addition, the position was advertised in the Sunday Times and the Yorkshire Post and was brought to the attention of those members who had previously shown an interest in becoming a non-executive director. A long list of candidates was considered by the Board Governance and Nominations Committee who then conducted interviews with the selected short list of candidates. The final stages of the process are underway and it is anticipated that an announcement will be made in the spring.

In January 2013 a search commenced for a further non-executive director to replace Roger Burden who is to retire immediately after the 2013 AGM. The Zygos partnership has also been retained in respect of this appointment and the position has recently been advertised on the Group's websites. The process remains at an early stage and an announcement is not expected to be made until mid-year.

Under the Society's rules all directors are subject to election by members at the AGM following their appointment (or at the AGM in the following year if the director is appointed by the Board in the period between the beginning of the year and the AGM). In addition, all directors must receive approval from the FSA as Approved Persons in order to fulfill their controlled function as a director. Subject to the appointment by the Board of the two new non-executive directors referred to above, these directors will be put forward for election by members at the 2014 AGM.

Diversity on the Board

The Board gives consideration to all aspects of diversity, including gender, on the Board although it has adopted the principle that all appointments should be made on merit. For this reason, the Board has not set any measurable objectives although this will be kept under review.

The percentage of females on the Society's Board at the date of this report is 18%. In addition, 25% of the General Management team (excluding executive directors) is female, although this will increase to 40% with effect from 4 March 2013. For the next level of senior managers (i.e. those managers who report directly to a member of the General Management team) the percentage of females is 26%.

The Society takes into account diversity at all levels of recruitment and encourages staff through various initiatives, including taking on voluntary roles such as trusteeship and non-executive roles in local voluntary organisations, to enable staff to gain experience of Board roles.

Performance evaluation

The Board undertakes an annual evaluation of the performance and effectiveness of the Board together with an annual review of the performance of individual directors. In the latter part of 2012 an internal Board evaluation was undertaken through the means of a questionnaire. The results were reviewed by the Board at its meeting in December 2012. Overall, these results were once again very positive but a number of actions were agreed. This included a review of matters delegated to the Group Risk Committee, a review of the order of matters on meeting agendas to ensure that appropriate time is given to each item and the inclusion of an annual presentation on remuneration on the Board agenda. In addition, the responses indicated that main areas of increased focus would be on succession planning of the executive team (which was ongoing), the People strategy and the impact of the new regulatory regime.

An external performance evaluation of the Board was undertaken between November 2010 and January 2011 and consideration will be given during 2013 as to when the next external review should take place.

In 2012 internal performance evaluations of the Audit, Group Risk and Remuneration Committees were carried out through the means of a questionnaire completed by all relevant committee members. The results were reviewed by the relevant committees and any appropriate improvements were identified for action.

In the latter part of 2012 individual evaluation of directors was undertaken through the completion of internal questionnaires which concluded that all directors continued to perform effectively. Each non-executive director was reviewed by all other directors and General Managers. The written results of the questionnaire were given to each such director by the Chairman in a 1:1 appraisal meeting which included a discussion on any training requirements. The Vice Chairman and Chief Executive conducted the 1:1 meeting with the Chairman.

CORPORATE GOVERNANCE REPORT continued

The non-executive directors reviewed the performance of each executive director (and also each General Manager) through the completion of an internal questionnaire. This was used as part of the year end performance appraisal meetings with the Chief Executive and the Chairman. The Chief Executive's appraisal meeting was conducted by the Chairman.

Board meetings

The Board held 10 meetings in 2012. The attendance record of each director at these meetings and at relevant Board committee meetings is set out on page 47. To provide focus on the development of strategy, twice a year (in June and September) the Board has specific strategy sessions outside of the usual Board meetings. The Board generally meets in West Yorkshire but at least one meeting each year is held in a location where the Group has an administrative centre or a branch which gives the non-executive directors an opportunity to meet local management and staff. In October 2012 the Board meeting was held at the administration centre in Peterborough (which was the head office of the former Norwich & Peterborough Building Society (N&P)) which gave the non-executive directors an opportunity to talk to staff, particularly in respect of integration of the N&P within the Group.

At each Board meeting, the Board receives a comprehensive management information pack covering financial and non-financial information (including customer service and people metrics) with risk being an integral part of each reporting item. The relevant executive director or General Manager highlights appropriate matters including the performance of particular aspects of the business against targets. In addition, the agenda includes the following:

- Minutes of Board committee meetings held since the previous Board meeting and oral updates from the chairs of Board committees on the main issues discussed and matters agreed. This ensures that all Board members are aware of the key discussions and decisions made by the committees.
- Minutes of the meetings of the General Management team, UK subsidiary Board meetings and those of the Financial Management Committee (which is a management committee).
- Items for decision and key matters which need to be debated. For example, in 2012 the Board considered papers on the disposal of the business of Norwich & Peterborough Insurance Brokers Ltd, the integration of the Egg savings and mortgage accounts, a major investment programme in the business, a capital buyback exercise, consideration of a revised corporate plan covering the next five years and Member Engagement. If a major item will require more detailed consideration then the Board may delegate this to be considered by the Chairman's Committee.

Board committees

Certain matters are referred to Board committees in order that they can be considered in more detail by those directors (and in the case of the Group Risk Committee, a number of the General Managers) with the most relevant skills and expertise. The committees are:

- The Audit Committee – details are contained in the Audit Committee Report on pages 48 to 51.
- The Board Governance and Nominations Committee – details are contained in the section on 'Appointments to the Board' on pages 42 to 43 of this Report.
- The Group Risk Committee – details are contained in the Risk Management Report on pages 52 to 60.
- The Remuneration Committee – details are contained in the Directors' Remuneration Report on pages 61 to 68.

Members of these committees are set out in the table on page 47. The terms of reference of the committees are available on request from the Group Secretary or on the Society's website at www.ybs.co.uk/committees. The chair of each committee reports to the subsequent Board meeting on the matters discussed at each committee meeting. The minutes of each committee meeting are circulated to all directors.

In addition to the above committees, there is a Chairman's Committee which is made up of the Chairman, Vice Chairman and Chief Executive. Other directors may be co-opted onto the committee, as agreed by the Board, to consider specific matters. The committee's main function is to decide on any matter that requires attention before the next Board meeting (except for specific issues that have to be determined by the full Board) or to consider any matter which the Board has specifically delegated to it.

Two of the Non-executive Directors also each undertake a Board oversight role to cover Conduct Risk (Kate Barker) and the Group's People strategy (Roger Burden). These roles were created in 2012 and are to ensure that there is a continuous in-depth and independent review of these two important areas. However, overall responsibility for Conduct Risk and the Group People strategy remains with the whole Board.

Non-executive directors

In addition to playing their part on the Board as a whole, the non-executive directors are responsible for bringing independent judgement to Board debate and decisions using their own experience and skills, and for constructively challenging the General Management team.

The non-executive directors meet, without the executive directors present, at least four times a year to discuss relevant matters including succession planning and the overall performance of the General Management team.

The Vice Chairman, who is also the Society's Senior Independent Director, deputises for the Chairman when appropriate and provides support and guidance to him. She would also act, if required, as an intermediary for the other directors. As Senior Independent Director, the Vice Chairman is also the main point of contact for members should the normal channels of communication with the Chairman, Chief Executive or other executive directors fail or be inappropriate.

One of the criteria which the Board takes into consideration when recruiting a non-executive director is his/her ability to have sufficient time to take on the position. In addition, during the term of their directorship with the Society any other positions that such directors take up have to first be referred to the Board so that the time commitment and any potential conflict of interest can be considered. The letters of appointment of non-executive directors give an indication of the time commitment required although this will change depending on whether he/she is chair and/or member of any Board committee(s). The commitment will also increase, inevitably, when a potential merger or other major development is being considered.

Copies of the letters of appointment of each of the non-executive directors are available for inspection on request from the Group Secretary.

The Board is satisfied that all of the non-executive directors are independent. By the 2013 AGM Mr Anderson, the Chairman, will have served nine years as a Non-executive Director since his first election by members. However, the Board is unanimously of the view that the independence of his judgement will not be prejudiced by his continuation as a director. As referred to on page 39, Mr Anderson will be put forward for annual re-election at the 2013 AGM which is in line with the Code.

Induction and development

The Chairman ensures that, on appointment, non-executive directors receive a comprehensive tailored induction programme on the Group's business and regulatory environment. All non-executive directors update their skills, knowledge and familiarity with the Group through internal presentations by senior managers, relevant external and internal courses and through branch visits and attendance at member events which are referred to on page 46. For example, throughout 2012 (and continuing into the early part of 2013) a series of Treasury workshops took place. These were conducted by an external trainer and were specifically tailored for the Society's non-executive directors. In November 2012, Deloitte presented their annual update on regulatory and other topical issues to the Board which was forward looking. Individual training requirements for non-executive directors are discussed as part of the performance evaluation process and a training record for each non-executive director is maintained by the Group Secretary.

Non-executive directors are encouraged to contact individual members of the senior management team to discuss any queries that they may have and to undertake branch and department visits on an ad hoc basis.

All directors have access to independent professional advice if required and have the benefit of appropriate liability insurance cover at the Society's expense. In addition, they have access to the advice and services of the Group Secretary who is responsible for ensuring that Board procedures are complied with and for advising the Board, through the Chairman, on governance matters.

CORPORATE GOVERNANCE REPORT continued

The roles of the Chairman and the Chief Executive

The roles of the Chairman and Chief Executive are held by different people and are distinct in their purpose.

The Chairman is responsible for leadership of the Board and for ensuring that the Board acts effectively, promoting high standards of corporate governance. The Chairman is key in setting the tone of the Board meetings to ensure, amongst other things, that there is a culture of openness. This is tested through the annual review process.

The Chief Executive has overall responsibility for managing the Society and its subsidiaries and for implementing the strategies and policies agreed by the Board, supported by the General Management team and through a suite of management and risk committees.

Member engagement

The Society's owners are its individual members who are made up of its investors (except deposit account holders) and borrowers. This is different to the shareholders of a listed company, whose owners may include institutional shareholders. The vast majority of the Society's customers are therefore its members and the Society encourages feedback from them on any aspect of the Society's activities.

This feedback takes various forms, including member 'Question Time' meetings which give members the opportunity to meet and ask questions of the Chief Executive, the senior management team and local branch staff. The Members' Forum, currently made up of 16 members who are drawn from a cross-section of the Society's membership, meets twice a year to debate and obtain views on specific relevant issues. The non-executive directors are encouraged to attend at least one member event during the year to engage with members and understand any concerns that they may have.

The Society also operates a Member Panel, consisting of 9,000 members, who are invited to complete surveys on a variety of topical issues. In addition, a monthly customer satisfaction survey is undertaken, the results of which are a key performance indicator, which is monitored by the Board on a monthly basis.

The AGM

At the AGM, the Chairman and Chief Executive give presentations on the previous year's financial performance and on future plans. The meeting also provides an opportunity for members to question the Chairman, Chief Executive and other directors on the resolutions to be proposed at the meeting and on any other aspect of the Society's business. All directors attend the AGM (unless their absence is unavoidable) including the chairs of all of the Board committees.

All members who are eligible to vote at the AGM receive a proxy voting form, which includes a 'vote withheld' option, and a pre-paid reply envelope to encourage them to exercise their vote through the appointment of a proxy if the member cannot attend and vote at the meeting. Members are also able to appoint a proxy online.

At the AGM, the Chairman calls for a poll on all resolutions so that all proxy votes are recorded. The results of the proxy votes, and the votes cast at the AGM, are published on the Society's website and in branches. They are also available on a telephone results line for a specified period after the AGM. A separate resolution is proposed on each issue, including a resolution on the Annual Report and Accounts.

Relations with other investors

The Society also places great importance in maintaining a frequent dialogue with its providers of external capital and funding. As part of the annual results publication process, the Society conducts a series of investor meetings to provide a detailed briefing on its financial performance. These briefings are held with a wide range of institutional investors and analysts and are not restricted to existing providers of wholesale funds or capital. The presentation materials are available throughout the year on the Society's website. In addition, representatives of the Society's treasury team conduct regular face-to-face meetings with external stakeholders throughout the year in order to provide updates on the Society's performance and respond to market queries.

Board and committee attendance record 2012

Set out below are details of the directors during 2012 and their attendance record at Board meetings and relevant Board committee meetings in the year. The figure in brackets indicates the number of meetings that the director was eligible to attend during 2012.

Director	Board Meetings	Board Committees				
		Audit	Chairman's	Nominations	Remuneration	Risk
Ed Anderson Chairman	10(10)	–	2(2)	3(3)	–	6(6)
Kate Barker Non-executive Director	10(10)	–	–	3(3)	–	5(6)
Ian Bullock Sales & Marketing Director	10(10)	–	–	–	–	5(6)
Roger Burden Non-executive Director	9(10)	–	–	–	9(10)	–
Andy Caton Corporate Development Director	9(10)	–	–	–	–	6(6)
Lynne Charlesworth Vice Chairman	10(10)	–	2(2)	3(3)	–	6(6)
Robin Churchouse Finance Director	10(10)	–	–	–	–	6(6)
Richard Davey Vice Chairman (retired 18.04.2012)	3(4)	2(2)	0(0)	0(0)	–	2(2)
Philip Johnson Non-executive Director	10(10)	6(6)	–	–	–	–
David Paige Non-executive Director	9(10)	6(6)	–	–	10(10)	5(6)
Chris Pilling Chief Executive	10(10)	–	2(2)	3(3)	–	6(6)
Simon Turner Non-executive Director	10(10)	6(6)	–	–	10(10)	–

Notes:

In addition, the written resolution procedure under the Society's Rules was used on one occasion by the Board and on a further four occasions by the Chairman's Committee to conduct business.

On behalf of the Board

Ed Anderson
Chairman

20 February 2013

AUDIT COMMITTEE REPORT

Membership and attendees

The Audit Committee is appointed by the Board and is made up of three non-executive directors. Membership and attendance at meetings in 2012 is shown on page 47. David Paige and I are the members with recent, relevant financial experience.

The committee invites the Chief Executive, the Finance Director, the Head of Group Internal Audit and the external auditor to attend all meetings and extends the invitation, as necessary, to other managers.

Private meetings are regularly held with the external auditor and, separately, with the Head of Group Internal Audit with no members of management present. This allows us to discuss any issues of concern in more detail directly with the teams involved.

Responsibilities

The responsibilities of the committee are in line with the provisions of the Financial Reporting Council (FRC) Guidance on Audit Committees (the 'Smith Guidance'). This guidance was updated in September 2012 and, while it will apply to our 2013 year end, we have adopted some of its disclosure requirements in the current report.

The main function of the committee is to assist the Board in fulfilling its oversight responsibilities, specifically the ongoing review, monitoring and assessment of:

- The integrity of the financial statements, any formal announcements relating to financial performance and significant financial reporting judgements contained in them.
- The effectiveness of the system of financial internal control processes.
- The internal and external audit processes.
- The Society's ethical and business standards.
- The appointment, re-appointment and removal of the external auditor and the periodic review of their performance and independence.
- The policy on the use of the external auditor for non-audit work.

The committee's full Terms of Reference are available from the Corporate Governance section of our website (www.ybs.co.uk/your_society/about_ybs/committees.html).

Areas considered in 2012

Financial reporting issues and judgements

Our role in monitoring financial reporting issues is key in ensuring that all our stakeholders maintain their trust in our activities and reporting. We utilise our external auditor, Deloitte LLP (Deloitte), to help ensure that suitable accounting policies have been implemented and appropriate judgements have been made by management. The main issues which we considered during 2012 were as follows:

- We followed up the estimates made of the fair values of assets and liabilities acquired on our merger with Norwich & Peterborough Building Society (N&P) in our 2011 accounts. No changes were required in our interim accounts and we had until October 2012 (the anniversary of the merger) to consider final adjustments. Management undertook a comprehensive review of the fair values using internal experts independent of the Finance function. The committee did not consider that it was necessary to adjust the fair values of assets and liabilities acquired on merger with N&P. The committee has continued to track the run-off of fair values from the previous merger with Chelsea Building Society.
- We continue to monitor impairment provisions closely. The committee and the external auditor are satisfied with the assumptions adopted and models used to calculate provisions over the retail mortgage books and commercial loan portfolio. The impact of forbearance in the mortgage portfolios has been considered and appropriate disclosures made in the financial statements. In terms of wholesale assets, we received full repayment of our historic Irish loan exposures in the year and our remaining exposure is in our relatively small inactive portfolio of structured credit assets. The carrying value of these assets has been thoroughly reviewed and no further impairment provision is considered to be necessary.

- We have maintained our strong oversight of the adoption of the going concern assumption for the interim and year end accounts and we adopt the same, comprehensive approach irrespective of the reporting period. This approach involves a rigorous consideration of our liquidity, capital and funding positions currently and in future as well as the potential risks which could impact upon these positions. This review is performed and reported on by functions outside Group Finance. Based on this, the adoption of the going concern assumption to prepare the accounts is appropriate.
- The committee considered the accounting for Financial Services Compensation Scheme (FSCS) provisions and use of the Funding for Lending Scheme (FLS). They also considered an International Financial Reporting Standards Interpretations Committee (IFRIC) which had been issued in 2012 and specified that levies raised by public bodies could only be accounted for at their trigger points. The FSCS levy which the Group pays is based on its year end savings balances and, as a result, no proportion of the full year charge was made in the interim accounts. Following discussions between the major accounting firms and regulatory bodies, it was confirmed that the transactions relating to participation in the FLS would mean that the mortgage balances used as collateral would remain 'on balance sheet' but that the Treasury Bills received in exchange would remain 'off balance sheet' unless used in a repo transaction. This could impact certain published ratios and the committee considered certain scenarios which might bring them back on to the balance sheet. These were dismissed as they would require actions which had no economic benefit for the Group and would be entered into only to affect the presentation of the accounts.
- The committee considered the carrying value of the equity release book acquired on merger with the Chelsea and concluded that certain impairment assumptions (principally around forced sale discount) should be aligned with those used in assessing impairment of the Group's other residential mortgage portfolios.
- Matters raised during the statutory external audit were considered by the committee and the committee concluded that there were no adjustments required which were material to the financial statements.

The committee considered these issues and the other critical areas of judgement (as identified in Note 2 on pages 82 to 83) and confirmed that they are appropriate. We adopt the same disciplines and approaches when compiling the interim results.

Internal controls

Our role in reviewing the effectiveness of internal controls is particularly important as the Group continues to witness significant changes through mergers and acquisitions and looks to deliver further future change to support its strategy. An effective control framework is vital to protect the delivery of our strategic priorities and maintain the trust of all our stakeholders. We review this aspect through regular reporting from Group Internal Audit and our external auditors which sets out the views of management as well as their own independent opinions. We work closely with the Group Risk Committee as some areas, such as regulatory compliance, formally report their opinions to that governance body. The main issues which we reviewed in 2012 are set out below:

- We maintained regular and close oversight of the control environment in Peterborough following the merger with N&P. We wanted to ensure that the control environment was robust and met the standards required of the wider Group. As a result, we diverted significant internal audit resource to examine the business in the early part of 2012 and carefully considered the resultant findings. A range of historic issues was identified and the committee tracks their resolution until their satisfactory completion.
- The Financial Services Authority (FSA) asked the internal audit functions of the largest building societies to perform reviews of the processes and content of regulatory returns in respect of liquidity and to report their findings to the regulator. These reviews were extensive in their scope and required significant internal and external resources. The committee held a specific meeting to consider the final report from Group Internal Audit before it was submitted to the FSA. Some relatively minor issues were raised which have been swiftly addressed.
- Our external auditor provides us with internal control reports arising from the external audit process. During the year, Deloitte did not highlight any material control weaknesses.
- The committee continues to pay close attention to the Group's contingency arrangements during this period of change and received reports from Group Internal Audit and management on how our approach to maintaining resilience in the face of unforeseen events is keeping pace. There has been considerable investment in infrastructure, training and people in this area.

AUDIT COMMITTEE REPORT continued

- We track the status of issues raised in control reports closely. During the year, the volume and age profile of outstanding control issues has remained within our risk appetite.
- The committee periodically reviews the use of the confidential reporting channel in the Group. Awareness of 'whistle blowing' arrangements is maintained through publications and is covered in a range of computer based training modules.
- During 2012, the committee oversaw a refresh of the integrated assurance reporting provided by Group Internal Audit. This provides a single view of all the assurance over internal control provided to the Group, whether it originates from management, risk functions, internal audit or external sources. It is valuable in identifying gaps in assurance or where more efficient approaches could be adopted. Further work is being undertaken to ensure that this report becomes an operational tool used by management.
- The committee considered the impact of the split of the FSA, from 1 April 2013, into the Financial Conduct Authority and the Prudential Regulation Authority. We approved a positioning paper from Group Internal Audit which set out the implications arising from this on their assurance activity.

External audit oversight

The effectiveness of the external auditor is assessed each year, immediately after the completion of their year end audit, and is reported to the March Audit Committee meeting. This assessment is facilitated by Group Internal Audit and is discussed, initially, without the presence of Deloitte in the meeting.

During 2012, the committee was provided with a report by the formerly named Audit Inspection Unit (AIU) now the Audit Quality Review Team (AQRT) which considered Deloitte's external audit of the Group's 2011 accounts. The AIU review was performed as part of their routine monitoring activities of audit quality in external audit firms and the findings are required to be shared with these firms' clients. The Audit Committee did not consider the small number of issues to have a material impact on the quality of the audit work performed by Deloitte. Changes to address the issues raised were included in Deloitte's strategy paper for the 2012 audit which was approved by the committee in September 2012.

Internal audit oversight

The effectiveness of the Group Internal Audit function is formally assessed each year using a variety of internal approaches including self-assessment and facilitated interviews by senior management outside the function. The review is performed by an external body every five years and is scheduled to take place in 2013.

During the year, the committee approved and monitored structural changes to the function which were made in response to changes in the Group, principally recent mergers. The skills and resource levels in the internal audit function continue to be monitored by the committee to ensure they are sufficient to provide the level of assurance needed.

External auditor

The current auditor, Deloitte, was appointed in July 2009 following a competitive tender process. As noted above, their effectiveness is considered at least annually. During 2012, the committee considered the approach to future tenders and agreed that it would consider the need for a competitive process on an annual basis. The committee was happy with the performance of Deloitte and they were reappointed at the AGM for the current year.

In September 2012, the FRC made revisions to the Combined Code which applies to the Group for next year's financial statements. This requires FTSE 350 companies to put their external audit out to tender at least every ten years. The Building Societies Association estimates that the top 12 Societies by asset size would fall into this category.

The Group has a policy on the use of the external auditor for non-audit work which is overseen by the Audit Committee. The purpose of this policy is to ensure the continued independence and objectivity of the external auditor. The policy sets out examples of services which the external auditor can and cannot perform. Fees for individual assignments which exceed pre-defined limits require prior notification to the Audit Committee Chairman who then decides if formal Audit Committee approval is needed. The level of fees incurred is regularly monitored. Details of the fees paid can be found in Note 7 on page 86.

The external auditor undertook a number of non-audit related assignments for the Group during 2012. These were conducted within the limits set out in the policy and are considered to be consistent with the professional and ethical standards expected of the external auditor in this regard.

The committee reviewed the approach to non-audit services in 2012 and concluded that tighter rules were not required and that no specific ceiling on such fees was necessary at this point in time.

System of internal controls

The Group recognises the importance of sound systems of internal control in the achievement of its objectives and the safeguarding of member and Group assets. Internal control also facilitates the effectiveness and efficiency of operations, helps to ensure the reliability of internal and external reporting and assists in compliance with applicable laws and regulations.

The Group operates in a dynamic business environment and, as a result, the risks it faces are continually changing. The internal control framework has been designed to ensure thorough and regular evaluation of the nature and extent of risk and the Group's ability to react accordingly. It is the role of management to implement the Board's policies on risk and control. It is also recognised that all employees have responsibility for internal control as part of their accountability for achieving objectives. Staff training and induction is designed to ensure that they are clear on their accountabilities in this area and are competent to operate and monitor the internal control framework.

The Group Internal Audit function provided independent assurance to the Board on the effectiveness of the internal control framework through the Audit Committee. The information received and considered by the committee provided reasonable assurance that during 2012 there were no material breaches of control and that, overall, the Society maintained an adequate internal control framework that met the principles of the Code and the supplementary Turnbull guidance.

Further details of actual risk management practices are provided in the Risk Management Report on pages 52 to 60.

Audit Committee effectiveness

The effectiveness of the committee is assessed annually. A self-assessment exercise, co-ordinated by Group Internal Audit, is performed using questionnaires and interviews with members and attendees at committee meetings. The results are also reported to the Board. The 2012 review concluded that the committee has operated effectively during the year.

Committee members are expected to undertake relevant training as part of their ongoing development as an individual Board member. Each year, the committee as a whole receives training on current topics. In 2012, this comprised updates on: current sector challenges, the impact of the revised regulatory structure, conduct risk issues, governance developments and financial reporting hot topics.

On behalf of the Board

Philip Johnson
Chair of the Audit Committee

20 February 2013

RISK MANAGEMENT REPORT

Introduction

The Group's risk management framework and governance structure provides a mechanism for proactively identifying and addressing the key risks to the achievement of the Group's objectives. It delivers comprehensive monitoring, control and ongoing management of the major risks to which the Group is exposed, so as to ensure the security of its members' funds. The Group's ability to properly identify, measure, monitor and report risk is critical to its sustainable financial security and its ability to provide value and fair outcomes to its membership and customers.

The Board is ultimately responsible for every aspect of the Group's activities. In particular, its role is to focus on the Group's strategy and ensure that the necessary resources are in place to meet its objectives and to ensure that robust financial controls and systems of risk management are in place. To assist the Board, a Group Risk Committee was established in 2006 (further details are given below) made up of non-executive directors and senior executives. This committee considers all risk matters relating to the Group, including credit risk, operational risk, market risk, liquidity risk, funding risk, business risk, and regulatory (including prudential and conduct risk) requirements.

The Group's overall statement of risk appetite is as follows:

'The organisation will not take, or retain, risk positions that threaten its ability to remain a sustainable and independent mutual organisation, therefore ensuring the sustainability of Yorkshire Building Society and thereby ensuring that no stakeholder can suffer a loss.'

The Group maintains an independent risk management function (Group Risk) that is responsible for ensuring that appropriate risk management techniques and measures are deployed, and that they seek to reflect leading practice, whilst remaining commensurate with the Group's strategic aims, its appetite for risk and the actual risks it faces at any time. The Group Risk department provides periodic independent reports on risk positions and risk management activities for consideration by the Group Risk Committee, its sub-committees and the Board. The General Manager – Risk provides a formal update to each Board meeting covering all areas of risk management, including both routine reporting and ad hoc issues.

The Board recognises that risk in various forms arises naturally from the Group's provision of various financial services to customers. The Group's Risk Vision promotes advanced risk management to support and direct financial security, fair outcomes, and a Group built on trust. The Group's Risk Management Strategy that results from that vision has three core components:

- A series of Principles for Risk Management that set out the headline rules that are appropriate and relevant across all of our activities, ensuring professionalism, responsibility and fairness at all times.
- A Conduct Risk Philosophy that directs that we treat customers' interests as being equal to the Group's own interests, highlighting the importance of having the right culture and cultural leadership and requiring evidentially good conduct behaviour across the five key pillars of customer treatment, product governance, sales suitability, complaints and redress, and reward and remuneration.
- A Prudential Risk Philosophy that considers the macro-economic environment, the volatility of outlook for that environment, and the internal risk management capabilities of the Group to determine the appropriate risk appetite for individual areas of the business. This relates most specifically to the strategic priority of the sustainable financial security of the Group.

The Group has a framework of consistently articulated risk appetites and a regularly updated Group Risk Map by which it aims to identify the major sources of risk to its strategic objectives, its assets and operations. The Group then deploys appropriate measures to control and monitor those risks. The key risks are plotted on the Group Risk Map with their position determined by the assessment of net impact and likelihood of occurrence, together with an assessment of whether each risk is outside or within the Group's risk appetite. Supporting each risk assessment is a risk dashboard that integrates all the relevant information about the risk, including key risk indicators, control assessments, audit and compliance points, emerging issues, and actions being taken. The risk dashboards are updated and reviewed monthly and the Group's risk sub-committees monitor the dashboards relevant to their activities. The dashboards are reviewed in detail on a quarterly basis by General Management, and the Group Risk Committee also reviews the dashboards relating to the most significant risks on a quarterly basis.

Principal risks and uncertainties

At an operational level, these principal risks and uncertainties can be considered in a number of categories, around which the Group has constructed its systems of monitoring and control. The individual risks, and the Group's response to them, are considered in more detail below within the context of the sub-committees of the Group Risk Committee established to oversee them under delegated authority of the Board. The categories are as follows:

- Credit risk – This risk arises from the Group's retail lending and the placing of liquidity with wholesale counterparties; it is overseen by Group Credit Committee (split operationally between Retail Credit Risk and Wholesale and Commercial Credit Risk). It is the risk that retail borrowers or wholesale and commercial counterparties fail to repay monies due to the Group.
- Market, liquidity and funding risk – The Group's balance sheet and financial position is exposed to market risk and liquidity and funding risk through the normal course of business. Market risk arises from balance sheet positions that are exposed to changes in interest rates (or similar indices); liquidity risk arises from the need to maintain an adequate overall level of liquidity to meet the Group's cash flow requirements as they arise, as well as to meet its ongoing regulatory requirements; and funding risk pertains to the need to fund the business from the retail and wholesale markets. These risks are overseen by the Group Asset and Liability Committee.
- Operational and regulatory risk – Overseen by the Group Operational and Regulatory Risk Committee, this encompasses the risk of direct or indirect loss resulting from inadequate or failed internal processes, from people and systems, and from external events; it includes the risk of non-compliance with laws and regulation (including prudential and conduct risk), and the risk of internal or external fraud.
- Business risk – This is the risk to the Group's financial sustainability and ability to grow; it brings together several strands managed in the above-mentioned risk management sub-committees plus the Group Capital Committee, and is overseen by the Financial Management Committee which deals with areas where risk categories overlap and interact.

The environment in 2012 was dominated by the continuing Eurozone crisis, by reduced growth expectations across the Organisation for Economic Co-operation and Development (OECD) economies, and a marked slow-down in the developing BRIC economies (Brazil, Russia, India, and China). The UK fell into and then emerged from a double-dip recession, the Bank of England maintained interest rates at a historical low with an indication that the economic outlook is flat. In addition the US averted the potentially disastrous 'fiscal cliff' of sudden tax rises and reductions in public spending that might plunge the world into recession, or at least temporarily averted it. 2013 may witness the unfolding of the Eurozone crisis and the UK remains at risk of triple-dip recession.

At the end of 2012 and the beginning of 2013, the principal risks and uncertainties faced by the Group can be broadly summarised as follows:

- The financial crisis continues and concerns around the Eurozone may re-emerge which may in turn have consequences for the UK economy including potential loss of the sovereign's AAA status; additionally, the US may fail to adequately address the political differences that led the country to the edge of the 'fiscal cliff' and which could, if unresolved, precipitate global recession.
- Changing market dynamics may curtail specific products and damage the customer offering; additionally, the government's Funding for Lending Scheme has dramatically impacted retail deposit pricing and mortgage margins.
- The changing regulatory environment with the formalisation of the 'twin peaks' regulatory structure and the disappearance of the FSA brings a degree of uncertainty for financial institutions; there is also some uncertainty around the timings and impact of the implementation of Basel III.
- The Group is embarking upon a significant change programme to achieve its ambitious strategic vision; whilst confident of our ability to become the most trusted provider of financial services in the UK, the successful management of risks and uncertainties in the delivery of significant change and in a continuing difficult environment, is a critical element of the programme.

RISK MANAGEMENT REPORT continued

Group Risk Committee (GRC)

The Group Risk Committee was established in 2006 by the Board to oversee the Group's risk governance framework and to provide an entity-wide perspective on all risk matters. It comprises non-executive directors and senior executives and is chaired by a non-executive director. It has delegated responsibility for the Group's risk strategy, risk appetite, risk monitoring, and capital management. Its duties include:

- Oversight of the Group Risk Profile and actions taken to manage key risks.
- Approval of the Group's risk appetite and monitoring of adherence to the appetite throughout the year.
- Recommending the Group Risk Management policies, standards and limits for Board approval.
- Monitoring on-going risk positions and issues, in particular, for compliance with Group Risk Management policies, standards and limits.
- Monitoring the Group's conduct risk management framework and its effectiveness in the delivery of fair/good customer outcomes.
- Annual review and approval of the Group's Internal Capital Adequacy Assessment Process, on recommendation from the Group Capital Committee.
- Approval of the Pillar 3 disclosure policy and annual review of those disclosures.
- Consideration of whether existing activities constitute appropriate utilisation of the Group's available capital.
- Oversight of risk stress testing, including reverse stress tests.
- Annual review and approval of the Group Individual Liquidity Adequacy Assessment on recommendation from the Group Asset & Liability Committee.
- Review and approval of the Group's approach to compliance with the liquidity regime.
- Review of the Money Laundering Reporting Officer's annual report.
- Review of the Group's current and proposed activities against its risk appetite and capital budgets.
- Oversight of the scope and review of the due diligence process for major acquisitions.
- Review and approval of the Group's recovery and resolution plans.
- Establishment and monitoring of the relevant sub-committees and associated governance structures.

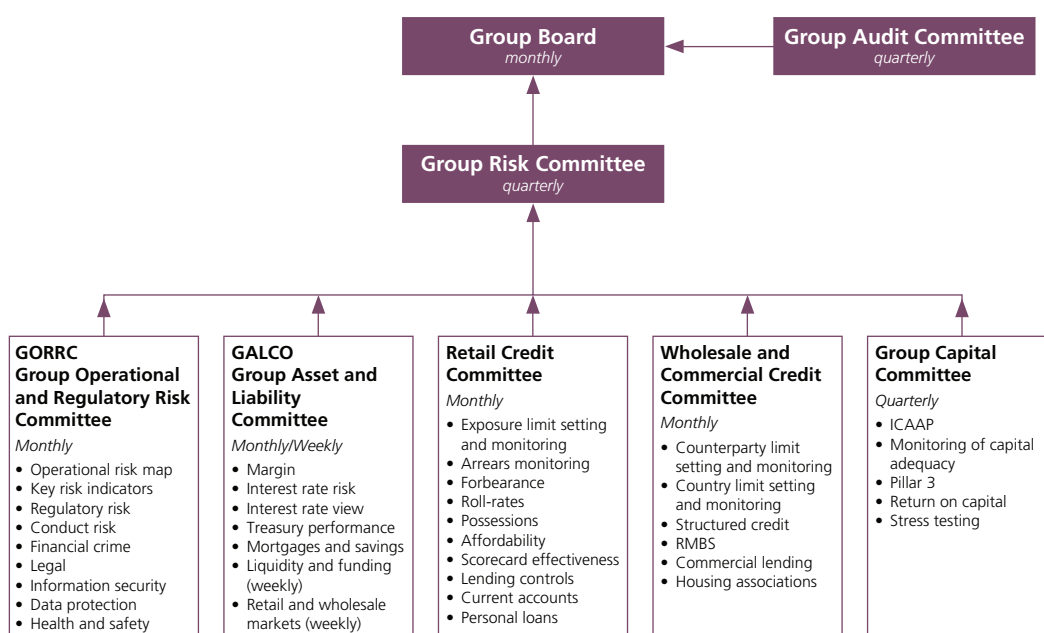
During 2012, the committee met six times in the execution of its responsibilities and, in particular, considered the following matters:

- Regulatory oversight including issues arising from all regulatory reviews, particularly those arising from the inception of the new 'twin peaks' regulatory framework that splits responsibility for prudential and conduct risk.
- External economic and political risks (including the ongoing Eurozone crisis) and assessing their potential impact on the Group.
- Liquidity risk management including stressed outcomes and regulatory limits.
- Capital risk management including stressed outcomes and regulatory limits.
- Consideration of any implications of the Group's reverse stress test outcomes.
- Recovery and resolution plans prior to their submission to the Regulator.
- The business continuity and disaster recovery arrangements for the Group.
- Plans for the annual internal conduct risk oversight programme.
- Self-evaluations to ensure the committee is fulfilling its responsibilities.
- The changing trends in the financial crime risks faced by the Group.
- Asset encumbrance risks to the Group from wholesale funding.

- Checks that the Group complies with the FSA's remuneration code.
- Oversight of the Group's liability management exercise.
- Agreement of a risk management strategy that would direct the Group's approach to best practice risk processes and a strong approach based on a mutual philosophy toward conduct risk management and prudential risk management.
- Agreement of a qualitative and quantitative risk appetite to frame the parameters for risk acquisition and risk management in 2013.

The GRC has established a number of sub-committees with day-to-day responsibility for risk management oversight. All of the sub-committees meet at least quarterly. Each is chaired by a senior manager with appropriate skills and each is attended by a number of executive directors and/or General Managers, as well as other senior managers and subject experts. Above the sub-committees, and to one side, sits the Financial Management Committee (FMC) that takes a broader, higher level perspective and reports to the Board. The Risk Governance structure is shown diagrammatically below.

YBS Governance & Risk Forums (purple boxes indicate the Board and its' committees)



Group Capital Committee

This committee has been established to monitor, in the broadest sense, the Group's overall capital position and the allocation of capital across its various operations, portfolios and entities.

This includes:

- Monitoring in detail the Group's overall capital position, current and forecast, including allocation of capital across activities. This includes responsibility for approving, reviewing and maintaining the central consolidated capital models used under Basel Pillar II to calculate the Group's overall capital requirements.
- Reviewing the appropriateness of capital usage in the context of the risks inherent within different business lines and of the returns thereon.
- Establishing target returns on capital across the Group, monitoring performance against those targets and making proposals to GRC for changes to capital usage.

Capital and capital ratios are detailed in Note 31 on page 107.

RISK MANAGEMENT REPORT continued

Group Asset and Liability Committee (GALCO)

This committee is responsible, under delegated authority of the Board, for managing the Group's liquidity, market risk and currency risk.

Liquidity risk

The Board recognises that a structural maturity mismatch inevitably exists within the Group's balance sheet, caused by the fundamental purpose of the Group's business, that is, providing its members with long-term mortgage advances funded, primarily, by contractually short-term retail savings accounts.

The Group's liquidity policy is to maintain sufficient liquid resources to cover a potential worst case stress outflow. This is achieved through maintaining a prudent level of appropriate high-quality liquid assets, through maintaining appropriate wholesale funding facilities, and through the management of the growth of the business.

The Group maintains and monitors a liquidity and funding risk appetite comprising qualitative statements and specific metrics. The Group holds sufficient liquidity to continue trading and protect members even under highly stressed conditions. On an annual basis, a range of liquidity stress scenarios are developed covering, in the last iteration, three idiosyncratic scenarios (a business continuity event, a false merger talk leak, and loss of customer data that results in fraud), two market-wide scenarios (Eurozone break-up, and the failure of several mid-sized building societies), and six scenarios combining each idiosyncratic event with each market-wide event. The scenarios are assessed over three timeframes: a two-week period, three months, and six months. The worst-case three-month scenario forms the basis of the individual liquidity adequacy assessment for regulatory purposes (referencing only high-quality 'buffer' liquidity) and also of the total, or overall, liquidity requirement (referencing the totality of marketable assets and cash at the disposal of the business). The Group's liquidity risk appetite is to hold buffer liquidity 10% higher than the regulatory requirement set by the FSA, and to hold sufficient total liquidity to survive a worst-case three-month stress scenario.

The stress test to ensure regulatory liquidity is adequate, and within our risk appetite, is run daily and reported within the business. The whole range of liquidity stress tests proving our overall liquidity adequacy are also run, reviewed and reported daily. The weekly GALCO meeting reviews an extended projection of funding and liquidity against a longer-term forecast for both the measures outlined above. All three views of liquidity adequacy are reported monthly to GALCO, FMC and to the Board.

The Group's funding risk appetite seeks to ensure that a stable and diverse funding base is maintained to support balance sheet lending activities and to meet operational requirements. This statement is supported by a range of limits and key risk indicators which are monitored daily and monthly. For wholesale funding, the appetite is for funding which is diversified in terms of investor profile, currency, geography, instrument type and maturity spectrum; for retail funding it is diversified in terms of product and distribution type.

The Group has continued to maintain a presence in wholesale markets raising funding of £500m via a sterling covered bond issuance, and a second securitisation (Brass 2) raising £600m. In addition, the Group has applied for, and been accepted into the government's Funding for Lending Scheme (FLS).

Detail of actual exposures at the year-end is contained in Note 35 on page 114.

Market risk

Market risk is the risk to earnings and capital arising from changes in interest rates, foreign currency exchange rates and the price of financial instruments.

The Group has a formal structure for managing its market risks including established risk limits, reporting lines, mandates and other control procedures. The market risk position is monitored daily and reviewed by GALCO at least monthly. The Board receives monthly summaries of risk positions and GALCO activity.

The Group's policies for the management of risks arising from movements in interest or currency exchange rates and the composition of the balance sheet provide the framework for the Group's Asset and Liability Management (ALM) and Treasury Risk Management activities. The primary purpose of the Group's ALM process is to ensure the accurate and timely identification, measurement and control of risk faced by the Group on its entire balance sheet. The primary purpose of the Treasury Risk Management process is to ensure that risks connected with all aspects of treasury activity are identified and that suitable measures and risk management practices are applied. Treasury Risk Management also monitors the suitability of and

compliance with the operating limits set for the activities of the Group's Treasury function by the Board and it reports and recommends accordingly. ALM and Treasury Risk Management form part of the same team within the Group Risk function and both submit monthly reports to GALCO, FMC and the Board, with quarterly reporting to the Group Risk Committee.

The Group's principal source of market risk is interest rate risk which focuses on four main measures:

- Value at Risk provides a measure of the maximum likely loss that could be sustained over a specified time period at a stated level of confidence.
- Basis point value sensitivity provides a measure of the sensitivity of the present value of the balance sheet to a one basis point (0.01%) parallel shift in interest rates.
- Balance sheet structural analysis monitors the composition of the balance sheet in terms of the different interest rate bases of assets and liabilities, in particular between LIBOR and other rates.
- Repricing gap analysis is used primarily for the identification of instrument re-pricing concentrations.

More details of these risk management measures can be found in Note 36 on pages 116 to 117.

The Board recognises that these key measures for managing interest rate risk cannot be individually optimised in a simultaneous fashion. For instance, attempts to reduce the volatility of net interest income are likely to result in an increase in the volatility of the market value of the balance sheet. The Board therefore advocates the use of a wide variety of complementary risk indicators and measures and is disinclined to adopt a narrow definition or 'one figure' measure. An important factor in the risk measures is the degree of internal consistency between them. To facilitate this approach, the key measures are supplemented by other techniques including:

- Stress testing which is used to monitor the sensitivity of net interest income to extreme market conditions.
- Earnings at Risk which provides a measure of the potential variability in net interest income for a given business mix over a given time period at a stated level of confidence.
- Scenario analysis which measures variability in net interest income using a number of possible interest rate scenarios.

Currency risk

The Group has certain money market instruments denominated in currencies other than sterling. Its policy is to eliminate currency risk, other than a small operational mismatch, through the use of cross-currency interest rate swaps and foreign exchange contracts.

Details of actual exposures are contained in Note 37 on page 117.

Other risks

Other market risks are minimised by the use of derivative instruments which are used exclusively for this purpose and not for trading activities.

Group Credit Committee (Retail Credit Committee/Wholesale and Commercial Credit Committee)

Credit risk is the potential risk of financial loss arising from the failure of a customer or other counterparty to settle their financial and contractual obligations as they fall due. The Group has in place a comprehensive set of controls and limits to monitor and govern the amount of such risk accepted. Credit risk is monitored on an ongoing basis within Group Risk, and the Group Credit Committee meets monthly to oversee risk management in this area. It falls into a number of distinct components – namely, credit risk from our retail lending activities, credit risk from investment of liquid assets with wholesale counterparties (a diminishing area owing to the restrictions of the liquidity regime), and credit risk from commercial lending primarily to SMEs and to Registered Social Landlords. The Group Credit Committee is therefore split operationally between the Retail Credit Risk and the Wholesale and Commercial Credit Risk Committees.

Retail credit risk

The most significant credit risk that the Group is exposed to relates to its core business of providing loans secured on residential property. The Group lends to households across the UK and does not consider there to be any undue concentration of credit risk in any particular part of the UK.

RISK MANAGEMENT REPORT continued

The Group's mortgage lending is split into a number of separate books, including YBS Prime, Barnsley, Accord Prime, Accord Credit Repair, Accord Buy-to-Let, Chelsea Building Society Prime, Chelsea Building Society Buy-to-Let, and Norwich & Peterborough Prime. Accord Buy-to-Let lending was only initiated in the last quarter of 2011. 85% of balances of the Group comprise prime lending, and 8% are represented by Buy-to-Let properties.

The Group is well aware of the risk disparity between the books and differentiates its lending criteria, its pricing and its monitoring and management processes and techniques accordingly. Retail credit exposures are managed in accordance with the Board-approved Statement of Lending Policy and through the use of credit scoring systems that factor in the profile of the borrower, the nature of the loan, environmental conditions and the collateral that may be provided as security for the loan. These scoring systems, and the way they are used within the initial lending process, are varied to suit the different risks and profiles of the Group's loan portfolios. Actual and forecast retail exposures are monitored and managed against policy limits by the Group Credit Committee. In particular the committee monitors arrears, loan-to-value ratios, expected losses, scorecard performance, and affordability.

The monitoring of retail credit risk is tailored to our different loan portfolios and to the economic and housing market conditions that prevail at any given time. The current focus is strongly on the impact of the housing downturn on our borrowers' behaviour and therefore on identifying, and seeking to help, those borrowers where the exposure to such a downturn is greatest. We have reviewed our forbearance policy in line with FSA guidance to ensure that it is clear and consistent, and that management information relating to forbearance, and the management of arrears generally, is comprehensive.

Retail credit risk management information is reported monthly to Retail Credit Committee, FMC, and the Board with quarterly reports to Group Risk Committee.

Detail of actual retail credit risk exposures is contained in Note 39 on pages 121 to 125.

Wholesale and commercial credit risk

The Group Credit Committee also takes primary responsibility for the task of assessing and monitoring wholesale counterparty creditworthiness and conducting credit research and analysis. It does this by reviewing the Group's exposures and through setting limits to individual counterparties based on its internal ratings methodology. Limits are also set against the aggregate exposure to equally-rated institutions and to all institutions based in any one country. Over the last three years, the Group has suspended a significant number of lines to other institutions, radically reducing the number of firms with which it is prepared to place funds. Additionally, all new derivative transactions are covered by an ISDA (International Swaps and Derivatives Association) master agreement and a credit support annex that mitigates our exposure.

The investment of liquidity with institutional counterparties has reduced markedly over the last few years since the inception of the current liquidity regime. The regime militates against anything other than the highest quality liquid assets by only permitting government or supranational debt securities to be included in the liquidity buffer. It is this liquidity buffer that is measured against the individual liquidity guidance as the key regulatory metric over liquidity risk. The radical reduction in banking exposures has meant that our vulnerability to consequences of the Eurozone crisis is largely limited to second and third order effects.

The Wholesale and Commercial Credit Committee also maintains oversight of the Group's commercial lending books that were inherited from Chelsea (£151m) and Norwich & Peterborough (£347m) building societies, and the Group's lending to Registered Social Landlords (£65m). The Chelsea commercial book has been managed down from £151m at merger to £57m as at the year end.

Prior to the financial crisis, the Group invested a limited amount of funds into higher yielding, and hence higher risk, structured credit instruments. The purpose of this portfolio was to maintain a range of investments that contributed to the Group's earnings and made effective use of the capital and treasury management resources available to the Group. The Group has always been aware that this portfolio carries greater credit and market risk than the core liquidity it holds, and for that reason additional risk management techniques have, from inception, been applied to it. These additional credit monitoring and portfolio valuation techniques have been specifically designed to allow independent oversight of this portfolio's risks and performance.

The events of the past few years have adversely impacted the value of these structured credit investments, principally through the illiquid state of the market but also, in a number of cases, through underlying credit issues. The Group was aware that the value of these investments could be impacted by a liquidity shortage but, in common with nearly all institutions and regulatory authorities, it did not foresee the extent of the liquidity issues that have arisen. The Group's response to these events has been to further increase its levels of performance monitoring, including frequent liaison with

investment managers, particularly if any individual investments have displayed signs of stress. At the same time it has looked, where available, at all alternatives for the future structure of individual investments and has adopted a conservative approach to their valuation and treatment within the Group's financial statements. The stated wholesale credit risk appetite precludes any further investment in structured credit.

Wholesale credit risk management information is reported to Wholesale and Commercial Credit Committee, FMC and the Board on a monthly basis, and quarterly to Group Risk Committee.

Details of actual exposures are contained in Note 38 on pages 118 to 120. Structured credit investments are currently valued at £54m.

Group Operational and Regulatory Risk Committee

Operational risk is the potential risk of financial loss or impairment to reputation arising from failures in operational processes or the systems that support them. To minimise operational risk, the Group maintains a system of internal controls commensurate with the characteristics of the business, the markets in which it operates, leading practice principles and regulatory considerations.

The Group's operational risk management framework sets out the group wide strategy for identifying, assessing and managing operational risk. The framework itself is not static and is updated periodically in line with changes in the business profile, product developments, internal management environment and external developments. The Operational Risk Management Programme is embedded in all business operations and provides management and their teams with a structure for managing risk and control issues and to assist management in decision making.

The Group has defined its key operational risks into the following categories:

Operational risk category	Definition
Legal and regulatory risk	External laws, regulations and codes (inclusive of anti-money laundering, mis-selling, Basel Committee or accounting regulations, Data Protection, Disability Discrimination Act, Consumer Credit Act, Financial Ombudsman Service, HM Revenue & Customs, building regulations, Building Society Acts 1986 & 1997, Financial Services and Markets Act 2000, and mortgage regulation), may not be complied with in an effective manner that remains commercially sound.
Product and service risk	The Group's products or services may fail to optimise value and/or meet customer requirements and/or may not be distributed effectively or in a timely manner. External factors may not be identified, monitored and/or considered with appropriate action taken with respect to economic, technological, political, social, ethical, environmental and reputational risks, competitive behaviour and external pressures and developments.
Governance and strategy risk	The Group may not be governed effectively at a Group, divisional or business unit level and/or the strategy selected by the Group may be ineffective or inappropriate. Corporate governance in this context embraces the structures, systems and processes that provide direction, control and accountability for the Group and encompasses the provision and use of robust management information for decision-making purposes in a timely manner and the delivery of requirements within budget and timescales. Strategy risk is the risk of loss or reduced earnings due to inappropriate senior management/Board actions caused by unprepared or misjudged strategic decisions and/or the implementation of those decisions.
Process and system risk	Inadequate or failed internal processes and systems, and/or an inability to implement change effectively or realise the desired benefits, resulting in a financial loss and/or a failure to achieve either strategic or business unit objectives.
People and resources risk	Staff may not be appropriately recruited, retained, trained and managed to achieve Group objectives whilst complying with external laws and regulations. Resources risk is the risk that physical resources, external suppliers or service providers may not satisfy the Group's requirements, and/or may not be managed effectively.
Theft and financial crime risk	The Group's assets may not be adequately protected resulting in fraud, theft, damage or other criminal acts.

RISK MANAGEMENT REPORT continued

The Group measures its operational risks based on both numerical and qualitative assessments of the risks it faces. These measures help to determine the level of control required to manage such risk within the overall risk appetite of the organisation. Operational and regulatory risk management information is reported to Group Operational & Regulatory Risk Committee and to the Board monthly, and quarterly to the Group Risk Committee.

The Group aims to maintain a sound system of internal control that provides reasonable, but not absolute, assurance that it will not be hindered in achieving its business objectives, nor in the orderly and legitimate conduct of its business, by circumstances that may be reasonably foreseen. The focus is adapted to current conditions. For example, recent years have seen the development of more refined fraud and financial crime strategies and controls in response to increasing levels and sophistication of such activity in the financial services market.

2012 has also seen a much stronger focus on conduct risk management to ensure that fair outcomes for customers are paramount – a focus that aligns perfectly with the Group's strategic vision. A new conduct risk strategic framework has been developed with a defined, Board-approved risk appetite, and outcome testing and monitoring of the five core pillars of conduct behaviour. This is an area of significant focus for the Group and will remain so during the coming years.

On behalf of the Board

Lynne Charlesworth
Chair of Group Risk Committee

20 February 2013

DIRECTORS' REMUNERATION REPORT

Introduction

This report:

- Explains to members the policy for the remuneration of executive directors, non-executive directors, General Managers and certain other senior managers for 2012 and sets out changes to the policy for 2013.
- Summarises the broader role of the Remuneration Committee in setting remuneration policy for all staff.
- Demonstrates how this policy complies with the FSA's Remuneration Code.
- Voluntarily addresses the statutory disclosure requirements for listed companies in relation to directors' remuneration that are considered relevant to a building society.
- Includes a table showing each director's remuneration for the year ended 31 December 2012.

A summary of this report will be sent to all members eligible to vote at the 2013 Annual General Meeting and members will have the opportunity to vote on the report.

Remuneration Committee

The committee is responsible for determining, on behalf of the Board, the overall group wide remuneration policy (including bonus levels) for all staff and, in particular, the policy and the level of remuneration of the executive directors, General Managers and other senior managers – in particular, those with a material impact on the Society's risk profile (known as 'Code Staff'). The full terms of reference of the committee can be found at www.ybs.co.uk/committees.

The committee normally meets at least five times a year with additional meetings as required. In 2012 it met 10 times. The committee takes independent external professional advice as appropriate, and monitors comparative remuneration packages within the financial sector. Towers Watson provided it with an overview of emerging market trends in remuneration across financial services and beyond in March 2012, to ensure that the committee was aware of the latest developments.

The committee is made up of at least three non-executive directors. In 2012, they were Roger Burden, David Paige and Simon Turner (Chairman of the committee).

The Society's Chief Executive, the General Manager – Human Resources and Customer Service and senior managers from the Society's Risk Management function present and comment upon proposals and supporting evidence as and when required and attend meetings at the committee's request. The Society's Chairman, Ed Anderson, also attends meetings other than when his own remuneration is being discussed.

Remuneration policy for non-executive directors

The committee does not set the remuneration of the non-executive directors other than the Chairman. Instead, their remuneration, including fees for committee membership, is reviewed on an annual basis by the executive directors and the General Manager – Human Resources and Customer Service, using external benchmarking data, and with reference to the responsibilities, skills and time commitment required for the role.

A recommendation is made to the full Board which determines any change in the remuneration of non-executive directors. Any such changes take effect from 1 July. In 2012, the fees of the Chairman and other non-executive directors were increased by between 2.8% and 2.9%.

Additional fees (details of which are given on page 68) are paid to those non-executive directors who undertake additional duties and responsibilities requiring additional time commitment, including membership of certain Board committees. The Chairman does not receive additional fees for his committee membership.

The non-executive directors do not have service contracts. They are only entitled to receive fees and do not participate in any performance pay scheme, nor do they receive any pension arrangements or other benefits.

DIRECTORS' REMUNERATION REPORT continued

Remuneration policy for executive directors and other senior managers with a material impact on the Society's risk profile ('Code Staff')

The overall policy is that:

- The remuneration of executive directors, General Managers and other Code Staff should deliver an appropriate balance between encouraging strong financial performance and ensuring sound risk management.
- The remuneration of executive directors (together with that of General Managers and other Code Staff) should be competitive with those of comparable organisations in the financial sector as well as reflecting the responsibilities and the intrinsic skills and capabilities required in the role, so as to attract and retain high-calibre individuals with the relevant experience.
- A significant part of the remuneration of executive directors, General Managers and other Code Staff should be variable, based primarily on the Group's financial, risk and service performance (in particular, the net promoter score) and should also be based on individual performance, using pre-determined targets to motivate and reward successful business and personal performance in the interests of current and future members. However, the proportion of variable pay is limited to ensure that it is feasible for none to be paid in years where business performance does not merit payment.
- Personal reviews of the executive directors, General Managers and other Code Staff are carried out at least annually to assess their performance in meeting individual and strategic objectives. These reviews are reflected in pay reviews which take effect from 1 May each year as well as in awards of variable pay.
- The remuneration of senior staff in the Risk and Compliance function is independently considered by the Group Risk Committee, in addition to being approved by the Remuneration Committee.
- No executive director, General Manager or member of Code Staff is involved in deciding his or her own remuneration.
- The policy should comply with the Financial Services Authority's (FSA) Remuneration Code.

The policy in relation to the various elements of remuneration structures for executive directors, General Managers and other Code Staff is set out below.

(a) Total remuneration

Overall remuneration will be market related (as it is for all employees), thus ensuring a competitive package that fairly reflects the market rate, skill, experience and expertise for the role.

The committee considers external data from independent national surveys of the financial sector and a comparator group of financial institutions to ensure remuneration remains competitive.

Independent reward specialists carry out an overall review of senior management remuneration, generally once every three years. The last review was undertaken in 2012 by Towers Watson, and concluded that whilst basic salaries at a senior level were broadly market-comparative, total remuneration was below the market median. Other than as pension scheme actuaries and consultants, Towers Watson has no other connection to the Group.

(b) Basic salary

Against the backdrop of the overall benchmarking process described above, individual development and progression is reflected through the annual salary and personal review processes.

The approach to the annual review of salaries for senior roles is the same as for all staff in the Group, with a performance-related structure being negotiated each year. In 2012, the central award for a fully competent performer was 2.8%, with a range from 0% to 5.7% based on individual performance. The average rise for executive directors (excluding the Chief Executive) on this basis in 2012 was 3.7%. The Chief Executive's salary was increased by 9% in line with his contract upon appointment, following the successful completion of his probationary period. These pay awards were applied from 1 May 2012. Consequently, the tables on pages 65 to 66 include four months' pay at the prior level and eight months' pay at the increased level.

(c) Variable pay

In 2012 the executive directors, General Managers and other Code Staff participated in a non-pensionable annual variable pay scheme, the elements of which reflected the Group's key measures of pre-tax profit (almost 50% of the scheme), retail savings flow, net mortgage lending, cost control, and customer service (measured through the net promoter score). A scheme with similar characteristics was in place for all other staff. The scheme also contained risk threshold conditions, approved by the Group Risk Committee, regarding sustainable levels of capital and liquidity. In addition, executive directors (together with General Managers and other Code staff) had an element of their variable pay based on the achievement of personal objectives.

Under the scheme applicable to the Executive Director, General Managers and other Code Staff no payment would have been due and deferred elements from previous years would have been cancelled if the profit had been less than 25% of the annual target in 2012, the risk threshold conditions had not been met or if individual performance had been unsatisfactory.

There was no minimum amount of variable pay and the maximum amount in the 2012 scheme, as a percentage of basic salary, was 93.75% for the Chief Executive, 68.75% for executive directors and General Managers and up to 47.5% for other Code Staff. The 'on target' level of payment was 60% for the Chief Executive, 45% for executive directors and General Managers and up to 30% for other Code Staff.

The target levels for each measure were set to provide stretching objectives, giving an incentive to perform at the highest level in a manner consistent with the long-term interests of members. In particular, the target for pre-tax profit was £115m and the target for customer service (net promoter score) was 43% across the Group. Against these two key elements, the 2012 results significantly exceeded their targets, resulting in payments above 'on target' levels – 93.75% for the Chief Executive, and an average of 56% for other executive directors. The percentage payments for other executive directors are lower than those awarded for 2011 and are subject to deferral (dependent on future performance) over a three year period, as set out below.

Executive Director	Total bonus granted for 2012 £000	Proportion vesting & paid in 2013 – 40% £000	Deferred until 2014 subject to future performance – 20% £000	Deferred until 2015 subject to future performance – 20% £000	Deferred until 2016 subject to future performance – 20% £000
Ian Bullock	151	61	30	30	30
Andy Caton	146	59	29	29	29
Robin Churchouse	150	60	30	30	30
Chris Pilling	389	155	78	78	78

In addition to the undeferred amount for 2012, the first deferred element from the 2011 scheme and the second deferred element from the 2010 scheme are also payable in 2013, since the performance conditions for profit, capital and liquidity attaching to these deferred elements have been met in full. The total deferred amounts from prior years payable in 2013 paid to individual executive directors are set out in the table on page 65. If future performance conditions for the unvested deferred elements are not met each year, these payments will be reduced or cancelled entirely.

The FSA's Remuneration Code requires 50% of all variable pay (both undeferred and deferred) to be paid in shares or share equivalent instruments, where variable pay is greater than 33% of total remuneration, or where total remuneration is greater than £500,000. Based on the results of the 2012 scheme, only the Chief Executive's remuneration is covered by this requirement. Consequently, 50% of Chris Pilling's payment due in 2013 (both the undeferred 2012 award and deferred elements payable from previous years as part of his joining arrangements with the Society), will be paid in the form of a new instrument designed specifically for the purpose, which has been agreed with the FSA as meeting the requirements for this regulation.

Overall, the committee confirms that 2012 variable pay for executive directors, General Managers and other Code Staff meets with the requirements of the FSA's Remuneration Code and represents an appropriate and proportionate reward in relation to the Group's overall 2012 performance.

DIRECTORS' REMUNERATION REPORT continued

Changes planned for 2013

The committee has conducted a full review of the Group's approach to senior management remuneration during 2012, articulating its ongoing principles as follows:

- Variable pay schemes will reward performance and productivity and be responsive and flexible to changing business needs.
- Schemes will be designed so that enhanced levels of payment can be directly linked to enhanced profit, cost and customer satisfaction.
- Payments will reward high performance and not under-performance.
- All schemes will reinforce desired behaviours – identified from values and leadership competencies as well focussing on business and financial results.
- Quality and audit controls will underpin all schemes.
- Arrangements will be straightforward and easy to understand.
- Where the level of variable pay is significant when compared to the fixed element of an employee's remuneration then deferred arrangements will be put in place. The payment of the deferred elements will be linked to future business performance.
- Principles of mutuality should flow through to form key targets in variable pay arrangements.
- Schemes will contain a clear link to long-term sustainability and will effectively balance financial performance with sound risk management.

In the light of these principles, the committee has agreed a number of changes to the approach to senior management remuneration from 2013 onwards as follows:

- The ratio of fixed and variable pay has been adjusted for executive directors and General Managers. The 'on target' payment has been reduced from 60% for the Chief Executive and from 45% for executive directors and General Managers, to 30% in all cases; and the maximum payment has been reduced from 93.75% for the Chief Executive and 68.75% for executive directors and General Managers, to 50% in all cases. To ensure that overall remuneration packages remain competitive, basic pay for 2013 will be increased by 10.27% (20% for the Chief Executive). This change will serve to reduce further any incentive to take undue risk in return for higher levels of variable pay, and will move the Group closer to a flatter scheme structure across all levels of staff, without increasing overall remuneration levels.
- Because variable pay will be lower, the deferral structure for relevant Code Staff (excluding the Chief Executive) will change, with 50% being paid in year one, and 25% being paid in years two and three respectively, subject to future performance conditions.
- Because the Chief Executive's total remuneration is over £500,000, his deferral structure will remain unchanged – i.e. 40% will be paid in year one, and 20% will be paid in years two, three and four respectively. In addition from March 2013 onwards, 50% of both the undeferred and deferred elements due to the Chief Executive each year will be paid in the form of the new share equivalent instrument, which will be subject to a six month retention requirement.
- The performance measures in the scheme have been simplified and reduced to three – pre tax profit (50% of the total), cost (25% of the total) and customer service measured by the net promoter score (25% of the total). This will allow a clearer line of sight between the key financial and customer performance metrics of the business and the ultimate level of variable pay.
- The approach to risk adjustment in the scheme has been enhanced, so that payments will be reduced if the sustainable level of capital required to support the Society's growth rate is not generated each year, or in the event of other material breaches of the Society's risk appetite.
- To ensure that the voting of members on the Directors' Remuneration Report at the AGM can be considered before payments are made, the Remuneration Committee has taken the decision to move the date for payment of variable pay awards to the end of April from 2014 onwards.

In addition, the Remuneration Committee has reviewed its approach to the incentivisation of sales staff in branches from 2013 onwards, and has removed all links to individual sales performance.

(d) Benefits

Each executive director is provided with benefits which comprise a company car (or an equivalent allowance), pension arrangements, private medical insurance and permanent health insurance.

In addition, in common with all other staff, the executive directors can participate in a concessionary mortgage scheme which is subject to a maximum concessionary amount of £160,000.

The executive directors are either members of the contributory defined benefit section (on a career average revalued earnings basis) or the defined contribution section of the Society's pension scheme.

The pension scheme also provides for dependants' pensions and a lump sum of four times basic salary on death in service.

Similar benefit structures exist for General Managers and other Code Staff.

(e) Service contracts

All the current executive directors have entered into contracts that can be terminated by either party on one year's notice or by the payment by the Society of an amount equivalent to one year's remuneration.

Service contracts for General Managers and other Code Staff have notice periods varying between three months and one year, depending on the particular role.

Non-executive directors are appointed by letter for an initial term of three years. They will generally be expected to serve a second three year term. Where the Board considers that it is in the interests of the Society, a non-executive director may be asked to serve a further term of up to three years.

Executive directors' remuneration

The following variable payments are disclosed in directors' remuneration, below:

- Payments relating to performance in the reporting period (ie 2012) which are payable within 12 months of the end of that period (whether unconditional or not).
- Payments deferred from previous years which become payable as a result of the performance in the reporting period.

The full cost of bonuses is recognised in the income statement in the same year as the performance to which it relates, irrespective of the fact that some of that bonus may be deferred and paid in future years.

	Salary ¹ £000	Variable pay ² £000	Deferred variable pay from previous years £000	Taxable benefits ³ £000	Increase in accrued pension ⁴ £000	Society's contribution to pension scheme ⁵ £000	Total £000
Executive directors 2012							
Ian Bullock	286 ⁶	61	64	8	–	28	447
Andy Caton	264	59	60	9	19	–	411
Robin Churchouse	286 ⁶	60	63	11	–	28	448
Chris Pilling	462 ⁶	155 ⁷	99 ^{7,9}	15	–	17	748
	1,298	335	286	43	19	73	2,054

DIRECTORS' REMUNERATION REPORT continued

	Salary ¹ £000	Variable pay ² £000	Deferred variable pay from previous years £000	Taxable benefits ³ £000	Increase in accrued pension ⁴ £000	Society's contribution to pension scheme ⁵ £000	Total £000
2011							
Ian Bullock	276 ⁶	63	32	13	–	27	411
Andy Caton	255	62	29	10	19	–	375
Robin Churchouse	276 ⁶	63	32	11	–	27	409
Iain Cornish (resigned 30.12.2011)	697 ^{6, 8}	–	–	18	6	21	742
Chris Pilling (appointed 31.12.2011)	–	156 ⁹	–	–	–	–	156
	1,504	344	93	52	25	75	2,093

Notes

¹ Basic pay plus cash pension allowance, see note 6 below.

² Only includes payments for 2012 which are due to be paid in 2013 (2011 – those paid in 2012).

³ Principally the provision of a company car. Directors have elected to take a cash allowance in lieu, or partly in lieu, of a company car as follows: Robin Churchouse £10,623 and Chris Pilling £14,394.

⁴ The increase in accrued pension represents the change in the annual pension to which each director is entitled as a result of changes in pensionable earnings (excluding inflation) and increases in pensionable service during the year. For Andy Caton, the value of executive directors' pension benefits includes those arising from unfunded arrangements.

⁵ Defined contribution section contributions only. The defined contribution section and the defined benefit section of the YBS pension scheme are now paid by salary sacrifice. The employer contributions above do not include these additional contributions as they are effectively included in the pre-salary sacrifice basic salary figures.

⁶ Includes partial cash pension allowance, as a result of reduced employer pension scheme contributions.

⁷ 50% of which is paid in a share equivalent instrument.

⁸ Includes basic pay until the expiry of Iain Cornish's notice period on 1 July 2012, paid on 30 December 2011.

⁹ Payment to honour lost earning incurred by Chris Pilling on leaving HSBC.

Executive directors' unpaid deferred elements:

Executive director	Year of award	Due 2014 £000	Due 2015 £000	Due 2016 £000	Total deferred £000
Ian Bullock	2010	32	–	–	32
	2011	32	32	–	64
	2012	30	30	30	90
	Total	94	62	30	186
Andy Caton	2010	29	–	–	29
	2011	31	31	–	62
	2012	29	29	29	87
	Total	89	60	29	178
Robin Churchouse	2010	31	–	–	31
	2011	32	32	–	64
	2012	30	30	30	90
	Total	93	62	30	185
Chris Pilling	2010	–	–	–	–
	2011	79	55	–	134
	2012	78	78	78	234
	Total	157	133	78	368

All deferred elements are subject to future performance conditions, and may be reduced or forfeit as appropriate.

Executive directors' pension benefits (defined benefit section) in 2012:

	Contributions from directors* £000	Increase in accrued pension £000	Accrued pension as at 31 December 2012 £000	Transfer value of accrued benefits as at: 1 January 2012 £000	31 December 2012 £000	Movement in transfer value less directors' contributions £000
Andy Caton	–	19	118	1,740	1,865	125

Notes

* With effect from 1 April 2010, pension contributions formerly made by members of Yorkshire Building Society Pension Scheme are now made on their behalf by the Society, with members instead sacrificing the equivalent amount of their salary. Andy Caton effectively made the following contributions via salary sacrifice, £21,000.

Chris Pilling, Ian Bullock and Robin Churchouse are members of the defined contribution section of the pension scheme and therefore are not included in the above table.

Aggregate remuneration data

The Prudential Sourcebook for Banks, Building Societies and Investment Firms (Remuneration Disclosures) Instrument 2010 now requires the publication of aggregate remuneration data for the Society as a whole, and in summary form for senior managers and members of staff whose actions have a material impact on the risk profile of the firm ('Code Staff'), as follows:

Fixed and variable pay

	Fixed pay £000	Variable pay (undeferred) £000	Percentage of variable pay as cash	Deferred variable pay from previous years ² £000	Outstanding deferred remuneration ³ £000	Number of beneficiaries
Code Staff ¹	5,521	1,059	93%	656	2,108	39

Notes:

¹ Senior managers and staff whose actions have a material impact on risk profile (including executive and non-executive directors). Non-executive directors' fees are included under fixed pay. No variable pay was awarded to non-executive directors.

² Payments deferred from previous years which become payable as a result of performance in 2012.

³ In relation to current and previous years.

DIRECTORS' REMUNERATION REPORT continued

Non-executive directors' fees

	Committee fees (notes 1 and 2)		Basic fees		Total	
	2012 £000	2011 £000	2012 £000	2011 £000	2012 £000	2011 £000
Ed Anderson (Chairman)	–	–	142	135	142	135
Kate Barker – note 3	16	7	43	42	59	49
Roger Burden	6	5	43	42	49	47
Lynne Charlesworth (Vice Chairman – from 18.04.2012)	21	24	57	42	78	66
Richard Davey (Vice Chairman – retired 18.04.2012)	5	14	18	61	23	75
Philip Johnson	18	17	43	42	61	59
David Paige	19	18	43	42	62	60
Simon Turner	18	14	44	42	62	56
	103	99	433	448	536	547

Notes:

- 2012 committee fees for non-executive directors consist of:
 - Member of the Audit Committee – £7,420 per annum (£7,210 per annum up to 30 June 2012).
 - Member of the Group Risk Committee – £7,420 per annum (£7,210 per annum up to 30 June 2012).
 - Member of the Remuneration Committee – £4,235 per annum (£4,120 per annum up to 30 June 2012).
 - Chair of the Audit Committee – £18,000 per annum (£17,510 per annum up to 30 June 2012).
 - Chair of the Group Risk Committee – £18,000 per annum (£17,510 per annum up to 30 June 2012).
 - Chair of the Remuneration Committee – £12,000 per annum (£10,000 per annum up to 30 June 2012).
 - 'Treating Customers Fairly'/Conduct Risk oversight role – £7,420 per annum (£7,210 per annum up to 30 June 2012).
 - People oversight role – £4,235 per annum.
- Membership of these committees and role-holders are set out in the table on page 47. Significant changes in 2012 were:
 - Kate Barker replaced Lynne Charlesworth in the 'Treating Customers Fairly'/Conduct Risk oversight role from 1 July 2012.
 - Roger Burden was appointed to a new People oversight role from 1 July 2012.
- Kate Barker's committee fees for 2012 include £5,125 for her duties as a trustee of the Norwich & Peterborough pension scheme.

On behalf of the Board

Simon Turner
Chair of the Remuneration Committee
20 February 2013

DIRECTORS' RESPONSIBILITIES STATEMENT

The following statement, which should be read in conjunction with the statement of the Auditor's responsibilities on page 70, is made by the directors to explain their responsibilities in relation to the preparation of the Annual Accounts, Annual Business Statement and Directors' Report.

The directors are required by the Building Societies Act 1986 (the 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 the affairs of the Society and the Group as at the end of the financial year and which provide details of directors' emoluments in accordance with Part VIII of the Act and regulations made under it.

The Act states that references to International Financial Reporting Standards (IFRS) accounts giving a true and fair view, are references to their achieving a fair presentation.

In preparing those 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 the Annual Accounts have been prepared in accordance with IFRS.
- Prepare the Annual Accounts on the going concern basis, unless it is inappropriate to presume that the Group will continue in business.

In addition to the Annual Accounts, the Act requires the directors to prepare, for each financial year, an Annual Business Statement and a Directors' Report, each containing prescribed information relating to the business of the Society and its subsidiary undertakings.

The directors are responsible for the maintenance and integrity of statutory and audited information on the Society's website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Directors' responsibilities for accounting records and internal control

The directors are responsible for ensuring that the Society and its subsidiary undertakings:

- Keep accounting records in accordance with the Building Societies Act 1986.
- Take reasonable care to establish, maintain, document and review such systems and controls as are appropriate to its business in accordance with the rules made by the Financial Services Authority under the Financial Services and Markets Act 2000.

The directors have general responsibility for safeguarding the assets of the Group and for taking reasonable steps for the prevention and detection of fraud and other irregularities.

On behalf of the Board

Ed Anderson
Chairman

20 February 2013

INDEPENDENT AUDITOR'S REPORT

to the members of Yorkshire Building Society

We have audited the Group and Society financial statements of Yorkshire Building Society for the year ended 31 December 2012 which comprise the Group and Society Income statements, the Group and Society Statements of comprehensive income, the Group and Society Statements of financial position, the Group and Society Statements of changes in members' interests, the Group and Society Statements of cash flows and the related Notes 1 to 42. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

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

Respective responsibilities of directors and auditor

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

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and Society's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31 December 2012 and of the Group's and the Society's profit for the year then ended; and
- have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Building Societies Act 1986

In our opinion:

- the Annual Business Statement and the Directors' Report have been prepared in accordance with the requirements of the Building Societies Act 1986;
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the accounting records and the financial statements; and
- the information given in the Annual Business Statement (other than the information upon which we are not required to report) gives a true representation of the matters in respect of which it is given.

Matters on which we are required to report by exception

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

- proper accounting records have not been kept by the Society; or
- the Society financial statements are not in agreement with the accounting records; or
- we have not received all the information and explanations and access to documents we require for our audit.

Stephen Williams (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Leeds, United Kingdom

20 February 2013

INCOME STATEMENTS

for the year ended 31 December 2012

	NOTES	Group		Society	
		2012 £m	2011 £m	2012 £m	2011 £m
Interest receivable and similar income	3	1,380.7	1,377.5	1,329.8	1,320.3
Interest payable and similar charges	4	(1,034.7)	(1,048.9)	(1,071.8)	(1,088.5)
Net interest income		346.0	328.6	258.0	231.8
Fees and commissions receivable		49.9	48.0	42.6	44.2
Fees and commissions payable		(6.7)	(8.1)	(6.0)	(7.7)
Net fee and commission income		43.2	39.9	36.6	36.5
Income from investments in subsidiaries	10	–	–	106.8	20.2
Net losses from fair value volatility on financial instruments	5	(11.8)	(10.1)	(8.1)	(15.7)
Net realised profits	6	77.9	3.5	77.9	3.5
Other operating income		5.1	7.5	23.0	22.6
Total income		460.4	369.4	494.2	298.9
Administrative expenses	7	(217.3)	(177.4)	(215.7)	(174.5)
Merger and acquisition costs	7	(16.4)	(17.5)	(16.2)	(17.5)
Depreciation and amortisation		(16.3)	(14.7)	(15.6)	(14.0)
Operating profit before provisions		210.4	159.8	246.7	92.9
Impairment of loans and advances to customers	9	(39.3)	(30.1)	(4.0)	23.6
Provisions	28	(14.0)	(5.6)	(14.0)	(5.6)
Impairment of loans to subsidiaries	10	–	–	(10.0)	(20.4)
Operating profit		157.1	124.1	218.7	90.5
Negative goodwill		–	5.6	–	5.6
Profit before tax		157.1	129.7	218.7	96.1
Tax expense	11	(34.2)	(23.5)	(30.9)	(6.9)
Net profit		122.9	106.2	187.8	89.2

Net profit arises from continuing operations and is attributable to members.

The notes on pages 76 to 130 form part of these accounts

STATEMENTS OF COMPREHENSIVE INCOME

for the year ended 31 December 2012

	NOTES	Group		Society	
		2012 £m	2011 £m	2012 £m	2011 £m
Net profit		122.9	106.2	187.8	89.2
Items that will subsequently be reclassified to profit and loss:					
Available for sale investments:					
Valuation gains taken to equity		33.2	69.0	33.2	69.0
Amounts transferred to income statement (included in net realised profits)		(40.4)	1.9	(40.4)	1.9
Cash flow hedges:					
Losses taken to equity		(34.8)	(16.5)	(34.8)	(16.5)
Amounts transferred to income statement (included in net realised profits)		6.2	12.7	6.2	12.7
Tax relating to items that may be reclassified	11	7.2	(25.2)	7.3	(25.2)
Items that will not be reclassified subsequently to profit and loss:					
Actuarial (loss)/gain on retirement benefit obligations	26	(22.5)	18.7	(22.5)	18.7
Tax relating to items not reclassified	11	3.5	(11.2)	3.4	(11.3)
Total comprehensive income for the year		75.3	155.6	140.2	138.5

The notes on pages 76 to 130 form part of these accounts.

STATEMENTS OF FINANCIAL POSITION

as at 31 December 2012

ASSETS	NOTES	Group		Society	
		2012 £m	2011 £m	2012 £m	2011 £m
ASSETS					
Liquid assets					
Cash in hand and balances with the Bank of England	13	4,165.3	1,598.4	4,165.3	1,598.4
Loans and advances to credit institutions	14	573.7	582.3	361.3	362.6
Debt securities	15	492.5	2,737.1	1,307.8	3,040.3
Loans and advances to customers					
Loans secured on residential property	16	27,213.1	26,659.3	17,470.4	18,267.1
Other loans	16	359.3	362.9	359.3	362.9
Derivative financial instruments	34	380.6	373.8	303.8	370.5
Investments	10	1.4	2.2	9,801.6	8,857.1
Intangible assets	17	34.3	30.4	34.2	30.2
Investment properties	18	17.3	25.5	17.1	25.3
Property, plant and equipment	19	113.0	109.6	95.2	91.3
Deferred tax assets	20	105.6	110.1	85.1	100.4
Retirement benefit surplus	26	22.0	32.9	22.0	32.9
Other assets	21	19.0	22.5	34.7	37.6
Total assets		33,497.1	32,647.0	34,057.8	33,176.6
LIABILITIES					
Shares	22	26,817.5	25,973.4	26,817.5	25,973.4
Amounts owed to credit institutions	23	911.1	765.4	911.1	765.4
Other deposits	24	475.7	510.3	1,995.2	1,589.5
Debt securities in issue	25	2,784.3	2,591.2	1,938.3	2,244.6
Derivative financial instruments	34	517.4	609.1	522.8	619.8
Current tax liabilities		21.5	22.3	5.4	7.6
Deferred tax liabilities	20	12.2	18.6	9.5	15.1
Retirement benefit obligations	26	3.5	1.2	3.5	1.2
Other liabilities	27	78.8	79.6	105.2	74.8
Provisions	28	112.1	110.4	112.1	110.4
Subordinated liabilities	29	122.8	230.9	122.8	230.9
Subscribed capital	30	7.3	177.0	7.3	177.0
		31,864.2	31,089.4	32,550.7	31,809.7
Total equity attributable to members		1,632.9	1,557.6	1,507.1	1,366.9
Total liabilities		33,497.1	32,647.0	34,057.8	33,176.6

The accounts on pages 71 to 130 were approved by the Board of directors on 20 February 2013 and were signed on its behalf by:

Ed Anderson
Lynne Charlesworth
Chris Pilling

Chairman
Vice Chairman
Chief Executive

The notes on pages 76 to 130 form part of these accounts.

STATEMENTS OF CHANGES IN MEMBERS' INTEREST

for the year ended 31 December 2012

	General reserve £m	Hedging reserve £m	Available for sale reserve £m	Total reserves £m
Group				
At 1 January 2012	1,581.9	(36.3)	12.0	1,557.6
Current year movement net of tax	103.9	(23.0)	(5.6)	75.3
At 31 December 2012	1,685.8	(59.3)	6.4	1,632.9
At 1 January 2011	1,408.1	(32.6)	(38.0)	1,337.5
Transfer of engagements*	60.2	–	4.3	64.5
Current year movement net of tax	113.6	(3.7)	45.7	155.6
At 31 December 2011	1,581.9	(36.3)	12.0	1,557.6
Society				
At 1 January 2012	1,391.4	(36.3)	11.8	1,366.9
Current year movement net of tax	168.6	(23.0)	(5.4)	140.2
At 31 December 2012	1,560.0	(59.3)	6.4	1,507.1
At 1 January 2011	1,238.8	(32.6)	(38.2)	1,168.0
Transfer of engagements*	56.1	–	4.3	60.4
Current year movement net of tax	96.5	(3.7)	45.7	138.5
At 31 December 2011	1,391.4	(36.3)	11.8	1,366.9

* Merger with Norwich & Peterborough Building Society.

The hedging reserve relates to fair value adjustments on derivative financial instruments designated as cash flow hedges. It is expected that the forecast transactions will largely occur over the next five years and the amount deferred will be recognised over this period.

The notes on pages 76 to 130 form part of these accounts.

STATEMENTS OF CASH FLOWS

for the year ended 31 December 2012

	NOTES	Group		Society	
		2012 £m	2011 £m	2012 £m	2011 £m
Cash flows from operating activities:					
Profit before tax		157.1	129.7	218.7	96.1
Working capital adjustments	42	(119.0)	71.0	(90.6)	26.5
Net (increase)/decrease in operating assets	42	(677.3)	(809.6)	(204.1)	2,216.9
Net increase/(decrease) in operating liabilities	42	955.2	881.7	1,395.5	(1,332.7)
Net cash flows from operating activities		316.0	272.8	1,319.5	1,006.8
Cash flows from investing activities:					
Cash acquired on transfer of engagements		–	251.5	–	251.5
Purchase of property, plant and equipment and intangible assets		(27.0)	(11.5)	(26.8)	(11.0)
Proceeds from sale of property, plant and equipment		7.4	1.5	7.4	1.5
Purchase of debt securities		(825.1)	(1,579.5)	(1,425.1)	(1,650.7)
Proceeds from sale and redemption of debt securities		3,140.4	2,725.0	3,228.3	2,493.0
Net cash flows from investing activities		2,295.7	1,387.0	1,783.8	1,084.3
Cash flows from financing activities:					
Redemption of securities		(949.0)	(2,963.3)	(846.8)	(2,909.5)
Issue of securities		1,127.5	1,178.0	527.5	778.0
Redemption of subordinated capital		(176.9)	–	(176.9)	–
Interest paid on subordinated liabilities and subscribed capital		(29.0)	(30.1)	(29.0)	(30.1)
Net cash flows used in financing activities		(27.4)	(1,815.4)	(525.2)	(2,161.6)
Taxation paid		(26.2)	(24.4)	(12.7)	(10.2)
Net increase/(decrease) in cash and cash equivalents		2,558.1	(180.0)	2,565.4	(80.7)
Opening balance		2,155.7	2,335.7	1,936.0	2,016.7
Total closing cash and cash equivalents		4,713.8	2,155.7	4,501.4	1,936.0
Cash and cash equivalents:					
Cash and balances with central banks		4,140.1	1,573.4	4,140.1	1,573.4
Loans and advances to banks	14	573.7	582.3	361.3	362.6
		4,713.8	2,155.7	4,501.4	1,936.0

The statement of cash flows has been prepared in compliance with 'IAS 7 Statement of Cash Flows' and has been presented under the indirect method.

For the purposes of the statements of cash flows, cash and cash equivalents comprise cash and other financial instruments with original maturities of less than three months.

The notes on pages 76 to 130 form part of these accounts.

NOTES TO THE ACCOUNTS

INTRODUCTION

Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) in issue that have been endorsed by the EU and are effective at 31 December 2012 and with those parts of the Building Societies Act 1986 and the Building Societies (Accounts and Related Provisions) Regulations applicable to societies reporting under IFRS.

The financial statements have been prepared on the historical cost basis, as modified by the revaluation of available for sale financial assets, derivative contracts and financial assets held at fair value through the Income Statement.

The financial statements have been prepared on the going concern basis. This is discussed in the Directors' Report on page 38, under the heading, 'Principal risks, uncertainties and going concern'.

The preparation of financial statements under IFRS requires the use of certain critical accounting estimates and judgement. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements, are set out in Note 2.

Accounting Developments

The following Accounting Standard amendments have been applied in the year:

- Amendment to IFRS 7 'Financial Instruments Disclosures' (October 2010) 'Disclosures – Transfers of Financial Assets' extends the scope of IFRS 7 disclosures but does not change the recognition or measurement of transactions in the financial statements.
- IAS 12 (revised) 'Income Taxes'. The application of this revised Standard does not have a material impact on the financial statements.

The following Standards which have not been applied in these financial statements were in issue but not yet effective for the 2012 year end:

- Amendment to IFRS 7 'Financial Instruments Disclosures' (December 2011) 'Disclosures – Offsetting Financial Assets and Financial Liabilities' extends the scope of IFRS 7 disclosures but does not change the recognition or measurement of transactions in the financial statements.
- IFRS 9 'Financial Instruments' was issued in December 2011 and is effective for periods commencing on or after 1 January 2015. The Standard is yet to be issued in its final form so the impact on the accounts of the company cannot be determined.
- IFRS 10 'Consolidated Financial Statements' is effective for periods commencing on or after 1 January 2013. It replaces IAS27 'Consolidated and Separate Financial Statements' and SIC-12 'Consolidation – Special Purpose Entities' by introducing a single consolidation model for all entities based on control. The new standard is not expected to have a significant impact.
- IFRS 11 'Joint Arrangements' is effective for periods commencing on or after 1 January 2013. The new standard is not expected to have a significant impact.
- IFRS 12 'Disclosure of Interests in Other Entities' is effective for periods commencing on or after 1 January 2013. The new standard is not expected to have a significant impact.
- IFRS 13 'Fair Value Measurement' is effective for periods commencing on or after 1 January 2013. The new standard established a single source of guidance for fair value measurement under IFRS.
- IAS 1 (amendment) 'Presentation of Items of Other Comprehensive Income' is effective on or after 1 July 2012. The amendment is not expected to have a significant impact.
- IAS 19 (revised) 'Employee Benefits' is effective on or after 1 January 2013. The application of this revised Standard does not have a material impact on the financial statements.
- IAS 27 (revised) 'Separate Financial Statements' is effective on or after 1 January 2013. The application of this revised Standard does not have a material impact on the financial statements.

INTRODUCTION (continued)

- IAS 28 (revised) 'Investments in Associates and Joint Ventures' is effective on or after 1 January 2013. The application of this revised Standard does not have a material impact on the financial statements.
- IAS 32 (amended) 'Offsetting Financial Assets and Financial Liabilities' is effective on or after 1 January 2014. This amendment is intended to address the differences in their respective accounting standards regarding offsetting of financial instruments not expected to have any impact on the financial statements.
- Annual improvements to IFRS 2009-2011 are effective on or after 1 January 2013. These improvements are not expected to have any impact on the financial statements.

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of consolidation

The Group financial statements consolidate the financial statements of the Society and its subsidiary undertakings. Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Inter-company transactions and balances are eliminated upon consolidation.

Interest income and expense

Interest income and expense on all financial instruments are recognised within interest receivable or payable on an effective interest rate basis.

The effective interest rate method is used to calculate the amortised cost of financial instruments and to recognise interest receivable or payable over the relevant period. The effective interest rate is the rate that exactly discounts estimated cash flows (excluding credit losses) to zero, through the expected life of the instrument. The main impact for the Group relates to mortgage advances where fees (such as application and arrangement fees) and costs are incorporated in the calculation. This has the effect of spreading these fees and costs over the expected life of the mortgage. Expected lives are estimated using historic data and management judgement and the calculation is adjusted when actual experience differs from estimates, with changes in deferred amounts being recognised immediately in the Income Statement.

Fees and commissions

Fees payable and receivable in relation to the provision of loans are accounted for on an effective interest rate basis. Other fees and commissions are recognised on the basis of when the relevant service is provided.

Derivative financial instruments and hedge accounting

Derivative financial instruments

Derivative financial instruments are held at fair value with movements in fair value being recognised in the Income Statement. Fair values of exchange traded derivatives are valued using closing prices from the appropriate exchanges. Other derivatives are calculated using valuation techniques including discounted cash flow models.

Embedded derivatives

Certain derivatives are embedded in other financial instruments. These are treated as separate derivatives where the economic characteristics and risks are not closely related to the host instrument and the host instrument is not measured at fair value. These embedded derivatives are measured at fair value with movements in value being recognised in the Income Statement. Where the Group is unable to value the embedded derivative separately, the entire instrument is measured at fair value with changes in value being taken to the Income Statement.

Hedging

All derivatives entered into by the Group are for the purposes of providing an economic hedge. Full details of hedging strategies are contained in Note 34. Hedge accounting is an optional treatment but the specific rules and conditions in IAS 39 have to be complied with before it can be applied. The Group has classified the majority of its derivatives as fair value and cash flow hedges in order to reduce volatility in the Income Statement.

NOTES TO THE ACCOUNTS continued

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

Fair value hedges

Where the fair value hedging requirements are met, changes in fair value of the hedged item arising from the hedged risk are taken to the Income Statement thereby offsetting the effect of parallel movements in the fair value of the derivative. Where the hedge no longer meets the criteria, or is terminated for any other reason, the adjustment to the hedged item is released to the Income Statement, over its remaining life, using the effective interest rate method.

Cash flow hedges

Where a derivative financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability, or a highly probable forecast transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity and recycled to the Income Statement over the life of the forecast transaction. Any ineffective portion of the gain or loss on the hedging instrument is recognised in the Income Statement immediately. If the forecast transaction is no longer expected to occur, the cumulative unrealised gain or loss recognised in equity is then recognised immediately in the Income Statement.

Impairment losses on loans and advances to customers

At each statement of financial position date the Group assesses whether or not there is objective evidence that individual financial assets (or groups of financial assets with similar credit characteristics) are impaired. In determining whether an impairment loss should be recognised, the Group makes judgements as to whether there is any evidence indicating a measurable decrease in the present value of cash flows expected from a financial asset or group of financial assets, resulting from an event (or events) that have occurred after initial recognition of the asset, but before the statement of financial position date.

Individual assessments are made of all loans and advances on properties which are in possession or in arrears by two months or more. All other loans and advances are grouped according to their credit characteristics and a collective review is undertaken of any evidence of impairment. Future cash flows are estimated on grouped credit characteristics in all cases.

Where there is objective evidence of impairment or that trigger events exist at the statement of financial position date, then the impairment loss is calculated as the difference between the assets' carrying value and the present value of the estimated cash flows from those assets. In assessing these cash flows a number of factors are taken into account, including the Group's historic default experience, historic and current loss emergence periods, the effect of changes in house prices and adjustments to allow for ultimate forced sale discounts.

Any increases or decreases in projected impairment losses are recognised through the Income Statement. If a loan is ultimately uncollectable, then any loss incurred by the Group on extinguishing the debt is written off against the provision for loan impairment. Any subsequent recoveries of amounts previously written off are recognised through the Income Statement as an adjustment to the loan impairment provision. If, in a subsequent period, the extent of impairment loss decreases, and that decrease can objectively be related to an event occurring after the initial impairment was recognised, then the impairment provision is adjusted accordingly and the reversal recognised through the Income Statement.

Impairment losses on debt instruments

At each statement of financial position date the Group assesses whether or not there is objective evidence that individual debt instruments are impaired. In determining whether there is any objective evidence of impairment the Group takes into account a number of factors including:

- Significant financial difficulties of the issuer or obligor.
- Any breach of contract or covenants.
- The granting of any concession or rearrangement of terms.
- The disappearance of an active market.
- Any significant downgrade of ratings.
- Any significant reduction in market value.

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

In some cases a significant adverse change in one of the above factors will cause the Group to determine that there is objective evidence of impairment. In other cases it may not be possible to identify a single event that identifies impairment. The Group may additionally determine that there is impairment where there are a number of factors contributing to that view.

Where the Group determines that there is objective evidence of impairment or that trigger events exist at the statement of financial position date, then, in the case of available for sale instruments, the cumulative loss that had been recognised directly in reserves is removed from reserves and recognised in the Income Statement. In the case of held to maturity instruments an appropriate charge is made to the Income Statement.

If in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be related to an event occurring after the impairment loss was recognised through the Income Statement, the impairment loss shall be reversed, with the amount of the reversal recognised through the Income Statement.

Segmental reporting

The chief operating decision maker has been identified as the Board of directors, which reviews the Group's internal reporting and is responsible for all significant decisions.

Financial information provided in the segmental reporting is consistent with that which is presented to the Board.

No segmental information is presented on geographical lines, because substantially all of the Group's activities are in the United Kingdom.

See Note 12 for further information.

Business combinations between mutual organisations

Identifiable assets and liabilities are measured at fair value. Intangible assets are amortised through the Income Statement over their estimated useful lives, being between one and ten years.

A deemed purchase price is calculated by measuring the fair value of the acquired business. Goodwill is measured as the difference between the adjusted value of the acquired assets and liabilities and the deemed purchase price. Goodwill is recorded as an asset; negative goodwill is recognised immediately in the Income Statement.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the Group reports provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted during the measurement period (see below), or additional assets or liabilities are recognised, to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the amounts recognised as of that date.

The measurement period is the period from the date of acquisition to the date the Group obtains complete information about facts and circumstances that existed as of the acquisition date, and is subject to a maximum of one year.

Cash and cash equivalents

For the purposes of the Statement of Cash Flows, cash and cash equivalents comprise cash and other financial instruments with less than three months original maturity.

The Statements of Cash Flows have been prepared using the indirect method.

NOTES TO THE ACCOUNTS continued

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

Financial assets

The Group classifies its financial assets into the following categories:

Loans and receivables

Loans and receivables are predominantly mortgage loans to customers and money market advances held for liquidity purposes. They are initially recorded at fair value plus any attributable costs and less any attributable fees and are subsequently held at amortised cost less any impairment losses other than where an adjustment is made as part of a fair value hedging arrangement. Income is recognised on an effective interest rate basis.

Financial assets at fair value through profit and loss

These comprise assets that have been specifically designated at inception and certain structured investments containing embedded derivatives where the Group has been unable to separately calculate the fair value of the embedded derivative. Where the embedded derivative has not been separated from the host instrument the entire (hybrid) instrument has been recorded at fair value with changes in value being taken to the Income Statement. Interest income is recognised on an effective interest rate basis.

Held to maturity

These comprise assets where the Group has both the intention and ability to hold to maturity. This category contains certain assets that have been specifically designated at inception and other assets that have been reclassified where we have the intention and ability to hold to maturity. They are initially recorded at fair value plus any attributable costs and less any attributable fees and are subsequently held at amortised cost less any impairment losses. Income is recognised on an effective interest rate basis.

Available for sale financial assets

Available for sale financial assets are securities held for liquidity and investment purposes. They comprise all non-derivative financial assets that are not classified as loans and receivables, held to maturity investments or financial assets at fair value through profit and loss. These are recorded at fair value with changes in value being taken to reserves. Interest is recognised on an effective interest rate basis. Any profit or loss on sale is recognised in the Income Statement on disposal.

Financial liabilities

The Group records all of its financial liabilities at fair value less directly attributable transaction costs, and subsequently measures them at amortised cost, other than derivative financial instruments and where an adjustment is made as part of a fair value hedging arrangement. Expense is recognised on an effective interest rate basis.

Joint ventures

Joint ventures are those entities over whose activities the Group has joint control, established by contractual agreement and requiring unanimous consent for strategic financial and operating decisions. The consolidated financial statements include the Group's proportionate share of the entities' assets, liabilities, revenue and expenses on a line-by-line basis.

Investment properties, property, plant and equipment

Investment properties

Investment properties comprise freehold properties and parts of freehold properties that are not used in the business. These properties are generally flats and offices ancillary to branch premises and earn rental income. Investment properties are stated at cost less accumulated depreciation and impairment losses.

Property, plant and equipment

Buildings, major alterations to office premises, fixtures and fittings, equipment and other tangible fixed assets are stated at cost less accumulated depreciation and impairment losses.

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

Subsequent costs

Costs incurred after initial purchase of assets are expensed unless it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. Repairs and maintenance are treated as an expense.

Depreciation

Depreciation is provided by the Group to write off the cost (excluding land) less the estimated residual value by equal instalments over estimated useful economic lives as follows:

Freehold/long leasehold buildings (including investment properties)	–	50 years
Short leasehold property	–	Life of lease
Equipment, fixtures, fittings and vehicles	–	3 to 8 years

Land is stated at cost less accumulated impairment losses and is not depreciated. Any impairment in the value of assets is dealt with through the Income Statement as it arises.

Intangible assets

Computer software

Costs incurred in the development of computer software for internal use are capitalised as intangible assets where the expenditure leads to the creation of an identifiable non-monetary asset and it is probable that the expected future economic benefits that are attributable to the asset will flow to the Group. Acquired software is classified as an intangible asset where it is not an integral part of the related hardware. Computer software costs are amortised over their estimated useful lives, which are generally three to five years. Any impairment in the value of these assets is dealt with through the Income Statement as it arises.

Goodwill

Goodwill represents the excess of the consideration transferred for an acquisition over the fair value of the Group's share of the net identifiable assets (including the fair value of contingent liabilities) of the acquired business at the date of acquisition. Goodwill on acquisitions is included as an intangible asset.

A purchase resulting in negative goodwill arises when the fair value of net identifiable assets acquired exceeds the cost of an acquisition. Negative goodwill is recognised as an immediate gain in the Income Statement.

Other intangibles

Other intangibles, which largely represent core deposit intangibles acquired by the Group, are amortised using the straight line method over their estimated useful lives of between one and ten years.

Employee benefits – Pension obligations

Defined contribution plans

Obligations for contributions to defined contribution pension plans are recognised as an expense in the Income Statement as incurred.

Defined benefit plans

The asset or liability recognised in the Statement of Financial Position in respect of the defined benefit pension schemes is the present value of the defined benefit obligation at the statement of financial position date less the fair value of plan assets, together with adjustments for unrecognised past service costs. The asset is recognised in the Statement of Financial Position to the extent that it is recoverable by the Group being the present value of available refunds and reductions in future contributions to the scheme. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. Projected benefit obligations are discounted to present value using the rate of return available on high quality corporate bonds of equivalent currency and term to the obligations. Actuarial gains or losses are recognised in full in the period in which they occur in the Statement of Comprehensive Income. Past service costs are recognised immediately in the Income Statement to the extent that benefits are already vested and otherwise is amortised on a straight-line basis over the average period until the benefits become vested.

NOTES TO THE ACCOUNTS continued

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

Scheme surplus

The Group has received a legal opinion that it can recover in full any surplus valuation of the scheme.

Tax

Tax comprises current tax and deferred tax. Tax is recognised in the Income Statement except to the extent that it relates to items recognised directly in equity, in which case the tax is also recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted on the statement of financial position date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised providing for temporary differences between the carrying amount of certain assets and liabilities for accounting purposes and for taxation purposes. Deferred tax is provided using tax rates enacted or substantively enacted at the statement of financial position date, depending on the rate at which they are expected to reverse.

The following temporary differences are not provided for:

- The initial recognition of assets or liabilities that affect neither accounting nor taxable profit
- Differences relating to investments in subsidiaries, to the extent that the parent company is able to control reversal of temporary differences and it is probable they will not reverse in the foreseeable future

Deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available, against which temporary differences can be utilised.

Leases

The leases entered into by the Group are operating leases. Operating lease rentals are expensed to the Income Statement on a straight-line basis over the period of the lease agreement.

Foreign currency

Assets and liabilities denominated in foreign currencies are translated into sterling at the appropriate rates of exchange prevailing at the year end date and exchange differences are recognised in the Income Statement as they arise. All income and expense is translated into sterling at the rate of exchange at the day of receipt or payment.

Derecognition of financial assets and liabilities

Financial assets are only derecognised when the contractual rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership. The Group has not derecognised the loans securing its issue of covered bonds because substantially all the risks and rewards are retained and recognises collateralised borrowing for the proceeds received. Financial liabilities are only derecognised when the obligation is discharged, cancelled, or has expired.

2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

The Group's financial statements are prepared in accordance with IFRS, as adopted by the EU, and with its accounting policies, the most significant of which are set out in Note 1. The results are inevitably sensitive to certain estimates and judgements exercised by the Group, the most critical of which are described below.

As explained on pages 48 to 49 the Audit Committee has confirmed that the accounting estimates and judgements applied are considered to be appropriate.

2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES (continued)

Impairment of mortgage assets

The creation of impairment provisions for a portfolio of mortgage loans is inherently uncertain and requires the exercise of a significant degree of judgement. Provisions are calculated using historic default and loss experience but require judgement to be exercised in predicting future economic conditions (e.g. interest rates and house prices), customer behaviour (e.g. default rates) and the length of time before impairments are identified (emergence period). The most critical estimate is the future level of house prices where a variance of 10% equates to £11.1m of provision. Other sensitivities include the emergence period (where a variance of three months equates to £3.4m) and the loss given default rate (where a 10% variance equates to £4.7m of provision).

Effective interest rate

IAS 39 requires that all of the cash flows directly associated with financial instruments held at amortised cost must be recognised in the Income Statement through the interest margin using the effective interest rate method. When this approach is applied to a mortgage portfolio, judgements must be made to estimate the average life of that portfolio. These judgements are applied to segments of the mortgage portfolio, taking into account factors including the terms of the particular products, historic repayment data and economic conditions. These estimates are updated in each reporting period to reflect the portfolio's actual performance. The most critical estimate is the estimated number of customers who will remain with the Society after the end of the initial product deal period. A 1% increase in the estimate of the number of customers who remain with the Society after the end of the initial product deal period would increase the value of the loans by less than £0.1m.

Financial Services Compensation Scheme (FSCS)

The FSCS levy in respect of failed financial institutions is calculated using the Group's share of industry protected deposits and projected forward interest rates. A 1% increase in the interest rate assumption would increase the provision by £5.7m. More detail of the FSCS and the Society's provision are contained in Note 28.

Regulatory and other provisions

Note 28 provides details of regulatory and other provisions which includes amounts provided in relation to customer redress claims totalling £61.1m (including fair value adjustments made on merger with Norwich & Peterborough Building Society). The customer redress provision is in respect of a range of customer claims for mis-selling and is calculated using management's estimate of the complaint volumes, redress payments, referral levels to the Financial Ombudsman Service and complaint handling costs. The main sensitivity is the level of complaint volumes where a 10% increase in the expected level of complaints would increase the provision by £3.7m.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the balance sheet date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows.

Pensions

The Group operates two defined benefit pension schemes. Significant judgements (on areas such as future interest and inflation rates, membership levels and mortality rates) have to be exercised in estimating the value of the assets and liabilities of the scheme, and hence of its net surplus/deficit. These are outlined in Note 26. The impact of a 0.1% increase in the rate used to discount the future value of the liabilities would be to reduce the present value of the liabilities by £11.7m. The impact of a one year increase in each of the quoted life expectancies at age 60 would be to increase the present value of the liabilities by £15.5m.

Business combinations

As described on page 79, identifiable assets and liabilities are measured at fair value. Such estimates are highly judgemental, particularly where a fair value is measured in respect of the critical judgements noted above. The amount recognised reflects management's best estimate. The merger with Chelsea is now outside of the measurement period. There were no changes in the period in relation to N&P, whose measurement period ended on 31 October 2012. Management has been through an extensive evaluation to reach this conclusion.

NOTES TO THE ACCOUNTS continued

3. INTEREST RECEIVABLE AND SIMILAR INCOME

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
On assets held at amortised cost				
Loans fully secured on residential property	1,168.2	1,094.4	746.0	709.6
Connected undertakings	–	–	380.3	377.6
Other loans	17.5	3.8	17.5	3.8
Other liquid assets/cash and short-term funds	18.0	16.0	17.1	15.0
On available for sale securities	21.1	44.9	21.1	48.9
On held to maturity securities	5.8	12.3	13.9	12.3
On financial instruments held at fair value through the Income Statement				
Derivatives	149.0	204.9	132.8	151.9
Other assets	1.1	1.2	1.1	1.2
Total interest receivable	1,380.7	1,377.5	1,329.8	1,320.3

Included within interest receivable and similar income is interest earned on impaired loans: Group £24.8m, Society £11.6m (2011 – Group £30.7m, Society £12.7m) which, once included in the mortgage and loans balance, is considered within the impairment calculation.

4. INTEREST PAYABLE AND SIMILAR CHARGES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
On liabilities held at amortised cost				
Shares held by individuals	683.2	555.9	683.2	555.9
Deposits from banks	6.0	5.7	6.0	5.7
Deposits from other financial institutions	0.9	0.4	0.9	0.4
Deposits from connected undertakings	–	–	1.4	18.8
Other deposits	3.5	19.8	3.5	2.1
Certificates of deposit	0.1	0.2	0.1	0.2
Other debt securities	88.9	155.2	79.4	150.0
Subordinated liabilities	21.8	21.5	21.8	21.5
Subscribed capital	7.2	8.6	7.2	8.6
Other interest payable	1.0	1.2	1.0	1.4
On financial instruments held at fair value through the Income Statement				
Deposits from connected undertakings	–	–	40.4	40.2
Derivatives	222.1	280.4	226.9	283.7
Total interest payable	1,034.7	1,048.9	1,071.8	1,088.5

5. NET LOSSES FROM FAIR VALUE VOLATILITY ON FINANCIAL INSTRUMENTS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Assets held at fair value	(4.6)	(0.8)	(4.6)	(0.8)
Embedded derivatives	5.3	(4.8)	5.3	(4.8)
Derivatives and hedging	(12.5)	(4.5)	(8.8)	(10.1)
Net losses from fair value volatility on financial instruments	(11.8)	(10.1)	(8.1)	(15.7)

Assets held at fair value relate to structured assets containing profit participation features that meet the definition of embedded derivatives. The Society is unable to separate the value of the embedded derivative from the host item and so has to treat the whole asset as held at fair value through the Income Statement in accordance with 'IAS 39 Financial Instruments: Recognition and Measurement'.

The embedded derivative category relates to synthetic features contained in certain structured investments which can be valued separately from the host instruments.

The derivative and hedging category relates to changes in fair value of derivatives that provide effective economic hedges but where the Group has not achieved hedge accounting. Ineffectiveness on those cash flow and fair value hedges for which hedge accounting has been achieved is an immaterial amount.

6. NET REALISED PROFITS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Net realised profit on sale of debt securities	16.1	3.5	16.1	3.5
Profits on capital repurchase	61.8	–	61.8	–
	77.9	3.5	77.9	3.5

Profits on capital repurchase relate to the buyback of certain remunerated capital at a discount to nominal value – see Notes 29 and 30.

7. ADMINISTRATIVE EXPENSES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Staff costs				
Salaries and wages	110.5	88.6	108.8	86.9
Social security costs	10.6	8.7	10.5	8.6
Pension costs – defined benefit plans	2.9	0.8	2.5	0.8
Pension costs – defined contribution plans	3.8	3.2	3.8	3.2
Other staff costs	0.9	5.7	0.9	5.7
Operating lease rentals	8.2	7.0	10.5	8.6
Other expenses	96.8	80.9	94.9	78.2
	233.7	194.9	231.9	192.0
Less: merger and acquisition costs	(16.4)	(17.5)	(16.2)	(17.5)
	217.3	177.4	215.7	174.5

Merger and acquisition costs comprises professional fees, external project resource and termination payments.

NOTES TO THE ACCOUNTS continued

7. ADMINISTRATIVE EXPENSES (continued)

The Society operates a salary sacrifice scheme whereby the employee agrees to a reduction in salary in return for the Society making the contributions that were previously paid by the employee. The amount shown above under Salaries and wages includes the headline salary (i.e. before the salary sacrifice deduction) and Pension costs excludes the additional contributions made by the Society as a result of the salary sacrifice scheme.

The Society's operating lease rentals include payments it makes to subsidiary companies which own properties and equipment.

Remuneration of the auditor and their associates	Group		Society	
	2012 £000	2011 £000	2012 £000	2011 £000
Fees payable to the auditor and their associates for the audit of the annual accounts	336	395	252	299
Fees payable to the auditor and their associates for other services to the group				
Audit-related assurance services (review of interim accounts)	47	36	47	36
Tax advisory services	28	67	28	67
Corporate finance services (including due diligence)	26	450	26	450
Other services				
Merger related costs – integration	–	17	–	17
All other services	232	127	232	127
	669	1,092	585	996

The above figures, relating to auditor's remuneration, exclude value added tax. Details of the Society's policy on non-audit work, which is implemented by the Audit Committee, is given in the Audit Committee Report on pages 50 to 51.

Staff numbers

The average number of persons employed by the Group during the year (including executive directors) was as follows:

	2012		2011	
	Full time	Part time	Full time	Part time
Building Society				
Central administration	1,975	428	1,585	381
Branches	1,173	454	953	334
Subsidiaries' offices	35	23	13	–
	3,183	905	2,551	715

8. REMUNERATION OF AND TRANSACTIONS WITH DIRECTORS

Total directors' remuneration amounted to £2,590,000 (2011 – £2,640,000).

Full details of directors' remuneration, bonuses and pensions are given in the Directors' Remuneration Report on pages 61 to 68. In addition, past directors' pensions in respect of services as directors (closed scheme) amounted to £17,000 (2011 – £17,000).

None of the directors had an interest in shares in, or debentures of, any associated body of the Society at any time during the financial year. Details of transactions with directors and loans held by directors and connected persons are disclosed in Note 41.

A register is maintained at the head office of the Society, containing details of loans, transactions and arrangements between the Society and its directors and connected persons. A statement of the appropriate details for 2012 will be available for inspection at the head office for a period of fifteen days up to and including the Annual General Meeting.

9. IMPAIRMENT

Loans and advances to customers

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
At 1 January				
Collective	8.0	4.5	0.5	0.2
Individual	52.7	54.0	3.0	3.0
	60.7	58.5	3.5	3.2
Amounts written off during the year				
Collective	–	–	–	–
Individual	(39.0)	(33.8)	(2.1)	(1.6)
	(39.0)	(33.8)	(2.1)	(1.6)
Impairment adjustment for the year				
Collective	(1.7)	3.5	(0.2)	0.3
Individual	42.1	32.5	4.9	1.6
	40.4	36.0	4.7	1.9
At 31 December				
Collective	6.3	8.0	0.3	0.5
Individual	55.8	52.7	5.8	3.0
	62.1	60.7	6.1	3.5
The charge for the year comprises:				
Impairment adjustment for loans and advances	40.4	36.0	4.7	1.9
Recoveries relating to amounts previously written off *	(1.1)	(5.9)	(0.7)	(25.5)
Net provision charge for the year	39.3	30.1	4.0	(23.6)

* Recoveries in 2011 included the proceeds of an insurance claim relating to loans which were part of the former Chelsea loan book (Group and Society – £5.0m) and the reversal of fair value adjustments (Society – £20.4m).

The interest arising from the unwind of the discount of expected future recoveries is not material.

Debt Securities

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
At 1 January and 31 December	12.9	12.9	12.9	12.9

Provisions for impairment of debt securities relate to individually assessed cash collateralised debt obligations.

10. INVESTMENTS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Equities	1.4	2.1	1.4	2.1
Joint ventures	–	0.1	0.3	0.3
Subsidiaries	–	–	9,799.9	8,854.7
	1.4	2.2	9,801.6	8,857.1

NOTES TO THE ACCOUNTS continued

10. INVESTMENTS (continued)

Investment in equities

The Group holds equity investments relating to participation in banking and credit card service operations which are classified as available for sale assets. During the year an impairment charge of £0.7m (2011 – £nil) was made in respect of an investment in a private equity portfolio.

Investment in joint venture

The Group has a 50% interest in a joint venture, MutualPlus Ltd, a branch sharing company.

	2012 £m	2011 £m
Share of joint ventures		
Gross assets	0.3	0.3
Gross liabilities	(0.3)	(0.2)
	–	0.1

Investment in subsidiaries

Society	Shares £m	Loans £m	Total £m
Cost			
At 1 January 2012	222.0	8,653.6	8,875.6
Additions	–	2,184.8	2,184.8
Repayments	(107.7)	(1,121.9)	(1,229.6)
At 31 December 2012	114.3	9,716.5	9,830.8
Impairment losses			
At 1 January 2012	(0.5)	(20.4)	(20.9)
Provided in year	–	(10.0)	(10.0)
At 31 December 2012	(0.5)	(30.4)	(30.9)
Net book value			
At 31 December 2012	113.8	9,686.1	9,799.9
Cost			
At 1 January 2011	220.4	10,265.9	10,486.3
Acquired on transfer of engagement	1.7	218.9	220.6
Additions	–	691.7	691.7
Repayments	(0.1)	(2,522.9)	(2,523.0)
At 31 December 2011	222.0	8,653.6	8,875.6
Impairment losses			
At 1 January 2011	(0.5)	–	(0.5)
Provided in year	–	(20.4)	(20.4)
At 31 December 2011	(0.5)	(20.4)	(20.9)
Net book value			
At 31 December 2011	221.5	8,633.2	8,854.7

Income from interest in subsidiaries

The Society has recognised dividend income of £106.8m (2011 – £20.2m) from its subsidiaries.

The £10.0m impairment charge on loans to subsidiaries relates to a subsidiary that has a portfolio of equity release mortgages. At a Group level the impairment charge on the mortgages is recognised via impairment of loans and advances to customers.

10. INVESTMENTS (continued)

The Society has the following principal subsidiary undertakings, all of which are consolidated:

	Principal activity
Accord Mortgages Ltd	Mortgage lending
BCS Loans and Mortgages Ltd	Loan and mortgage broker
Chelsea Mortgage Services Ltd	Third party residential mortgage portfolios
YBS Investments (No. 1) Ltd	Non-trading
YBS Investments (No. 2) Ltd	Non-trading
YBS Properties (Edinburgh) Ltd	Property holding
YBS Properties Ltd	Property holding
Yorkshire Building Society Covered Bonds LLP	Mortgage acquisition and guarantor of covered bonds
Yorkshire Building Society Estate Agents Ltd	Non-trading
Yorkshire Guernsey Ltd	Non-trading
Yorkshire Investment Services Ltd	Non-trading
Yorkshire Key Services Ltd	Computer services
Brass No.1 PLC	Funding vehicle
Brass No. 2 PLC	Funding vehicle
Flexible Choice Ltd	Non-trading
Lynch Wood Services Ltd	Non-trading
Norwich and Peterborough Insurance Brokers Ltd	Non-trading
Norwich and Peterborough (LBS) Ltd	Mortgage finance
Norwich and Peterborough Sharedealing Services Ltd	Non-trading
Norwich and Peterborough Estate Agents Ltd	Non-trading
Norwich and Peterborough Covered Bonds LLP	Non-trading

All the companies are registered in England and operate in the United Kingdom except for Yorkshire Guernsey Ltd which is registered in Guernsey.

All the entities are wholly owned except for Yorkshire Building Society Covered Bonds LLP, Norwich and Peterborough Covered Bonds LLP, Brass No.1 PLC and Brass No.2 PLC. The Society's interests in these entities are, in substance, no different than if they were 100% held subsidiary undertakings and consequently they are consolidated in the Group accounts.

NOTES TO THE ACCOUNTS continued

11. TAX EXPENSE

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Current tax:				
UK corporation tax at 24.5% (2011 – 26.5%)	48.2	37.2	32.0	22.1
Corporation tax – adjustment in respect of prior periods	(1.1)	(16.1)	0.1	(16.1)
Overseas tax	–	(0.1)	–	–
Total current tax	47.1	21.0	32.1	6.0
Deferred tax (Note 20):				
Current year	(7.7)	3.0	(1.0)	1.4
Adjustment in respect of prior periods	(5.2)	(0.5)	(0.2)	(0.5)
Total tax expense in Income Statement	34.2	23.5	30.9	6.9

The actual tax expense/(credit) for the year differs from that calculated using the standard rate of corporation tax in the UK. The differences are explained below:

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Profit before tax	157.1	129.7	218.7	96.1
Tax calculated at a tax rate of 24.5% (2011 – 26.5%)	38.5	34.4	53.6	25.5
Effects of:				
Lower tax rate on overseas earnings	–	0.7	–	–
Income not subject to tax	(0.6)	(1.7)	(26.3)	(7.0)
Expenses not deductible for tax purposes	0.9	6.3	3.4	5.2
Adjustment to tax charge in respect of previous periods	(6.3)	(16.6)	(0.1)	(16.6)
Change in tax rate	1.7	0.4	0.3	(0.2)
Total tax expense in Income Statement	34.2	23.5	30.9	6.9
Tax (credit)/expense recognised directly in equity:				
Tax on available for sale securities	(1.8)	18.8	(1.8)	18.8
Tax on pension costs	(5.5)	4.9	(5.5)	4.9
Deferred tax on cash flow hedges	(7.0)	(1.0)	(7.0)	(1.0)
Adjustment to tax in respect of previous periods	(2.8)	9.1	(2.8)	9.1
Change in tax rate	6.4	4.6	6.4	4.7
	(10.7)	36.4	(10.7)	36.5

The main rate of corporation tax was reduced to 24% from 1 April 2012 and will reduce further to 23% from 1 April 2013.

12. SEGMENTAL REPORTING

This section analyses the Group's performance by business segment.

The chief operating decision maker has been identified as the Board, which reviews the Group's internal reporting and is responsible for all significant decisions. Financial information provided in the segmental reporting is consistent with that which is presented to the Board.

No segmental information is presented on geographical lines, because substantially all of the Group's activities are in the United Kingdom.

The Group's reportable segments under IFRS 8 'Operating Segments', based on the information reviewed by the Board, have been determined according to similar economic characteristics and the nature of the products and service. Details of the segments are listed below:

- Retail – this comprises prime residential owner occupied lending, non-owner occupied lending (including buy-to-let), non-prime lending, traditional member savings, non-traditional savings, off-shore savings (in Yorkshire Guernsey Limited) and consumer banking.
- Commercial – the commercial lending portfolio.
- Head office – this consists of head office supporting functions, such as the treasury function.
- Other – this includes supporting non-core business units.

Given recent expansion, the Group is currently in the process of developing its divisional analysis. The information below shows the current principal analysis. Please note, at present there is no recharging of funding across the Group.

The majority of the Group's revenues are in the form of interest and the Board monitors the Group's net interest income, to assess performance and direct the Group. Therefore, interest receivable and similar income has been shown net of interest payable and similar charges.

Income and directly attributable costs have been allocated to each segment as applicable, with support costs being apportioned based on levels of income.

	Notes	Retail £m	Commercial £m	Head office £m	Other £m	Total £m
2012						
Net interest income/(expense)		482.9	17.1	(154.0)	–	346.0
Non interest income and costs	a	39.4	0.7	77.9	8.2	126.2
Fair value		–	–	(11.8)	–	(11.8)
Management expenses	b	(187.2)	(1.6)	(60.2)	(1.0)	(250.0)
Operating profit/(loss) before provisions		335.1	16.2	(148.1)	7.2	210.4
Impairment of loans and advances to customers		(39.3)	–	–	–	(39.3)
Provisions		(6.1)	–	(7.9)	–	(14.0)
Profit/(loss) before tax		289.7	16.2	(156.0)	7.2	157.1
Tax (expense)/credit		(63.0)	(3.5)	33.9	(1.6)	(34.2)
Net profit/(loss)		226.7	12.7	(122.1)	5.6	122.9
Total assets		26,872.7	478.7	6,145.7	–	33,497.1
Total liabilities		27,208.4	–	4,655.8	–	31,864.2
Equity		–	–	1,632.9	–	1,632.9

NOTES TO THE ACCOUNTS continued

12. SEGMENTAL REPORTING (continued)

	Notes	Retail £m	Commercial £m	Head office £m	Other £m	Total £m
2011						
Net interest income/(expense)		517.3	7.2	(195.9)	–	328.6
Non interest income and costs	a	44.4	0.4	3.5	2.6	50.9
Fair value		–	–	(10.1)	–	(10.1)
Management expenses	b	(146.4)	(0.7)	(62.2)	(0.3)	(209.6)
Operating profit/(loss) before provisions		415.3	6.9	(264.7)	2.3	159.8
Impairment of loans and advances to customers		(30.1)	–	–	–	(30.1)
Provisions		(5.6)	–	–	–	(5.6)
Operating profit/(loss)		379.6	6.9	(264.7)	2.3	124.1
Negative goodwill	c	5.2	0.4	–	–	5.6
Profit/(loss) before tax		384.8	7.3	(264.7)	2.3	129.7
Tax (expense)/credit		(69.8)	(1.3)	48.0	(0.4)	(23.5)
Net profit/(loss)		315.0	6.0	(216.7)	1.9	106.2
Total assets		26,437.7	457.7	5,751.6	–	32,647.0
Total liabilities		26,322.9	–	4,766.5	–	31,089.4
Equity		–	–	1,557.6	–	1,557.6

Notes

- a Non interest income and costs includes fees and commissions receivable, fees and commissions payable, income from investments in subsidiaries, net realised profits and other operating income.
- b Management expenses include administrative expenses, merger and acquisition costs, depreciation and amortisation.
- c Negative goodwill, in 2011, arose from the merger with Norwich & Peterborough Building Society (N&P). As such, this goodwill has been apportioned according to the constituent elements of the N&P balance sheet.

13. CASH IN HAND AND BALANCES WITH THE BANK OF ENGLAND

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Cash in hand	17.0	18.9	17.0	18.9
Cash ratio deposit with the Bank of England	25.2	25.0	25.2	25.0
Other deposits with the Bank of England	4,123.1	1,554.5	4,123.1	1,554.5
	4,165.3	1,598.4	4,165.3	1,598.4

Cash ratio deposits are mandatory requirements of the Bank of England. They are not available for use in the Group's day to day operations. These balances are non-interest-bearing, whereas other deposits are at variable money market rates.

14. LOANS AND ADVANCES TO CREDIT INSTITUTIONS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Loans and advances to banks	573.7	582.3	361.3	362.6

Loans and advances to credit institutions are all due within one year.

15. DEBT SECURITIES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Debt securities issued by:				
Public bodies	133.6	1,448.2	133.6	1,448.2
Other borrowers	358.9	1,288.9	1,174.2	1,592.1
	492.5	2,737.1	1,307.8	3,040.3

All debt securities are listed on a recognised investment exchange.

Debt securities of £0.5bn (2011 – £2.0bn) are due in over one year.

Group	Held at fair value £m	Embedded Derivatives £m	Available for sale £m	Held to maturity £m	Total £m
Movements in debt securities during the year were:					
At 1 January 2012	16.2	(31.9)	2,182.0	570.8	2,737.1
Additions	–	–	825.1	–	825.1
Disposals and repayments	(6.2)	–	(2,638.8)	(431.8)	(3,076.8)
Exchange translation	–	–	(3.0)	(2.4)	(5.4)
Other changes in value	(5.1)	21.9	(4.5)	0.2	12.5
At 31 December 2012	4.9	(10.0)	360.8	136.8	492.5
Movements in debt securities during the year were:					
At 1 January 2011	17.5	(27.2)	2,820.4	804.5	3,615.2
Acquired on transfer of engagements	–	–	224.1	78.7	302.8
Additions	–	–	1,583.8	–	1,583.8
Disposals and repayments	–	–	(2,578.9)	(313.8)	(2,892.7)
Exchange translation	(0.6)	–	(0.5)	(2.4)	(3.5)
Other changes in value	(0.7)	(4.7)	133.1	3.8	131.5
At 31 December 2011	16.2	(31.9)	2,182.0	570.8	2,737.1

The disposals and repayments for the held to maturity category relate entirely to repayments.

A number of debt securities are structured so that they can pay a return over and above their regular coupon. This feature is regarded as an embedded derivative. The Group is unable to value this element separately from the host instrument so, in accordance with IAS 39, has designated these securities as being held at fair value with movements in value being taken to the Income Statement.

The Group also holds synthetic collateralised debt obligations, which also contain embedded derivatives. These embedded derivatives are separated from the host instrument and movements in fair value are taken to the Income Statement. The embedded derivative component is held at fair value.

NOTES TO THE ACCOUNTS continued

15. DEBT SECURITIES (continued)

Society	Held at fair value £m	Embedded Derivatives £m	Available for sale £m	Held to maturity £m	Total £m
Movements in debt securities during the year were:					
At 1 January 2012	16.2	(31.9)	2,182.0	874.0	3,040.3
Additions	–	–	825.1	600.0	1,425.1
Disposals and repayments	(6.2)	–	(2,638.8)	(521.2)	(3,166.2)
Exchange translation	–	–	(3.0)	(2.4)	(5.4)
Other changes in value	(5.1)	21.9	(4.5)	1.7	14.0
At 31 December 2012	4.9	(10.0)	360.8	952.1	1,307.8
Movements in debt securities during the year were:					
At 1 January 2011	17.5	(27.2)	2,711.8	804.5	3,506.6
Acquired on transfer of engagements	–	–	224.1	78.7	302.8
Additions	–	–	1,305.0	350.0	1,655.0
Disposals and repayments	–	–	(2,191.7)	(360.9)	(2,552.6)
Exchange translation	(0.6)	–	(0.4)	(2.4)	(3.4)
Other changes in value	(0.7)	(4.7)	133.2	4.1	131.9
At 31 December 2011	16.2	(31.9)	2,182.0	874.0	3,040.3

16. LOANS AND ADVANCES TO CUSTOMERS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Loans and advances to customers comprise:				
Loans secured on residential property				
Loans fully secured on residential property	27,044.9	26,408.3	17,320.2	18,057.0
Other loans secured on residential property	38.3	56.4	13.2	28.7
Fair value hedging adjustments	192.0	255.3	143.1	184.9
Impairment provisions	(62.1)	(60.7)	(6.1)	(3.5)
	27,213.1	26,659.3	17,470.4	18,267.1
Other loans				
Loans fully secured on land	354.6	351.0	354.6	351.0
Unsecured loans	4.7	11.9	4.7	11.9
	359.3	362.9	359.3	362.9

Loans and advances to customers are held at amortised cost, with interest and associated costs being recognised in the interest receivable and similar income line of the Income Statement on an effective interest rate basis. Amounts totalling £26.4bn (2011 – £26.1bn) are due in over one year.

Fair value hedging adjustments of £192.0m (2011 – £255.3m) have been made to certain fixed rate mortgages that are in fair value hedging relationships.

Note 35 details the extent to which these assets are encumbered.

17. INTANGIBLE ASSETS

	Goodwill £m	Software £m	Other £m	Total £m
Group				
Cost				
At 1 January 2012	–	55.1	26.9	82.0
Additions	–	15.8	–	15.8
Disposals	–	(22.5)	(8.4)	(30.9)
At 31 December 2012	–	48.4	18.5	66.9
Amortisation				
At 1 January 2012	–	43.5	8.1	51.6
Charged in year	–	5.5	3.0	8.5
Disposals	–	(22.5)	(5.0)	(27.5)
At 31 December 2012	–	26.5	6.1	32.6
Net book value				
At 31 December 2012	–	21.9	12.4	34.3
Cost				
At 1 January 2011	–	50.8	14.3	65.1
Additions	(5.6)	4.6	–	(1.0)
Acquired on transfer of engagements	–	–	12.6	12.6
Written off in the year	5.6	–	–	5.6
Disposals	–	(0.3)	–	(0.3)
At 31 December 2011	–	55.1	26.9	82.0
Amortisation				
At 1 January 2011	–	39.8	4.9	44.7
Charged in year	–	4.0	3.2	7.2
Disposals	–	(0.3)	–	(0.3)
At 31 December 2011	–	43.5	8.1	51.6
Net book value				
At 31 December 2011	–	11.6	18.8	30.4

Other intangible assets primarily comprise the intrinsic value of items acquired on mergers (current accounts, retail savings and brands) and an amount paid for the transfer of a number of employee sharesave schemes to the Society.

Amortisation is provided to write off the cost less the estimated residual value of intangible assets over their estimated useful economic lives of between one and ten years.

Any impairment in the value of intangible assets is dealt with through the Income Statement as it arises.

NOTES TO THE ACCOUNTS continued

17. INTANGIBLE ASSETS (continued)

	Goodwill £m	Software £m	Other £m	Total £m
Society				
Cost				
At 1 January 2012	–	44.6	26.9	71.5
Additions	–	15.8	–	15.8
Disposals	–	(13.0)	(8.4)	(21.4)
At 31 December 2012	–	47.4	18.5	65.9
Amortisation				
At 1 January 2012	–	33.2	8.1	41.3
Charged in year	–	5.4	3.0	8.4
Disposals	–	(13.0)	(5.0)	(18.0)
At 31 December 2012	–	25.6	6.1	31.7
Net book value				
At 31 December 2012	–	21.8	12.4	34.2
Cost				
At 1 January 2011	–	40.3	14.3	54.6
Additions	(5.6)	4.6	–	(1.0)
Acquired on transfer of engagements	–	–	12.6	12.6
Written off in the year	5.6	–	–	5.6
Disposals	–	(0.3)	–	(0.3)
At 31 December 2011	–	44.6	26.9	71.5
Amortisation				
At 1 January 2011	–	29.6	4.9	34.5
Charged in year	–	3.9	3.2	7.1
Disposals	–	(0.3)	–	(0.3)
At 31 December 2011	–	33.2	8.1	41.3
Net book value				
At 31 December 2011	–	11.4	18.8	30.2

18. INVESTMENT PROPERTIES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Cost				
At 1 January	29.9	22.9	29.7	22.7
Additions	0.1	0.1	0.1	0.1
Acquired on transfer of engagements	–	0.6	–	0.6
Disposals	(9.6)	(0.9)	(9.6)	(0.9)
Transfers	(0.1)	7.2	(0.1)	7.2
At 31 December	20.3	29.9	20.1	29.7
Depreciation				
At 1 January	4.4	4.2	4.4	4.2
Charged in year	0.3	0.4	0.3	0.4
Disposals	(1.7)	(0.2)	(1.7)	(0.2)
At 31 December	3.0	4.4	3.0	4.4
Net book value				
At 31 December	17.3	25.5	17.1	25.3
Fair value				
At 31 December	19.3	28.5	18.9	28.1

Transfers relate to the reclassification of assets between investment properties and property, plant and equipment.

Investment properties are generally flats and offices, ancillary to branch premises and not used by the Group. Rental income of £2.1m on investment properties has been included within other operating income (2011 – £2.3m).

Depreciation is provided by the Group to write off the cost less the estimated residual value of investment properties (excluding land) by equal instalments over their estimated useful economic life of 50 years.

Land is not depreciated. Any impairment in the value of properties is dealt with through the Income Statement as it arises.

The fair value of the Group's investment properties at 31 December 2012 has been arrived at on the basis of an internal valuation carried out by the Group's Estates Manager, an appropriately qualified surveyor.

The method used to estimate the fair value of investment properties is to obtain their market value as an approximation. Market value is calculated in accordance with the RICS Appraisal and Valuation Manual issued by the Royal Institution of Chartered Surveyors and is defined as 'the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion, assuming that the buyer is granted vacant possession of all parts of the property required by the business'.

The directors have considered the previous independent valuation of the investment properties undertaken on the basis of open market value. In the opinion of the directors the open market valuation of such investment properties as at 31 December 2012 was not materially different from their valuation incorporated in the financial statements.

NOTES TO THE ACCOUNTS continued

19. PROPERTY, PLANT AND EQUIPMENT

Group	Construction in progress £m	Land and buildings £m	Equipment fixtures, fittings and vehicles £m	Total £m
Cost				
At 1 January 2012	0.5	118.6	87.1	206.2
Additions	1.1	1.9	8.1	11.1
Disposals	–	(0.8)	(35.0)	(35.8)
Transfers	(1.6)	1.2	0.5	0.1
At 31 December 2012	–	120.9	60.7	181.6
Depreciation				
At 1 January 2012	–	22.5	74.1	96.6
Charged in year	–	2.8	4.7	7.5
Disposals	–	(0.6)	(34.9)	(35.5)
At 31 December 2012	–	24.7	43.9	68.6
Net book value At 31 December 2012	–	96.2	16.8	113.0
Cost				
At 1 January 2011	–	114.3	83.9	198.2
Additions	0.5	1.5	4.8	6.8
Acquired on transfer of engagements	–	10.0	–	10.0
Disposals	–	–	(1.6)	(1.6)
Transfers	–	(7.2)	–	(7.2)
At 31 December 2011	0.5	118.6	87.1	206.2
Depreciation				
At 1 January 2011	–	20.3	70.6	90.9
Charged in year	–	2.2	4.9	7.1
Disposals	–	–	(1.4)	(1.4)
At 31 December 2011	–	22.5	74.1	96.6
Net book value At 31 December 2011	0.5	96.1	13.0	109.6

Transfers relate to the reclassification of assets between property, plant and equipment and investment properties. In addition to this there is reclassification of assets from construction in progress to land and buildings, equipment, fixtures, fittings and vehicles as the assets are completed and put into service.

19. PROPERTY, PLANT AND EQUIPMENT (continued)

	Construction in progress £m	Land and buildings £m	Equipment fixtures, fittings and vehicles £m	Total £m
Society				
Cost				
At 1 January 2012	0.5	96.2	41.1	137.8
Additions	1.1	1.9	7.9	10.9
Disposals	–	(0.4)	(1.2)	(1.6)
Transfers	(1.6)	1.2	0.5	0.1
At 31 December 2012	–	98.9	48.3	147.2
Depreciation				
At 1 January 2012	–	17.9	28.6	46.5
Charged in year	–	2.2	4.7	6.9
Disposals	–	(0.4)	(1.0)	(1.4)
At 31 December 2012	–	19.7	32.3	52.0
Net book value				
At 31 December 2012	–	79.2	16.0	95.2
Cost				
At 1 January 2011	–	92.0	38.5	130.5
Additions	0.5	1.6	4.2	6.3
Acquired on transfer of engagements	–	9.8	–	9.8
Disposals	–	–	(1.6)	(1.6)
Transfers	–	(7.2)	–	(7.2)
At 31 December 2011	0.5	96.2	41.1	137.8
Depreciation				
At 1 January 2011	–	16.1	25.3	41.4
Charged in year	–	1.8	4.7	6.5
Disposals	–	–	(1.4)	(1.4)
At 31 December 2011	–	17.9	28.6	46.5
Net book value				
At 31 December 2011	0.5	78.3	12.5	91.3

Transfers relate to the reclassification of assets between property, plant and equipment and investment properties. In addition to this there is reclassification of assets from construction in progress to land and buildings, equipment, fixtures, fittings and vehicles as the assets are completed and put into service.

NOTES TO THE ACCOUNTS continued

20. DEFERRED TAX ASSETS AND LIABILITIES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
The movement on the net deferred tax asset is as follows:				
At 1 January	91.5	94.1	85.3	87.3
Acquired on transfer of engagements	–	33.2	–	32.3
Income statement credit/(charge)	12.9	(2.5)	1.2	(0.9)
Tax expense recognised directly in equity	(11.0)	(33.3)	(10.9)	(33.4)
At 31 December	93.4	91.5	75.6	85.3

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

Deferred tax assets				
Provision for loan impairment	0.4	0.6	0.3	0.4
Other provisions	0.2	0.7	0.2	0.7
Other temporary differences	0.5	0.4	0.5	0.4
Accelerated tax depreciation	4.1	5.0	4.0	4.9
Transfer of engagements – tax value of losses carried forward	13.8	15.1	13.8	15.1
Pensions and other post retirement benefits	3.3	5.1	3.3	5.1
Implementation of IAS 39 – mortgages and hedging	1.1	1.5	1.1	1.2
Cash flow hedging	17.7	12.1	17.7	12.1
Transfer of engagements – fair value adjustments	51.3	69.6	44.2	60.5
Fair value volatility on financial instruments in securitisation entities	13.2	–	–	–
	105.6	110.1	85.1	100.4
Deferred tax liabilities				
Pensions and other post retirement benefits	5.1	8.2	5.1	8.2
Accelerated tax depreciation	0.3	0.3	–	–
Implementation of IAS 39 – mortgages and hedging	3.7	5.3	3.1	4.5
Other temporary differences	0.5	1.5	0.4	1.4
Transfer of engagements – fair value adjustments	2.6	3.3	0.9	1.0
	12.2	18.6	9.5	15.1

Within deferred tax assets, are balances in respect of fair value adjustments and tax value of losses acquired on transfer of engagements, which are expected to be recoverable against future taxable profits (as projected in the latest Strategic Plan) within five to six years. The deferred tax assets have not been discounted.

The deferred tax (credit)/charge in the Income Statement comprises the following temporary differences:

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Accelerated tax depreciation	0.9	1.0	0.9	1.0
Pensions and other post retirement benefits	0.4	0.7	0.4	0.7
Other provisions	0.4	1.3	0.4	1.3
Other temporary differences	(1.7)	(2.1)	(1.9)	(1.9)
Release of fair value adjustments on merger	0.3	1.6	(1.0)	(0.2)
Fair value volatility on financial instruments in securitisation entities	(13.2)	–	–	–
	(12.9)	2.5	(1.2)	0.9

21. OTHER ASSETS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Prepayments and accrued income	16.1	17.9	11.3	12.2
Due from subsidiary undertakings	–	–	21.9	22.2
Other assets	2.9	4.6	1.5	3.2
	19.0	22.5	34.7	37.6

22. SHARES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Shares comprising balances held by individuals	26,962.4	26,145.4	26,962.4	26,145.4
Fair value adjustments	(144.9)	(172.0)	(144.9)	(172.0)
	26,817.5	25,973.4	26,817.5	25,973.4

23. AMOUNTS OWED TO CREDIT INSTITUTIONS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Amounts owed to:				
Banks	907.1	761.4	907.1	761.4
Other credit institutions	4.0	4.0	4.0	4.0
	911.1	765.4	911.1	765.4

24. OTHER DEPOSITS

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Amounts owed to:				
Group companies	–	–	1,695.8	1,198.1
Other customers	475.7	510.3	299.4	391.4
	475.7	510.3	1,995.2	1,589.5

Amounts due to Group companies comprise balances due to Yorkshire Building Society Covered Bonds LLP.

25. DEBT SECURITIES IN ISSUE

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Certificates of deposit	1.0	31.6	1.0	31.6
Fixed rate notes	1,264.0	1,985.3	1,264.0	1,985.3
Floating rate notes	1,382.6	488.1	536.6	141.5
Fair value hedging adjustment	136.7	86.2	136.7	86.2
	2,784.3	2,591.2	1,938.3	2,244.6

Debt securities in issue include Group £2.7bn (2011 – £1.7bn) and Society £1.9bn (2011 – £1.4bn) secured on certain loans and advances to customers. Further information is given in Note 35.

NOTES TO THE ACCOUNTS continued

26. RETIREMENT BENEFIT OBLIGATIONS

The Group operates one main employee benefit scheme (the Scheme), the costs of which are borne by the Society, with both defined benefit and defined contribution sections.

With effect from 1 November 2011, the Society operates a further additional defined benefit employee benefit scheme (the Norwich & Peterborough Scheme) in relation to the Society's transfer of engagements of Norwich & Peterborough Building Society. The Society also contributes to a group personal pension arrangement in relation to the Society's transfer of engagements of Norwich and Peterborough Building Society.

The assumptions and figures below include the Norwich & Peterborough Scheme where appropriate.

In addition, the Group operates unfunded defined benefit pension schemes for certain current and former members of staff. The present value at 31 December 2012 of the defined benefit obligation in relation to these schemes was £6.0m (2011 – £5.5m) and the relevant disclosures have been aggregated with those of the main employee benefits scheme.

Defined contribution post-employment benefits

In addition to the defined benefit section (see below) the Group operates a defined contribution section of the main scheme for new employees and for existing employees who are not members of a defined benefit scheme. The Group also contributes to a group personal pension arrangement in relation to the Society's transfer of engagements of Chelsea Building Society and Norwich and Peterborough Building Society. The total expense recognised for these defined contribution benefits is £6.2m (2011 – £4.8m).

Defined benefit post-employment benefits

The Group operates a funded defined benefit scheme for certain employees, providing benefits based on final salary. However, benefits earned by members of the defined benefit section of the main scheme since 1 April 2010 are based on career average revalued earnings. The assets of the scheme are held in a separate trustee-administered fund. Contributions are assessed in accordance with the advice of an independent qualified actuary using the projected unit method. The defined benefit section was closed to new employees in 2000.

The Group's policy for recognising actuarial gains and losses is to recognise them immediately in the Statement of Financial Position through the Statement of Comprehensive Income.

Summary of assumptions	31 Dec 2012	31 Dec 2011	31 Dec 2010	31 Dec 2009	31 Dec 2008
	%	%	%	%	%
Retail Prices index (RPI) Inflation	3.2	3.3	3.8	3.8	3.2
Consumer price index (CPI) inflation	2.7	2.3	3.1	n/a	n/a
Discount rate	4.5	4.9	5.5	5.7	6.4
Expected return on assets	4.9	4.9	6.3	6.3	5.9
Rate of increase in pay	4.2	4.3	5.3	5.3	4.7
Rate of increase of pensions in payment*					
subject to a min of 3% and a max of 5%	3.8	3.7	4.0	4.0	3.4
subject to a min of 0% and a max of 5%	3.0	3.1	3.8	3.8	3.2
subject to a min of 0% and a max of 3%	2.2	2.4	2.9	n/a	n/a
subject to a min of 0% and a max of 2.5%	2.0	2.1	2.4	2.4	n/a
Rate of increase for deferred pensions*					
subject to a min of 0% and a max of 5%	2.7	2.3	3.1	3.8	3.1
subject to a min of 0% and a max of 2.5%	2.5	2.3	2.3	n/a	n/a

*In excess of any Guaranteed Minimum Pension (GMP) element.

The expected return on assets has been derived as the weighted average of the expected returns from each of the main asset classes. The expected return for each asset class reflects a combination of historical performance analysis, the forward looking views of the financial markets (as suggested by the yields available) and the views of investment organisations.

26. RETIREMENT BENEFIT OBLIGATIONS (continued)

The most significant non-financial assumption is the assumed rate of longevity. The assumptions made are equivalent to the following life expectancies for scheme members at age 60:

	2012	2011
	Years	Years
For a current 60 year old male	28.5	28.4
For a current 60 year old female	28.2	28.1
For a current 45 year old male	30.3	30.2
For a current 45 year old female	29.5	29.4

Categories of assets	31 Dec	31 Dec	31 Dec	31 Dec	31 Dec
	2012	2011	2010	2009	2008
	%	%	%	%	%
Equities	28	26	32	44	42
Bonds	61	63	56	55	17
Cash and other	11	11	12	1	41
	100	100	100	100	100

Reconciliation of funded status	31 Dec	31 Dec	31 Dec	31 Dec	31 Dec
	2012	2011	2010	2009	2008
	£m	£m	£m	£m	£m
Present value of defined benefit obligation	(589.3)	(532.9)	(456.7)	(317.3)	(231.1)
Assets at fair value	607.8	564.6	442.5	313.0	259.9
Funded status/defined benefit asset/(liability)	18.5	31.7	(14.2)	(4.3)	28.8

The 2009 and 2008 balances include those of the Barnsley scheme, as follows:

Present value of defined benefit obligation	(9.9)	(8.0)
Assets at fair value	6.8	6.1
Funded status/defined benefit liability	(3.1)	(1.9)

The 2010 balances include those of the Chelsea scheme, as follows:

Present value of defined benefit obligation	(116.9)
Assets at fair value	106.6
Funded status/defined benefit liability	(10.3)

The 2012 and 2011 balances include those of the Norwich & Peterborough scheme, as follows:

Present value of defined benefit obligation	(90.5)	(79.5)
Assets at fair value	87.0	78.3
Funded status/defined benefit liability	(3.5)	(1.2)

Statement of comprehensive income (SCI)	2012	2011	2010	2009	2008
	£m	£m	£m	£m	£m
Actuarial (loss)/gain recognised in SCI	(22.5)	18.7	4.8	(50.4)	17.8
Cumulative actuarial gains/(losses) recognised at 1 January	20.8	2.1	(2.7)	47.7	29.9
Cumulative actuarial (losses)/gains recognised at 31 December	(1.7)	20.8	2.1	(2.7)	47.7

NOTES TO THE ACCOUNTS continued

26. RETIREMENT BENEFIT OBLIGATIONS (continued)

Experience gain and losses	2012	2011	2010	2009	2008
	£m	£m	£m	£m	£m
(Loss)/gain on change of assumptions	(44.9)	(19.4)	(5.9)	(80.0)	45.2
Gain on other experience	3.0	30.8	0.5	4.0	8.6
Experience gain/(loss) on assets	19.4	7.3	10.2	25.6	(36.0)
Actuarial (loss)/gain recognised in SCI	(22.5)	18.7	4.8	(50.4)	17.8

Components of pension expense as shown in the Income Statement	2012	2011
	£m	£m
Service cost	5.7	5.0
Interest cost	25.8	25.5
Expected return on assets	(27.5)	(28.3)
Total pension expense	4.0	2.2

Service cost is the Group's cost, net of employee contributions and inclusive of interest to the reporting date.

Reconciliation of present value of defined benefit obligation	2012	2011
	£m	£m
Present value of defined benefit obligation at 1 January	532.9	456.7
Acquired on transfer of engagements	–	73.6
Defined benefit service cost	5.7	5.0
Interest cost	25.8	25.5
Actuarial loss/(gain)	41.9	(11.4)
Defined benefit actual benefits paid	(17.0)	(16.5)
Present value of defined benefit obligation at 31 December	589.3	532.9

Movement in defined benefit fair value of assets		
Fair value of assets at 1 January	564.6	442.5
Acquired on transfer of engagements	–	75.8
Expected return on assets	27.5	28.3
Actuarial gain on assets	19.5	7.3
Defined benefit actual company contributions	13.2	27.2
Defined benefit actual benefits paid	(17.0)	(16.5)
Fair value of plan assets at 31 December	607.8	564.6

None of the assets were invested in the Group's own financial instruments (2011 – £nil) or property (2011 – £nil).

Estimated contributions in 2013

	2013
	£m
Society contributions	7.7
Employee contributions	–
Total contributions	7.7

Society contributions include £1.5m in relation to a salary sacrifice scheme whereby employees have accepted a reduction in salary in return for the Society agreeing to make the contributions that were previously paid by the employee.

27. OTHER LIABILITIES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Accruals and deferred income	28.8	31.6	27.2	26.7
Income tax deducted at source	43.8	40.8	43.8	40.8
Other	6.2	7.2	34.2	7.3
	78.8	79.6	105.2	74.8

28. PROVISIONS

Movements in provisions during the year were as follows:

	FSCS	Customer	Other	Total
	Levy	Redress		
Group and Society	£m	£m	£m	£m
At 1 January 2012	47.8	58.3	4.3	110.4
Amounts utilised during the year	(9.8)	(6.2)	(1.0)	(17.0)
Recoveries relating to amounts previously provided for	–	–	4.7	4.7
Provision charge/(release) during the year	6.1	9.0	(1.1)	14.0
At 31 December 2012	44.1	61.1	6.9	112.1
At 1 January 2011	40.8	9.0	0.6	50.4
Acquired on transfer of engagements	9.5	50.2	4.1	63.8
Amounts utilised during the year	(8.1)	(0.9)	(0.4)	(9.4)
Provision charge during the year	5.6	–	–	5.6
At 31 December 2011	47.8	58.3	4.3	110.4

Financial Services Compensation Scheme

The FSCS has borrowings of £18bn in the form of loans from HM Treasury as a consequence of the default of a number of deposit taking institutions. The FSCS levies member firms to recover the interest cost on those loans. Whilst it is anticipated that the majority of the loans will be recovered from the failed institutions (although not expected until the early 2020s), the FSCS has notified the sector of an expected shortfall of £802m. The FSCS plans to recover the shortfall by levying member firms, in three equal instalments beginning in the scheme year 2013/14. The Group's share of the shortfall is estimated to be £22m. Fair value adjustments were made on merger with Chelsea and Norwich and Peterborough building societies to provide for the possibility of such a shortfall.

The Group has recognised in this year's results a provision for a levy of £8.7m for the scheme year 2013/14, including £2.8m in respect of the shortfall, and a release of £2.6m for earlier scheme years due to interest rates being lower than anticipated.

The Group also has a potential exposure to future levies from capital losses, however the qualification and timing of such losses has yet to be determined. Accordingly the Group has not recognised a provision for such contingent liabilities.

Customer redress

Provisions have been made in respect of various customer claims. The largest provision (£47m) relates to financial advice mis-selling by Chelsea and Norwich and Peterborough building societies prior to their respective mergers with Yorkshire in 2010 and 2011 and is calculated using management's estimate of complaint volumes, redress payments and complaint handling costs. The remaining provision of £14m relates to sales of payment protection insurance (PPI), the majority of which (£12m) is in respect of policies sold by Norwich and Peterborough prior to the merger in 2011. Both the Norwich and Peterborough and Yorkshire PPI provisions are calculated using management's estimate of complaint volumes, referral levels to the Financial Ombudsman Service (FOS), claim rates upheld internally and by FOS, redress payments and complaint handling costs.

NOTES TO THE ACCOUNTS continued

28. PROVISIONS (continued)

Other

Other provisions include provisions for claims relating to negligent valuations undertaken prior to 2010 by a subsidiary of Norwich and Peterborough Building Society and property related provisions. The release in the year relates to a reduction in the estimated number of negligent valuation claims.

29. SUBORDINATED LIABILITIES

Group and Society	2012	2011
	£m	£m
6.63% Subordinated Bonds 2015	10.2	10.2
Floating Subordinated Bonds 2018	5.0	5.0
6% Subordinated Bonds 2019	–	25.9
11¾% Subordinated Bonds 2022	5.0	25.3
6¾% Subordinated Bonds 2024	4.1	51.7
13½% Convertible Tier 2 Capital Notes 2025	100.2	99.9
Fair value hedging adjustments	(1.7)	12.9
	122.8	230.9

During 2012 there was a major capital buyback exercise undertaken to take advantage of an opportunity to retire capital that under new regulatory rules now in place will mean our remunerated capital (including Subordinated Liabilities) will cease to be effective as regulatory capital over the next 5 years. Market conditions allowed us to buy back a significant proportion of this capital at a profit to the Society. The result of this buyback of subordinated liabilities after the impact of cancelling related hedge positions and fees was a profit of £10.7m.

All subordinated liabilities are denominated in sterling. The following notes are repayable at the dates stated or earlier at the option of the Society and with the prior consent of the Financial Services Authority under the following conditions:

- Redemption of all (but not some only) of the 11¾% Notes at par on 27 November 2017 after giving not less than thirty nor more than sixty days' notice to the holders. In the event the Society does not redeem the notes on 27 November 2017 the fixed rate of interest will become the greater of 11¾% and an aggregate of 3.10% and the then current five year benchmark Gilt rate.
- Redemption of all (but not some only) of the 13½ % Convertible Tier 2 Capital Notes will occur on 1 April 2025 unless the notes are converted to Profit Participating Deferred Shares (PPDS). The 'Conversion Trigger' shall occur if on any Calculation Date the Society's Consolidated Core Tier 1 Capital Ratio, as confirmed in a report of the auditor to the Society and addressed to the Board of Directors of the Society, is less than 5%. Should the Conversion Trigger occur on the 13½% Convertible Notes and these notes convert into PPDS, the PPDS will be perpetual in nature, ranking pari passu with the currently issued Subordinated Capital (detailed in Note 30).

The rights of repayment of the holders of subordinated liabilities are subordinated to the claims of all depositors, creditors and members holding shares in the Society, as regards the principal of their shares and interest due on them.

30. SUBSCRIBED CAPITAL

Group and Society	2012	2011
	£m	£m
5.649% Permanent Interest Bearing Shares	6.2	151.4
Fair value hedging adjustments	1.1	25.6
	7.3	177.0

30. SUBSCRIBED CAPITAL (continued)

As referred to in Note 29, during 2012 a major capital buyback exercise was undertaken which included the majority of our Subscribed Capital. The result of this buyback of subscribed capital after the impact of cancelling related hedge positions was a profit of £51.1m.

All Permanent Interest Bearing Shares (PIBS) are unsecured and denominated in sterling. Interest is payable half yearly on 27 March and 27 September. PIBS are repayable at the option of the Society, in whole, in March 2019 or any interest payment date thereafter.

Repayment requires the prior consent of the Financial Services Authority. If the PIBS are not repaid on a call date the interest rate is reset at a margin to the then prevailing LIBOR rate. They are deferred shares of the Society and the rights of repayment of the holders of PIBS are subordinated to the claims of all depositors, creditors, members holding shares in the Society and holders of subordinated liabilities, as regards the principal of their shares and interest due on them. The interest rate risk arising from the issuance of fixed rate PIBS has been mitigated through the use of interest rate swaps.

31. CAPITAL MANAGEMENT

More detail of capital management strategies can be found in the Risk Management Report on page 55.

	Group	
	2012	2011
	£m	£m
Tier 1		
General reserve	1,685.8	1,581.9
Subscribed capital	7.3	177.0
Pension fund adjustments *	(16.6)	(29.4)
Intangible fixed assets	(34.3)	(30.4)
Deductions from Tier 1 capital	(13.3)	(19.9)
	1,628.9	1,679.2
Tier 2		
Subordinated liabilities **	117.2	227.4
Collective allowances for impairment	6.3	8.0
Deductions from Tier 2 capital	(13.3)	(19.9)
	110.2	215.5
Other items excluded	(4.1)	(2.6)
Total capital	1,735.0	1,892.1
Risk weighted assets	11,905.7	11,964.6
Core Tier 1 ratio (%)	13.6%	12.6%
Tier 1 ratio (%)	13.7%	14.1%
Solvency ratio (%)	14.6%	15.8%

* The regulatory capital rules allow a pension fund surplus/deficit to be deducted from/added back to regulatory capital and in case of a deficit a deduction taken instead for an estimate of the additional contributions to be made in the next five years, less associated deferred tax.

** Subordinated liabilities are adjusted for amortisation in the regulatory capital value of instruments with less than five years to maturity.

The above ratios, deductions and definitions are in accordance with Financial Services Authority guidelines.

Throughout the year the Group Capital Committee has kept the Group's capital position under review as well as regulatory developments under Basel III.

NOTES TO THE ACCOUNTS continued

32. FINANCIAL COMMITMENTS

	Group and Society	
	2012	2011
	£m	£m
Committed undrawn standby facilities	171.9	155.0

The Society has an obligation under the Building Societies Act 1986 to discharge the liabilities incurred up to 11 June 1996 of all subsidiaries in so far as those subsidiaries are unable to discharge the liabilities out of their own assets. The Society has given undertakings whereby it has agreed to discharge the liabilities incurred after 11 June 1996 by certain of its subsidiaries, including Yorkshire Guernsey Ltd, in the event that these subsidiaries may be unable to discharge them out of their own assets. The Society accounts for these guarantees in accordance with 'IFRS 4 Insurance Contracts'.

Capital commitments contracted for at 31 December 2012, but for which no provision has been made in the accounts, amounted to Group £5.2m and Society £5.2m (2011 – Group £0.6m and Society £0.5m).

Amounts payable under non-cancellable operating leases are as follows:

Group	2012		2011	
	Land and buildings £m	Other £m	Land and buildings £m	Other £m
Within one year	5.2	1.1	4.7	1.1
Between one and five years	16.1	2.8	15.1	2.7
Over five years	22.0	–	18.4	–
	43.3	3.9	38.2	3.8

The Group is not in default on any of its financial liabilities or commitments.

33. FINANCIAL INSTRUMENTS

The table below summarises the main financial instruments, their significant terms and conditions and the accounting treatment adopted.

Financial instrument	Significant terms and conditions	Accounting treatment
Cash in hand and balances with the Bank of England	Short-term cash balances and Statutory deposits Fixed, variable and non-interest bearing rates	Amortised cost
Loans and advances to credit institutions	Short-term Fixed and variable interest rates	Amortised cost*
Debt securities	Short-term, medium-term and long-term Fixed and variable interest rates	Generally held at fair value as available for sale assets. Certain investments are held at fair value through the income statement or held to maturity at amortised cost. Detail is given in Note 15
Loans fully secured on residential property	Loan period is typically up to 25 years A variety of mortgage products offering fixed and variable interest rates	Amortised cost*
Derivative financial instruments	Primarily medium-term Value derived from underlying price, rate or index	Fair value through profit and loss
Intercompany deposit from Covered Bond Limited Liability Partnerships	Long-term Fixed and variable interest rates	Fair value through profit and loss
Investments	Investment in subsidiary companies	Amortised cost/cost
Shares	Deposits made by individuals Varying withdrawal notice periods Fixed and variable interest rates	Amortised cost*
Amounts owed to credit institutions and other customers	Primarily short-term Time Deposits Fixed and variable interest rates	Amortised cost*
Debt securities in issue	Short-term and medium-term Fixed and variable interest rates	Amortised cost*
Subordinated liabilities	Long-term Fixed and variable interest rates	Amortised cost*
Subscribed capital	Long-term Fixed interest rates	Amortised cost*

* Except where hedge accounting allows a fair value adjustment to be made for interest rate risk.

NOTES TO THE ACCOUNTS continued

34. DERIVATIVE FINANCIAL INSTRUMENTS

Instruments used for the management of market risk include derivative financial instruments (derivatives), which are contracts or agreements whose value is derived from one or more underlying price, rate or index inherent in the contract or agreement, such as interest rates, exchange rates or stock market indices.

Derivatives are only used by the Group in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and accordingly they are only used to reduce the risk of loss on core assets or liabilities arising from changes in interest rates, currency rates or other factors of a prescribed description.

The principal derivatives used in balance sheet risk management are interest rate swaps, interest rate options, cross-currency interest rate swaps, forward rate agreements, futures contracts and foreign exchange contracts. These are used to hedge Group exposures arising from fixed rate mortgage lending and savings products, funding and investment activities.

The following table describes the significant activities undertaken by the Group, the related risks associated with such activities and the type of derivatives which are typically used in managing such risks. Such risks may alternatively be managed using 'on-balance sheet' instruments as part of the Group's integrated approach to risk management.

Activity	Risk	Type of hedge
Management of the investment of reserves and other net non-interest bearing liabilities	Sensitivity to changes in interest rates	Interest rate swaps
Fixed rate savings products and options, forward fixed rate funding	Sensitivity to changes in interest rates	Interest rate swaps, forward rate agreements and futures
Fixed rate mortgage lending and options, forward fixed rate investments	Sensitivity to changes in interest rates	Interest rate swaps, equity release swaps, forward rate agreements and futures
Management of the interest basis risk arising from differences in the underlying pricing basis of assets and liabilities	Sensitivity to changes in relationships between interest rate bases	Interest rate swaps where one leg is referenced to LIBOR and the other to bank base rate
Equity linked investment products	Sensitivity to changes in equity indices	Equity linked interest rate swaps
Investment and funding in rate swaps and foreign currencies	Sensitivity to changes in foreign exchange rates	Cross-currency interest rate swaps and foreign exchange contracts

The Group's objective is to manage risk within its risk tolerance, irrespective of the accounting treatment.

Those derivative products which are combinations of more basic derivatives are used only in circumstances where the underlying position being hedged contains the same risk features. In such cases the derivatives used will be designed to match the risks of the underlying asset or liability and therefore to hedge the associated market risk.

Certain financial instruments (including some retail products) contain features that are similar to derivatives. In the majority of such cases, the Group manages the associated risks by entering into derivative contracts that match these features.

Whilst all derivatives have been entered into for hedging purposes, only certain ones have been designated as such for accounting purposes. In some cases a natural offset can be achieved without applying the requirements of IAS 39. The Group only designates hedges where a high degree of effectiveness can be achieved.

Fair value hedges are designated where interest rate swaps are used to minimise the variability in the fair value of fixed interest financial instruments (mainly fixed rate mortgages).

Cash flow hedges are designated where interest rate swaps are used to convert the interest rate variability on short-term financial instruments into fixed rates.

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

The following tables summarise the notional and fair value of all derivative financial instruments held at the year end and the hedging designations in place at that date.

Group	Contract/notional	Fair values	
	amount	Assets	Liabilities
At 31 December 2012	£m	£m	£m
Interest rate swaps designated as fair value hedges	4,038.7	37.8	205.6
Interest rate swaps designated as cash flow hedges	1,643.9	–	95.8
Cross-currency interest swaps designated as fair value hedges	3,253.3	148.5	63.5
Derivatives not designated as hedges:			
Interest rate swaps	8,296.0	153.4	78.6
Cross-currency interest rate swaps	40.8	4.8	–
Equity linked interest rate swaps	614.9	31.9	2.0
Call options	10.1	4.0	–
Forward foreign exchange	72.0	0.2	0.2
Interest rate options	12.0	–	–
Forward rate agreements	–	–	–
Equity release swaps	204.9	–	71.7
Total derivatives held for hedging	18,186.6	380.6	517.4
Society			
At 31 December 2012			
Interest rate swaps designated as fair value hedges	4,038.7	37.8	205.6
Interest rate swaps designated as cash flow hedges	1,643.9	–	95.8
Derivatives not designated as hedges:			
Interest rate swaps	10,310.0	153.4	147.5
Cross-currency interest rate swaps	40.8	4.8	–
Equity linked interest rate swaps	614.9	31.9	2.0
Call options	10.1	4.0	–
Forward foreign exchange	72.0	0.2	0.2
Interest rate options	12.0	–	–
Forward rate agreements	–	–	–
Equity release swaps	409.9	71.7	71.7
Total derivatives held for hedging	17,152.3	303.8	522.8

The Group continues to use discount curves based on term LIBOR rates to fair value both collateralised and non-collateralised positions. There is an increasing trend in the market for collateral held to be based on Overnight Index Swap (OIS) rather than LIBOR and the Group is currently assessing the implications of this.

Credit risk on derivative exposures is significantly mitigated within the Group by the existence of a Credit Support Annex (CSA) with the vast majority of our derivative counterparties. Under a CSA, cash is passed between parties to mitigate the counterparty risk inherent in the outstanding positions. Where cash collateral is received, to mitigate the risk inherent in amounts due to the Group, it is included as a liability within amounts owed to credit institutions. Where cash collateral is given to mitigate the risk inherent in amounts due from the Group, it is included as an asset in loans and advances to credit institutions.

NOTES TO THE ACCOUNTS continued

34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Group	Contract/notional amount	Fair values	
		Assets	Liabilities
At 31 December 2011	£m	£m	£m
Interest rate swaps designated as fair value hedges	5,448.8	55.8	273.1
Interest rate swaps designated as cash flow hedges	1,107.5	17.0	59.5
Cross-currency interest swaps designated as fair value hedges	1,251.4	100.2	–
Derivatives not designated as hedges:			
Interest rate swaps	12,245.4	171.1	161.0
Cross-currency interest rate swaps	58.5	14.2	–
Equity linked interest rate swaps	447.9	11.1	5.7
Call options	12.9	3.2	–
Forward foreign exchange	349.9	0.8	12.8
Interest rate options	117.0	0.2	–
Forward rate agreements	550.0	0.2	0.1
Equity release swaps	200.9	–	96.9
Total derivatives held for hedging	21,790.2	373.8	609.1
Society			
At 31 December 2011			
Interest rate swaps designated as fair value hedges	5,448.8	55.8	273.1
Interest rate swaps designated as cash flow hedges	1,107.5	17.0	59.5
Derivatives not designated as hedges:			
Interest rate swaps	12,245.4	171.1	171.7
Cross-currency interest rate swaps	58.5	14.2	–
Equity linked interest rate swaps	447.9	11.1	5.7
Call options	12.9	3.2	–
Forward foreign exchange	349.9	0.8	12.8
Interest rate options	117.0	0.2	–
Forward rate agreements	550.0	0.2	0.1
Equity release swaps	401.7	96.9	96.9
Total derivatives held for hedging	20,739.6	370.5	619.8

35. LIQUIDITY RISK

Liquidity risk is an intrinsic part of the Group's business as long-term mortgages are funded by short-term retail customer balances. Most mortgages have a contractual maturity date of around 25 years but in practice are frequently repaid early; currently the estimated average life of a mortgage is approximately five years. Conversely, experience shows that retail deposits, nominally repayable on demand or with short notice periods, actually remain with the Society for relatively long periods. It is this inherent mismatch in the maturity profiles of retail assets and liabilities that creates liquidity risk.

The Group's liquidity management policy is designed to ensure maintenance of adequate investments in liquid assets to cover statutory, regulatory and operational requirements. The primary function of liquidity is the provision of sufficient assets in realisable form to ensure the Group is able to meet its liabilities as they arise and to absorb potential cash flow requirements created by the maturity mismatches referred to above or by a liquidity stress scenario. The policy is further designed to delegate liquidity management, within limits and a structure established by the Board, as well as to monitor the composition of liquidity in line with risk management objectives.

The Group's liquidity management comprise the following key areas:

- Limits are established by the Board that govern the quantity, quality and marketability of and returns from the Group's portfolio of liquidity investments. The portfolio is managed by the Treasury function, monitored by the Risk function and overseen by the Group Asset and Liability Committee (GALCO) under a series of delegated authorities.
- The Group conducts a series of daily stress tests that are designed to ensure that its liquidity is sufficient to meet its cash flow needs under any one of a number of adverse scenarios should they arise. The scenarios include ones caused by both Group specific and general market events, and incorporate both severe retail savings outflows and the unavailability of wholesale funding. They are constructed on various timescales as far out as six months.
- The Society also manages liquidity in line with the regulatory requirements issued by the FSA in the form of the Individual Liquidity Guidance (ILG). This is set by the FSA following the submission and subsequent regulatory review of the Individual Liquidity Adequacy Assessment (ILAA). The ILG determines the amount of highly liquid collateral (government and supranational debt securities and cash) that the Society is required to hold. The ILAA document is updated on an annual basis, and approved by Group Risk Committee, and incorporates updates to both the ILG (which require regulatory review and approval before implementation) and internal liquidity stress test scenarios.

There are three key measures that the Group considers key to monitoring its liquidity position:

- Buffer liquidity – which analyses daily the amount of highly liquid collateral that it is deemed necessary to hold in a liquidity buffer, to absorb the worst-case stress scenario over the ensuing 3 months.
- Liquidity stress tests – where, as noted above, the Group models how far its liquid asset holdings would fall under a number of different stress scenarios.
- Wholesale refinancing gap – which sets a maximum permitted net wholesale outflow limit over the following two weeks.

Liquidity risk in subsidiary companies, with the exception of other deposits, is mitigated by the use of appropriate inter-company loans and deposits.

NOTES TO THE ACCOUNTS continued

35. LIQUIDITY RISK (continued)

Pledged assets ('Encumbrance')

Certain debt securities in issue (funding) are secured against the Group's assets.

The Society established Yorkshire Building Society Covered Bonds LLP in November 2006. The LLP provides security for issues of covered bonds made by the Society to external counterparties and also for the purposes of creating collateral. In March 2012 the Society issued a £500m 4 year deal.

The Group established its Brass No.2 PLC securitisation structure, on 1 October 2012, with a £1,200m issue secured against certain loans of Accord Mortgages Ltd, of which £600m was retained by the Yorkshire Building Society for use as collateral to potentially access funding schemes launched by the Bank of England.

	2012		2011	
	Assets pledged £m	Secured funding £m	Assets pledged £m	Secured funding £m
Secured against loans and advances to customers:				
Covered bonds	3,414.2	1,897.3	4,253.3	1,350.4
Securitisation	1,128.3	1,014.3	421.1	346.5
Secured against liquid assets	5.3	5.0	–	–

Pledged assets include those available to Yorkshire Building Society Covered Bonds LLP, Brass No.1 PLC and Brass No.2 PLC to provide collateral to support external funding transactions.

All of the assets pledged are retained in our Group's balance sheet as they substantially retain the risks and rewards relating to the loans.

The covered bond programme operates under a Mortgage Sale Agreement, where there is an equitable assignment of the loans from the Society to the LLP. Legal title remains with the Society and full transfer of title is not affected until the occurrence of certain 'perfection' events such as a failure to pay or breach of obligation on behalf of the Society or the insolvency of the Society or the LLP.

The securitisation programme operates under Mortgage Sale Agreements, where there is an equitable assignment of the loans from the Seller (Accord Mortgages Limited) to the Issuers (Brass No.1 PLC and Brass No.2 PLC). Legal title remains with Accord and full transfer of title is not affected until the occurrence of certain 'perfection' events such as it being directed by a regulatory authority, the Courts or the Society.

35. LIQUIDITY RISK (continued)

The tables below show contractual cash flows for all financial liabilities including interest payments. Further details of liquidity management are contained within the Risk Management Report on page 56.

Group	Repayable	In more than	Over five	Total
	on demand and up to one year £m	one year but not more than five years £m	years £m	
As at 31 December 2012				
Shares	21,747.5	5,419.0	1.7	27,168.2
Amounts owed to credit institutions	264.2	487.2	127.7	879.1
Other deposits				
Society	300.5	–	–	300.5
Subsidiaries	176.3	–	–	176.3
	476.8	–	–	476.8
Debt securities in issue	113.7	2,079.4	785.6	2,978.7
Subordinated liabilities	15.0	68.5	224.7	308.2
Subscribed capital *	0.3	1.4	1.7	3.4
Operating lease payments	6.3	18.9	22.0	47.2
Derivative financial liabilities	175.8	417.9	309.0	902.7
Total	22,799.6	8,492.3	1,472.4	32,764.3
Group				
As at 31 December 2011				
Shares	20,167.6	6,237.5	4.3	26,409.4
Amounts owed to credit institutions	278.4	353.4	136.6	768.4
Other deposits				
Society	395.1	–	–	395.1
Subsidiaries	110.7	–	–	110.7
	505.8	–	–	505.8
Debt securities in issue	913.9	1,105.9	785.6	2,805.4
Subordinated liabilities	21.8	86.4	337.0	445.2
Subscribed capital *	8.5	33.9	42.4	84.8
Operating lease payments	5.8	17.8	18.4	42.0
Derivative financial liabilities	230.7	395.2	328.9	954.8
Total	22,132.5	8,230.1	1,653.2	32,015.8

* The liquidity table includes interest payments on subscribed capital for ten years.

NOTES TO THE ACCOUNTS continued

36. MARKET RISK

Value at Risk (VaR)

VaR is a risk management tool which evaluates the potential losses that may be incurred as a result of movements in market conditions over a specified holding period and to a given level of confidence. The model used is based on a 10 day holding period and a 99% confidence level.

The VaR model calculates potential movements in market prices by reference to market data from the last 90 days and incorporates underlying risk factors based on historic interest rate volatilities and correlations.

VaR for the Treasury portfolios is calculated and reported on a daily basis and for the Group Statement of Financial Position on a monthly basis. A quarterly back test of the VaR model is performed to test the validity of the assumptions and parameters within the model.

A number of limitations should be considered in relation to the VaR model:

- Historic data is not necessarily a good guide to future events.
- The model, by definition, does not capture potential losses outside the 99% confidence level, particularly those events that are extreme in nature.
- VaR is calculated on the basis of exposures outstanding at the close of business and, therefore, does not necessarily reflect intra-day exposures.

VaR measures below are based upon full balance sheet positions excluding the investment of the Group's free reserves.

Structural risk analysis (basis risk)

An analysis of interest bearing items by rate type is performed to illustrate key areas of structural mismatch. It identifies mismatches between administered rates, fixed rates and other rates including those linked to Bank Base Rate and LIBOR. The effect of LIBOR mismatches within the Statement of Financial Position is measured as the impact on net interest income (for a 12 month rolling period) of an isolated increase in LIBOR of one basis point (0.01%).

Basis point value (BP) sensitivity

This measure calculates the change in value of the assets and liabilities resulting from a one basis point parallel shift in interest rates. Within the Treasury portfolio this is calculated and reported on a daily basis separately for each currency and at the full statement of financial position level on a monthly basis.

Repricing gap analysis

Repricing dates are analysed, primarily to avoid repricing risk concentrations – the situation where too great a proportion of the Group's assets and liabilities see the interest rates earned or charged on them resetting within a given time period. The aim is to prevent excessive volatility in the net interest margin that could arise if rates shifted adversely within a given time period, and since the Group cannot dictate interest rate movements themselves, the best approach is to limit the amount of assets or liabilities that are exposed in this way. The analysis identifies the net asset/liability repricing position across a series of time intervals. Positions are calculated using nominal amounts and exclude interest flows. General reserves, fixed assets and other liabilities are classified as having 'non-specific' repricing characteristics with a zero rate of interest. The measure is calculated as a reverse cumulative gap.

36. MARKET RISK (continued)

All market risk is managed in the Society on behalf of the Group, hence the tables below apply to both the Group and the Society.

2012	Year end £000	Average £000	Maximum £000	Minimum £000
VaR	2,911	3,055	5,548	790
Basis risk	153	45	153	(45)
BP sensitivity	334	134	334	(108)
		Greater than one year £m	Greater than five years £m	Greater than 10 years £m
Repricing gap		(1,582)	(103)	(8)

2011	Year end £000	Average £000	Maximum £000	Minimum £000
VaR	4,200	3,535	7,557	660
Basis risk	67	33	145	(98)
BP sensitivity	(123)	(77)	25	(147)
		Greater than one year £m	Greater than five years £m	Greater than 10 years £m
Repricing gap		25	(5)	(12)

Detail of how the Group manages its interest rate risk is included in the Risk Management Report on pages 56 to 57.

37. CURRENCY RISK

Currency exchange risk is monitored daily and the Group seeks to minimise its net exposure to assets and liabilities denominated in currencies other than sterling. Maximum positions throughout the year represented less than 0.01% of total assets. More detail of this policy can be found in the Risk Management Report on page 57. Actual exposures were:

	2012 £m	2011 £m
Year end	0.4	0.1
Maximum	0.4	1.9

NOTES TO THE ACCOUNTS continued

38. WHOLESALE CREDIT RISK

The Group's wholesale credit risk arises principally from assets held for liquidity purposes. The risk is that counterparties with whom the Group invests liquid assets fail to repay those investments when they fall due. The Group, through the Group Risk function, undertakes its own internal rating of all its counterparties and sets individual limits accordingly. These limits are reviewed at least annually, with revocation or suspension taking place where considered appropriate. The ratings are compared with those produced by external rating agencies at least annually.

Whilst recognising that exposures will be maintained across a spectrum of counterparties the Board has maintained a low risk appetite for wholesale credit risk resulting in our inter-bank exposures being limited to operational requirements subject to our internal ratings process. Primary liquidity holdings are buffer eligible and restricted to the Bank of England, UK Government and Multilateral Development Banks. Individual exposure limits are set according to the internal credit rating applied to a given institution. Limits are in place governing the types of instrument in which the Group will invest, as well as geographic and sector limits designed to prevent overexposure to a given country or business type. The following table breaks down exposures using Basel methodology and composite external ratings and includes RMBS and Structured Credit Investments.

	2012	2011
	%	%
AAA	88	81
AA+ to AA-	5	7
A+ to A-	6	7
Other	1	5
	100	100

The Society uses an internal credit ratings process to help identify potential risks. Wholesale related credit risks are reported and discussed at the Group Wholesale and Commercial Credit Committee and this has resulted in the avoidance of both Sovereign and direct counterparty exposures to countries such as Ireland, Portugal, Italy and Greece.

The Society's only Sovereign exposure is in the UK. At the year end, Sovereign exposure to the UK was £4,148m (2011 – £1,579m) to the Bank of England and £111m (2011 – £1,369m) in UK Government bonds (Gilts).

All wholesale exposures (including structured credit and RMBS) are to financial institutions within major industrial countries. The largest exposure to a single institution (other than the UK Government & Multilateral Development Banks) was £242m (2011 – £195m) in both instances to a UK clearing bank.

38. WHOLESale CREDIT RISK (continued)

Country	Wholesale Exposures (including RMBS & Structured Credit Investments) at 31 December 2012 (£m)	Wholesale Exposures (including RMBS & Structured Credit Investments) at 31 December 2011 (£m)
United Kingdom	4,806.5	3,971.7
Multilateral Development Banks	153.3	321.7
Ireland	27.6	249.3
Australia	0.4	85.3
Switzerland	31.0	23.4
Austria	–	55.1
Netherlands	28.0	28.8
United States	43.9	20.0
Cayman Islands	21.9	22.9
Germany	2.4	9.0
Luxembourg	–	8.4
France	1.1	2.1
Denmark	0.4	1.2
Belgium	–	0.1
Spain	–	0.1
Italy	–	–
Greece	–	–
Portugal	–	–

The Society has maintained its low risk appetite for wholesale credit risk to financial institutions outside the UK. The maximum gross exposure to any one country other than the UK and Multilateral Development Banks as at 31 December 2012, (including structured and money market fund exposures) was £43.9m (2011 – £249.3m). The exposures listed above for Ireland consists of a £9.4m 'AAA' rated money market fund exposure and £18.2m structured assets all domiciled in Ireland.

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.

In addition to the above direct exposures the Group regularly monitors its indirect exposures (the primary exposures of our counterparties) to establish whether any second order concentration risks exist. This is performed on a best efforts basis given the inconsistency and timings of information that exists in the public domain with regard to this information.

The key trigger events used to evaluate impairments are set out in Note 1 on pages 78 and 79.

NOTES TO THE ACCOUNTS continued

38. WHOLESALE CREDIT RISK (continued)

Wholesale credit risk is recorded in the following Statement of Financial Position captions:

	2012	2011
	£m	£m
Cash in hand and balances with the Bank of England	4,165.3	1,598.4
Loans and advances to credit institutions	573.7	582.3
Debt securities	492.5	2,737.1
Derivative financial instruments	380.6	373.8
Investments (Note a)	1.4	2.2
Total wholesale credit risk	5,613.5	5,293.8

Debt securities, which are shown after fair value and impairment adjustments, can be further analysed as:

UK Government securities	133.6	1,448.2
Medium-term notes issued by financial institutions	171.2	664.5
Certificates of deposit	–	–
Mortgage backed securities (Note b)	133.7	567.6
Combination note (Note c)	4.9	10.0
Synthetic credit investments (Note d)	26.3	25.2
Cash collateralised debt obligations (Note e)	22.8	21.6
	492.5	2,737.1

- (a) Principally an equity investment in VocaLink Holdings Limited which is associated with the Group's operation of cash machines.
- (b) Mortgage backed securities are all backed by AAA rated UK prime residential mortgages.
- (c) The combination note continues to pay contractual coupons with no evidence of impairment. Changes in fair value are taken directly to the Income Statement.
- (d) There are three holdings in synthetic credit investments. These contain embedded derivatives that have been separated with changes in fair value being taken directly to the Income Statement.
- (e) There are investments in five cash based collateralised debt obligations, each of which continues to perform and there is no evidence of any impairment. These investments have been classified as available for sale.

39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS

Credit risk management

The Group articulates its desired level of credit risk through a series of risk appetite statements. These statements are supported by a number of qualitative and quantitative measures that are monitored closely by the Group Risk function and reported monthly to the Group's credit risk committees. Further challenge and oversight is provided by the Group Risk Committee which reviews credit risk reporting as part of their quarterly meetings.

The Group's exposure to retail credit risk can be broken down as follows:

	Group		Society	
	2012 £bn	2011 £bn	2012 £bn	2011 £bn
Retail mortgages	27.4	26.8	17.6	18.4
Commercial lending	0.4	0.4	0.4	0.4
Retail unsecured lending	<0.1	<0.1	<0.1	<0.1
Total gross exposure (contractual amounts)	27.8	27.2	18.1	18.8
Impairment, fair value and hedging adjustments	(0.2)	(0.2)	(0.2)	(0.2)
Total net exposure	27.6	27.0	17.9	18.6

Retail mortgages

The Group's exposure to mortgage related credit risk is monitored closely by the Retail Credit Risk area within Group Risk. Reporting on risk exposures is provided monthly to the Retail Credit Risk Committee. Reports include analysis of the movement of loans into arrears and between arrears bands by differing loan portfolios and loan characteristics (e.g. loan-to-value), as well as monitoring of the overall characteristics of the loan portfolios (e.g. geographic location, indexed loan-to-value concentrations and income multiples). In addition, Group Risk undertakes a number of stress tests that subject the mortgage portfolios to different levels of default, house price deflation and other factors to identify the potential loan losses under the different economic conditions represented by those stress tests.

At an operational level, adherence to the Group's retail credit risk appetite is supported through the use of a suite of tools used in activities such as credit decisioning, portfolio management and arrears management.

Geographic distribution of retail mortgage balances

	2012 %	2011 %
Scotland	7	8
North East	4	4
Yorkshire & Humberside	11	11
North West	11	11
Midlands	13	12
East of England	5	6
South West	6	6
Greater London	19	17
South East	20	20
Wales & Northern Ireland	4	5
	100	100

NOTES TO THE ACCOUNTS continued

39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

Substantially, all retail mortgage balances are secured on property. As part of the portfolio monitoring process, these properties are subject to regular updates in respect of their loan-to-value by way of an indexation process. This is applied to provide some measure of relative house price movements across the UK and their impact on the relative properties values. Although the indexation approach is very broad, typically at the regional level, it is an industry standard for providing senior management with a view as to the value and risk of the properties on which retail mortgages are secured. The retail credit risk area maintains oversight of the suitability of the indexation approach, process and its application on a regular basis.

	Book		New Lending	
	2012	2011	2012	2011
	%	%	%	%
Greater than 90%	16	18	–	–
75% to 90%	26	25	36	30
50% to 75%	36	33	54	60
Less than 50%	22	24	10	10
	100	100	100	100

The Group has continued to restrict the loan-to-values permitted on new lending. The average indexed loan-to-value, based on a simple average of each loan's indexed loan-to-value, is 55% (2011 – 54%).

	Book		New Lending	
	2012	2011	2012	2011
	%	%	%	%
First time buyer	18	17	22	24
Other buyers, i.e. movers	42	40	44	45
Remortgage	35	34	32	31
Buy-to-let	5	8	2	–
Other	–	1	–	–
	100	100	100	100

	Group		Society	
	2012	2011	2012	2011
	%	%	%	%
Arrears outstanding as a percentage of debt				
No arrears	93.54	93.61	94.37	95.04
Less than three months	4.77	4.13	4.46	3.56
Three to six months	0.86	1.12	0.62	0.70
Six to 12 months	0.41	0.60	0.27	0.35
12 months or over	0.17	0.23	0.10	0.15
Property in possession	0.25	0.31	0.18	0.20
	100.00	100.00	100.00	100.00

Number of properties in possession at the year end	471	545	240	283
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The percentage of retail mortgages with arrears of three months or more has fallen during 2012 despite the challenging economic environment. The Group's retail mortgage arrears ratio is below CML comparables. Arrears on more recent lending are minimal, reflecting the Group's credit risk appetite.

Commercial lending

Commercial lending credit risk exposures are monitored by Group Risk and reported to the Group Wholesale Credit Committee. Reporting includes analysis of the movement of loans into arrears and between arrears bands by differing loan portfolios and loan characteristics (e.g. loan-to-value, risk grades), as well as monitoring of the overall characteristics of the loan portfolios (e.g. geographic location, risk grade, loan-to-value concentrations).

39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

The properties on which commercial mortgages are secured are located across England, Wales and Scotland and comprise a range of industrial and commercial premises, offices, leisure and retail units spanning a range of business sectors. Loans against specialist properties are strictly limited, with only a single property, a sporting facility, falling into this category. There are no loans secured against land only. The Group assesses whether current valuations are appropriate by re-valuing properties periodically using third party valuation data which takes into account the property type and geographical location. Third party valuation data is also used to assess the risk of loss on individual loans to monitor whether loan-to-value covenants are met. Where borrowers are more than two months in arrears, consideration is given to obtaining a professional valuation of the property.

At 31 December 2012 the Group has a commercial lending book of £439m. The Group only originates commercial lending via its N&P brand. The N&P commercial loan portfolio is managed by a specialist team using a combination of lending policy rules, underwriting and close relationship management to assess new applicants and manage existing loans. Loans were advanced against commercial properties using a vacant possession valuation to mitigate against future losses.

This proactive approach to account management has resulted in 0.19% of accounts being more than three months in arrears as at the year end (2011 – 0.17%). While arrears and losses to date have been low, as part of the merger, all N&P's commercial loans were subject to a fair value adjustment to reflect likely future losses on the portfolio.

The Chelsea commercial loan portfolio is in run-off with only 10 loans (including commercial buy-to-let) remaining.

The commercial loan portfolio is spread throughout the UK as follows:

Geographic distribution of commercial mortgage balances	2012	2011
	%	%
Scotland	3	3
North East	2	2
Yorkshire & Humberside	3	4
North West	9	10
Midlands	12	13
East of England	9	10
South West	7	7
Greater London	31	28
South East	22	21
Wales	2	2
	100	100

The average loan-to-value of the commercial mortgage balances is 73% (2011 – 65%).

Retail unsecured lending

The Group originates unsecured lending in the form of current accounts, via its N&P brand. In addition, the Group has an N&P branded personal loan portfolio that is in run-off. As at 31 December 2012 unsecured lending balances stood at £14m (current account overdrafts of £3.7m and personal loans of £10.3m). Within the Group, unsecured lending is managed by the Retail Credit Risk area within Group Risk, with monthly reporting provided to the Retail Credit Committee. Reporting includes analysis of accounts in arrears and overdraft limits.

Current account overdrafts are assessed and managed using a combination of statistical credit models, lending policy rules and underwriting, with all overdraft limits reviewed on at least a monthly basis. Accounts are monitored closely for early signs of distress and advice offered to customers where deemed appropriate. Customers who are unable to repay overdrafts when due are passed to the Collections Department who review individual customer circumstances before deciding what appropriate action to take. As at 31 December 2012, accounts that have been in excess of their agreed overdraft for three or more consecutive months stand at 2.2% of the portfolio.

The personal loan portfolio is currently in run-off. Customers who are unable to repay personal loans are passed to the Collections Department who review individual customer circumstances before deciding what appropriate action to take. As at 31 December 2012, accounts three or more months in arrears stand at 12.8% of the portfolio.

At the point of merger, as with all N&P loan books, a fair value adjustment was applied against all unsecured lending.

NOTES TO THE ACCOUNTS continued

39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

Impairment

All loans (retail mortgage, commercial and unsecured) are reviewed on a monthly basis for indications of impairment. As at the year end, impairment on the overall loan balances is as follows:

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Not impaired:				
Neither past due nor impaired	25,942.1	25,369.5	16,965.5	17,788.0
Past due but not impaired	1,058.4	829.3	665.1	525.5
Impaired	810.9	1,000.3	419.9	490.6
Total loans and advances	27,811.4	27,199.1	18,050.5	18,804.1

Loans acquired from the Norwich & Peterborough and Egg in 2011, and the Chelsea in 2010, have been fair valued on a basis which makes allowances for anticipated losses over the remaining life of the loans. Impaired loans totalling £351.6m in the above analysis for 31 December 2012 have thus been fair valued and are, therefore, unlikely to contribute any significant further losses to the Group.

The following table shows a prudent assessment of collateral held against total loans and advances. The collateral is calculated as the lower of the value of the property and the outstanding loan amount. It is not the overall value of properties secured against the loans.

Group	Loans and advances		Collateral	
	2012 £m	2011 £m	2012 £m	2011 £m
Neither past due nor impaired	25,942.1	25,369.5	25,657.1	25,095.5
Past due but not impaired	1,058.4	829.3	1,035.8	810.8
Impaired	810.9	1,000.3	757.5	948.7
Total loans and advances	27,811.4	27,199.1	27,450.4	26,855.0
Society				
Neither past due nor impaired	16,965.5	17,788.0	16,757.8	17,587.9
Past due but not impaired	665.1	525.5	651.3	513.6
Impaired	419.9	490.6	391.1	464.6
Total loans and advances	18,050.5	18,804.1	17,800.2	18,566.1

Impairment is assessed based on the arrears of each loan. Where retail or commercial mortgages are in arrears by two months or more, they are individually assessed for impairment. All such mortgages that are past due but not impaired are less than two months in arrears. Where retail or commercial mortgages are less than two months in arrears they are assessed for collective impairment.

Note 1 on page 78 describes the Group's approach to impairment provisioning and the key factors used in the calculation. The key assumptions underpinning the current mortgage impairment provisions (shown in Note 9) are as follows:

Factor	Value or range	Derivation
Forecast house price inflation/(deflation)	2013 (1.60%) 2014 (0.30%) 2015 2.00% 2016 2.90%	Judgemental
Probability of default*	10% to 60% for impaired accounts depending on the degree of impairment	Judgemental and experience
Emergence period	3 to 6 months	Experience
Loss given default*	10% to 40% for impaired accounts	Current experience
Forced sale discount	25%	Current experience

* 'Default' is defined as the property being in possession.

39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

No overlays are applied in the calculation and there have been no changes in approach during 2012.

Personal loans are individually assessed for impairment where they are more than one month in arrears and assessed for collective impairment if they are one month or less in arrears.

All overdrawn balances on current accounts are assessed for impairment. The default rate applied being dependent on the period which has elapsed since the account was last in credit.

Forbearance

The Group uses forbearance tools where they are deemed appropriate for an individual customer's circumstances, and are used in line with industry guidance. Forbearance tools which the Group may offer include capitalisation, temporary interest only concessions, payments arrangements, payment holidays and term extensions. The use of account management tools are either fully recognised within provisioning or are low in materiality. The Arrears Transformation Programme will provide greater data granularity around the use of forbearance across the Group and its impact on provisions, enabling more comprehensive reporting in future years.

The analysis below sets out a total of £0.6bn mortgage balances which are subject to some form of forbearance in its widest sense. Balances totalling £0.3bn are more than two months in arrears and therefore fall within the Group's individual provision calculation. The remaining £0.3bn are covered by the Group's collective provision through the assumptions surrounding emergence period. There is nothing in the forbearance data to suggest that the impairment provisioning methodology or assumptions do not provide adequate cover in respect of lending which is subject to forbearance. Forbearance is included in mortgage provisions in the same way as any other debt, with that which is more than two months in arrears being recorded as impaired, and that which is less than or equal to two months being collectively assessed. If it were all to be incorporated as impaired the mortgage provision would increase from £62.1m to £62.8m.

Some of these forbearance tools are also applied on a small number of commercial mortgages with minimal values.

	Positive arrears arrange- ments*	Negative arrears arrange- ments**	Capital- isation	Payment holidays	Permanent interest only	Temporary interest only	Term extension	Direct debit suspension	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Not in arrears	18.8	1.1	4.6	3.3	87.3	27.0	14.8	17.9	174.8
Less than one month	87.7	1.7	1.0	0.2	2.2	5.4	1.1	3.9	103.2
One to two months	70.2	1.9	0.4	0.6	1.4	4.7	0.3	5.0	84.5
Two to three months	61.9	1.3	–	–	0.3	2.3	–	1.1	66.9
Three to six months	109.2	0.6	–	–	0.7	2.6	–	0.5	113.6
Six to 12 months	63.2	0.2	–	–	0.4	1.1	–	0.2	65.1
12 months or over	17.7	0.3	–	–	0.2	0.2	–	–	18.4
Property in possession	8.4	–	–	–	–	0.1	–	–	8.5
	437.1	7.1	6.0	4.1	92.5	43.4	16.2	28.6	635.0

* A positive arrears arrangement is one where the customer's regular monthly repayment is in excess of their contractual repayment amount in order to reduce their arrears.

** A negative arrears arrangement is one where an agreement is in place, due to the borrower's circumstances, that allows the customer to repay less than their contractual repayment amount for a short period. In this circumstance arrears will continue to accrue on the unpaid amounts.

NOTES TO THE ACCOUNTS continued

40. FAIR VALUES

The tables below are a comparison of book and fair values of the Group's financial instruments by category as at the statement of financial position date. Where external market prices are available they have been used to determine fair value. Otherwise, internal pricing models using external market data have been used.

Group	2012		2011	
	Book Value £m	Fair Value £m	Book Value £m	Fair Value £m
Assets				
Cash in hand and balances with the Bank of England	4,165.3	4,165.3	1,598.4	1,598.4
Loans and advances to credit institutions	573.7	573.7	582.3	582.3
Debt securities – fair value	4.9	4.9	16.2	16.2
Debt securities – embedded derivative	(10.0)	(10.0)	(31.9)	(31.9)
Debt securities – available for sale	360.8	360.8	2,182.0	2,182.0
Debt securities – held to maturity	136.8	133.0	570.8	560.6
Loans and advances to customers	27,572.4	27,876.4	27,022.2	27,612.4
Investments	1.4	1.4	2.2	2.2
Liabilities				
Shares	26,817.5	26,974.4	25,973.4	25,973.4
Amounts due to credit institutions	911.1	911.1	765.4	765.4
Other deposits	475.7	475.7	510.3	510.3
Debt securities in issue	2,784.3	2,798.8	2,591.2	2,546.9
Subordinated liabilities	122.8	157.7	230.9	205.1
Subscribed capital	7.3	5.1	177.0	95.9
Society				
Assets				
Cash in hand and balances with the Bank of England	4,165.3	4,165.3	1,598.4	1,598.4
Loans and advances to credit institutions	361.3	361.3	362.6	362.6
Debt securities – fair value	4.9	4.9	16.2	16.2
Debt securities – embedded derivative	(10.0)	(10.0)	(31.9)	(31.9)
Debt securities – available for sale	360.8	360.8	2,182.0	2,182.0
Debt securities – held to maturity	952.1	954.6	874.0	860.4
Loans and advances to customers	17,829.7	17,907.1	18,630.0	18,950.4
Investments	9,801.6	9,801.6	8,857.1	8,857.1
Liabilities				
Shares	26,817.5	26,974.4	25,973.4	25,973.4
Amounts due to credit institutions	911.1	911.1	765.4	765.4
Other deposits	1,995.2	1,995.2	1,589.5	1,589.5
Debt securities in issue	1,938.3	1,945.6	2,244.6	2,204.4
Subordinated liabilities	122.8	157.7	230.9	205.1
Subscribed capital	7.3	5.1	177.0	95.9

Fair values of derivative financial instruments are shown in Note 34.

The fair values of all cash in hand, balances with the Bank of England and loans and advances to credit institutions have been recorded at par as they are all due in under one year and there is no impairment.

The fair values of debt securities are determined wherever possible from external market prices. Where reliable prices are not available, valuations are determined using models and externally verifiable market factors. The main inputs used in these models are underlying asset credit ratings, credit spreads, defaults in underlying instruments and credit enhancement or subordination factors.

40. FAIR VALUES (continued)

Loans and advances to customers are initially recorded at fair value plus any attributable costs and less any attributable fees and are subsequently held at amortised cost less any impairment losses, other than where an adjustment is made to certain fixed rate mortgages that are in hedging relationships. In addition, a fair value adjustment in relation to mortgage balances acquired as part of mergers takes account of the differential between market rates and product rates. Also as part of the mergers, mortgage loan balances were subject to fair value adjustments to reflect anticipated future losses on the portfolios in line with IFRS 3 'Business Combinations'. Consequently, a significant proportion of such balances are held on balance sheet at fair value. Overall the fair value is higher than carrying value by £304m which arises primarily due to the product rates being above prevailing market rates.

The fair value of loans and advances to customers has been calculated on an individual loan basis taking into account factors such as impairment and interest rates. It is not considered appropriate to value them collectively as a portfolio sale. The estimated fair value of fixed rate loans represents the discounted amount of estimated future cash flows expected to be received. Expected cashflows are discounted at current market rates to determine fair value. Impairment is calculated on an incurred loss basis except to the extent that acquired mortgage books have been fair valued on a basis which makes allowances for anticipated losses over the remaining life of the loans.

All of the Group's financial liabilities are initially recorded at fair value less directly attributable costs and are subsequently measured at amortised cost other than derivative financial instruments or where an adjustment is made to certain fixed rate shares balances that are in hedging relationships. In addition, shares balances acquired as part of mergers are carried at fair value in accordance with IFRS 3 'Business Combinations'. Consequently the carrying value and the fair value are similar and in 2011 were not materially different. In 2012, the estimated fair value of share balances is now higher than the carrying value by £157m which arises primarily due to the product rates being above prevailing market rates.

The fair value of debt securities, subordinated liabilities and subscribed capital are calculated using observable market prices. The fair value of subordinated liabilities is higher than carrying value by £34.9m which arises primarily due to the interest rates on the notes being significantly above prevailing market rates.

The table below classifies all financial instruments held at fair value according to the method used to establish the fair value.

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Investments classified as Level 3 are principally unquoted equity investments related to the operation of cash machines (see Note 10).

Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2012				
Debt Securities – fair value	–	4.9	–	4.9
Embedded derivatives	–	(10.0)	–	(10.0)
Debt Securities – available for sale	301.7	59.1	–	360.8
Investments	–	–	1.4	1.4
Derivative assets	–	380.6	–	380.6
Derivative liabilities	–	(517.4)	–	(517.4)
	301.7	(82.8)	1.4	220.3

NOTES TO THE ACCOUNTS continued

40. FAIR VALUES (continued)

Group	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
As at 31 December 2011				
Debt Securities – fair value	6.2	9.9	–	16.1
Embedded derivatives	–	(31.9)	–	(31.9)
Debt Securities – available for sale	2,126.2	55.8	–	2,182.0
Investments	–	–	2.2	2.2
Derivative assets	–	373.8	–	373.8
Derivative liabilities	–	(609.1)	–	(609.1)
	2,132.4	(201.5)	2.2	1,933.1

41. RELATED PARTIES

Identity of related parties

The Group and Society have related party relationships with their subsidiaries, joint venture, the pension schemes and key management personnel. The Group considers its key management personnel to be its directors.

Contributions to the pension scheme

The Society paid contributions of £19.4m to the pension scheme (2011 – £32.0m).

Key management compensation

The key management personnel compensations are as follows:

	No. of key management personnel	2012 £000	No. of key management personnel	2011 £000
Short-term employee benefits		2,498		2,540
Post employment benefits		92		100
Total key management personnel compensation	12	2,590	13	2,640

Transactions with key management personnel

Key management personnel and their close family members have undertaken the following transactions with the Society under normal business terms.

	No. of key management personnel 2012	Amounts in respect of key management personnel and their close family members 2012 £000	No. of key management personnel 2011	Amounts in respect of key management personnel and their close family members 2011 £000
Mortgage loans				
At 1 January		508		758
Net movements in the year		(75)		(250)
At 31 December	2	433	2	508
Deposit accounts and investments				
At 1 January		734		796
Net movements in the year		348		(62)
At 31 December	11	1,082	12	734

41. RELATED PARTIES (continued)

Mortgage loans made to key management personnel and their close family members were granted in the ordinary course of business and are subject to repayment under normal lending terms. The maximum outstanding balances during the year were £507,894.

Amounts deposited by key management personnel and their close family members earn interest at the same rates offered to the public.

Key management personnel and their close family members paid interest totalling £8,538 (2011 – £22,141), received interest totalling £21,090 (2011 – £15,122), and paid no fees and commissions during the year. Interest paid reflects amounts relating to 'offset' mortgages where savings balances are used to reduce the interest bearing balance of mortgage loans.

Transactions with subsidiaries

The Society enters into a number of transactions with its subsidiaries in the normal course of business. These include loans and shares. The value of related party transactions, outstanding balances at the year end and related income and expense for the financial year are as follows:

	2012 £m	2011 £m
Shares in subsidiaries		
At 1 January	221.5	219.9
Acquired on transfer of engagements	–	1.7
Net movements	(107.7)	(0.1)
At 31 December	113.8	221.5
Loans to subsidiaries		
At 1 January	8,633.2	10,265.9
Acquired on transfer of engagements	–	218.9
Net movements	1,052.9	(1,851.6)
At 31 December	9,686.1	8,633.2
Deposits from subsidiaries		
At 1 January	1,198.1	4,172.4
Net movements	497.7	(2,974.3)
At 31 December	1,695.8	1,198.1
Interest receivable on loans	380.3	377.6
Interest payable on deposits	(41.8)	(59.0)
Fees and expenses receivable	23.0	18.5
Fees and expenses payable	(2.5)	(2.6)

Transactions with joint ventures

The Society holds 50% of the share capital of MutualPlus Ltd, a branch sharing company. The outstanding investment at 31 December 2012 and 31 December 2011 is less than £0.1m.

NOTES TO THE ACCOUNTS continued

42. CASH FLOWS FROM OTHER OPERATING ACTIVITIES

	Group		Society	
	2012 £m	2011 £m	2012 £m	2011 £m
Working capital adjustments:				
Depreciation and amortisation	16.3	14.7	15.6	14.0
Loss/(profit) on sale of assets	4.2	(0.6)	4.1	(0.6)
Interest on subordinated liabilities and subscribed capital	29.0	30.1	29.0	30.1
Provisions	53.3	35.7	28.0	2.4
Gain attributable to transfer of engagements	–	(5.6)	–	(5.6)
Fair value of subordinated liabilities and subscribed capital	(100.9)	14.4	(100.9)	14.4
Profit on realisation of debt securities	(77.9)	(3.5)	(77.9)	(3.5)
(Increase)/decrease in other assets	(8.3)	(11.6)	(8.9)	1.5
Decrease in other liabilities	(34.7)	(2.6)	20.4	(26.2)
Working capital adjustments	(119.0)	71.0	(90.6)	26.5
(Increase)/decrease in operating assets:				
Loans and advances to credit institutions	–	56.0	–	50.0
Loans and advances to customers	(565.6)	(1,167.0)	786.3	278.5
Investments	0.8	–	(944.5)	1,855.4
Derivative financial instruments	(112.5)	301.4	(45.9)	33.0
Net (increase)/decrease in operating assets	(677.3)	(809.6)	(204.1)	2,216.9
Increase/(decrease) in operating liabilities:				
Shares	844.1	1,897.8	844.1	1,897.8
Amounts owed to credit institutions	145.7	(166.0)	145.7	(956.4)
Other deposits	(34.6)	(850.1)	405.7	(2,274.1)
Net increase/(decrease) in operating liabilities	955.2	881.7	1,395.5	(1,332.7)

ANNUAL BUSINESS STATEMENT

1. STATUTORY PERCENTAGES

	2012 %	Statutory Limit %
Lending limit	3.3	25.0
Funding limit	13.5	50.0

The above percentages have been calculated in accordance with the provisions of the Building Societies Act 1986.

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

The Funding limit measures the proportion of shares and borrowings (excluding offshore deposits held by individuals) not in the form of shares.

The statutory limits are as laid down under the Building Societies Act 1986 and ensure that the principal purpose of a building society is that of making loans which are secured on residential property and are funded substantially by its members.

2. OTHER PERCENTAGES

	2012 %	2011 %
As a percentage of shares and borrowings:		
Gross capital	5.69	6.59
Free capital	5.18	6.06
Liquid assets	16.88	16.48
Profit after taxation for the financial year as a percentage of mean total assets	0.37	0.34
Management expenses as a percentage of mean total assets	0.76	0.67
Management expenses as a percentage of mean total assets adjusted for the effects of mergers, acquisitions and closures	0.71	0.61

The above percentages have been prepared from the Group accounts and in particular:

- 'Shares and borrowings' represent the total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue.
- 'Gross capital' represents the aggregate of general reserve, hedging reserve, available for sale reserve, subordinated liabilities and subscribed capital.
- 'Free capital' represents the aggregate of gross capital and collective impairment provision less property, plant and equipment, intangible assets and investment properties.
- 'Liquid assets' represent the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions, debt securities and other liquid assets.
- 'Mean total assets' represent the amount produced by halving the aggregate of total assets at the beginning and end of the financial year.
- 'Management expenses' represent the aggregate of administrative expenses, depreciation and amortisation.

ANNUAL BUSINESS STATEMENT continued

3. INFORMATION RELATING TO THE DIRECTORS AND OTHER OFFICERS AT 31 DECEMBER 2012

Director Name and Date of Birth	Business Occupation	Date of Appointment	Other Directorships
E. J. S. Anderson, BSc, CPFA 22 December 1950	Company Director	19 May 2003	Airport Operators Association Ltd Leeds International Pianoforte Competition Leeds Trinity University University of Leeds
Ms K. M. Barker, CBE 29 November 1957	Economist	5 November 2010	Electra Private Equity Plc Essex Community Foundation Kate Barker Ltd Pro Bono Economics Society of Business Economists Taylor Wimpey Plc
I. J. Bullock, BSc, FIA 7 November 1960	Building Society Sales and Marketing Director	12 April 2007	Accord Mortgages Ltd BCS Loans & Mortgages Ltd MutualPlus Ltd
R. F. Burden, PhD (hon), FCIB, MBCS, FRSA 3 June 1946	Company Director	1 April 2010	Football Association Ltd Gloucestershire Football Association Ltd The Football Foundation
A. M. Caton, BA 27 July 1963	Building Society Corporate Development Director	1 July 2004	Bradford Chamber of Commerce and Industry CBS Capital Ltd CBS Nominees Ltd Chelsea Building Society Charitable Foundation Chelsea Mortgage Services Ltd YBS Investments (No. 1) Ltd YBS Investments (No. 2) Ltd Yorkshire Building Society Charitable Foundation Yorkshire Guernsey Ltd Yorkshire Investment Services Ltd
Mrs L. F. Charlesworth, BA, MBA 24 August 1956	Company Director	31 December 2006	St. James Investments Ltd St. James Investment Company UK No. 3 Ltd
R. J. Churchouse, MA, ACA 16 January 1966	Finance Director	1 June 2010	BCS Loans and Mortgages Ltd CBS Capital Ltd CBS Nominees Ltd Chelsea Mortgage Services Ltd Flexible Choice Ltd Norwich and Peterborough General Insurance Services Ltd Norwich and Peterborough Sharedealing Services Ltd Waters Lunniss Nominees Ltd YBS Investments (No. 1) Ltd YBS Investments (No. 2) Ltd Yorkshire Building Society Estate Agents Ltd Yorkshire Investment Services Ltd Yorkshire Key Services Ltd Yorkshire Key Services (No. 2) Ltd

3. INFORMATION RELATING TO THE DIRECTORS AND OTHER OFFICERS AT 31 DECEMBER 2012 (continued)

Director Name and Date of Birth	Business Occupation	Date of Appointment	Other Directorships
P. R. Johnson, FCA 12 October 1946	Chartered Accountant	1 June 2007	Cheadle Hulme School
D. V. Paige, BSc, FCA 3 July 1951	Company Director	31 December 2006	IFG Group PLC Willis Ltd
C. J. Pilling, MA 30 March 1965	Building Society Chief Executive	31 December 2011	Department of Health
S. Turner, BSc 29 November 1951	Company Director	13 October 2005	Identive Group Inc TradeDoubler AB

The standard contractual notice period for all executive directors is one year. Mr I. J. Bullock, Mr A. M. Caton and Mr R. J. Churchouse entered into renegotiated contracts in 2009 and Mr C. J. Pilling entered into a contract on 31 December 2011 on this basis.

Documents may be served on the above-named directors: Ref. 'Yorkshire Building Society' c/o Deloitte LLP at the following address:
1 City Square, Leeds LS1 2AL.

ANNUAL BUSINESS STATEMENT continued

3. INFORMATION RELATING TO THE DIRECTORS AND OTHER OFFICERS AT 31 DECEMBER 2012 (continued)

Officer	Business Occupation	Directorships
Mrs R. D. Court, BA	General Manager – Human Resources and Customer Service	Yorkshire Guernsey Ltd
Mrs A. L. FitzPatrick, LLB	Group Secretary and Head of Legal	Bank of East Anglia Ltd Brokerline Ltd East England Financial Services Group Ltd Mortgage Loan Management Ltd Norwich and Peterborough Financial Services Ltd Norwich and Peterborough Insurance Services Ltd Norwich and Peterborough Ltd Phillip Schofield & Company Phillip Schofield (Property Management) Phonebank Ltd YBS Ltd Yorkshire Direct Ltd Yorkshire Estate Agents Ltd Yorkshire Insurance Services Ltd Yorkshire Life Assurance Services Ltd Yorkshire Mortgage Services Ltd Yorkshire Personal Financial Services Ltd Yorkshire Property Services Ltd Yorkshire Services Ltd Yorkshire Syndications Ltd
D. N. Henderson, BSc	General Manager – Group Change and Chief Information Officer	Barnsley Property Services Ltd CBS Property Services Ltd Lynchwood Services Ltd Norwich and Peterborough (LP) Ltd YBS Properties Ltd YBS Properties (Edinburgh) Ltd YBS Properties (York) Ltd Yorkshire Computer Services Ltd Yorkshire Key Services Ltd Yorkshire Key Services (No 2) Ltd
M. R. Jenkins, BA, FCA, DipL	General Manager – Commercial Services	BCS Loans and Mortgages Ltd Guide Dogs For The Blind Lynch Wood Insurance Services Ltd Norwich and Peterborough General Insurance Services Ltd Norwich and Peterborough Insurance Brokers Ltd Norwich and Peterborough Insurance Services Ltd Norwich and Peterborough (LBS) Ltd Norwich and Peterborough Sharedealing Services Ltd Waters Lunniss Nominees Ltd
R. S. Wells, FCIB	General Manager – Risk	Accord Mortgages Ltd

GLOSSARY

The following glossary defines terminology used within the Annual Report and Accounts to assist the reader and to facilitate comparison with publications by other financial institutions:

Arrears	A customer is defined as in arrears when they fall behind in meeting their obligations to pay their mortgage and as a result there is an outstanding loan commitment that is overdue.
Audit Committee	A committee whose responsibility is to assist the Board in fulfilling its oversight responsibilities specifically the ongoing review, monitoring and assessment of internal control processes, internal and external audit processes and the integrity of the financial statements.
Basel II	The Basel Committee on Banking Supervision's statement of best practice that defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses.
Buffer liquidity	Cash and investments with the UK government (deposits with the Bank of England or holdings of UK Gilts and similar investments) and with supranational institutions. The limit is set by the Financial Services Authority (FSA).
Buy-to-let (BTL)	Lending on property that is to be let to individuals.
Chairman's Committee	A Board committee whose main function is to decide on any items that require attention before the following Board meeting except for specific issues that have to be determined by the full Board.
Collateralised Debt Obligations	Investment in cash and synthetic credit investments.
Commercial lending	Loans secured on commercial property.
Contractual maturity	The final payment date of a loan or financial instrument, at which all the outstanding loan and interest is repayable.
Core Tier 1 capital	The highest quality regulatory capital resources, comprising of retained earnings less regulatory adjustments.
Core Tier 1 ratio	The ratio of Core Tier 1 Capital to Risk Weighted Assets
Cost:income ratio	A ratio that represents management expenses as a percentage of total income.
Council of Mortgage Lending (CML)	A not-for profit organisation and a trade association for the mortgage lending industry.
Covered bonds	A type of wholesale funding backed by cash flows from mortgages.
Credit risk	The risk of financial loss arising from a failure of a customer or counterparty to settle their financial and contractual obligations as they fall due.
Currency risk	The exposure to risk from assets and liabilities denominated in currencies other than sterling.
Debt Securities In Issue	Transferable certificates of indebtedness of the Group to the bearer of the certificates. These include certificates of deposits, fixed rate and floating rate notes.

GLOSSARY continued

Derivative Financial Instruments	Contracts or agreements whose value is derived from one or more underlying price, rate or index inherent in the contract or agreement, such as interest rates, exchange rates or stock market indices. Examples of derivatives include interest rate swaps, forward rate agreements and futures.
Earnings at risk	A measure of potential variability in net interest income for a given business mix over a given period of time at a stated confidence level.
Effective interest rate	The method used to calculate the amortised cost of financial instruments and to recognise interest receivable or payable over the relevant period. The effective interest rate is the rate that exactly discounts estimated cash flows (excluding credit losses) to zero, through the expected life of the instrument.
Expected loss	An estimate of the potential losses on current exposures due to potential defaults on a mid-cycle assumption.
Exposure	The maximum loss that a financial institution might suffer if a borrower, counterparty or group fails to meet its obligations to the Group.
Fair value movements/adjustments	The value of the assets based on either the external market price or internal pricing models (using external data).
Financial Conduct Authority (FCA)	A new conduct regulator (replacing the FSA from April 2013), which will be responsible for regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets. The FCA's objective will be to protect consumers, promote competition and enhance market integrity.
Financial Ombudsman Service (FOS)	An independent service which provides a service for settling disputes between financial service providers and their customers.
Financial Services Authority (FSA)	The current regulator of the financial services industry in the UK, which will be replaced by two new regulators, Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), in April 2013.
Financial Services Compensation Scheme (FSCS)	A protection fund for depositors of failed institutions. This is funded by the financial services industry and each firm including the Society is obliged to pay an annual levy.
Free capital	The aggregate of gross capital and collective impairment provision less property, plant and equipment, intangible assets and investment properties.
FSA Remuneration Code	Guidance provided by the FSA on directors' remuneration.
Funding for Lending Scheme (FLS)	A scheme launched by the Bank of England and HM Treasury designed to boost lending to households and businesses. Banks and building societies participating in the scheme can access funding at rates below the natural market rate.
Funding limit	The proportion of shares and borrowings (excluding offshore deposits held by individuals) not in the form of shares.
Funding Ratio	A ratio that calculates the proportion of total shares and borrowings (excluding offshore deposits held by individuals) that are not in the form of shares.

Goodwill	Goodwill is measured as the difference between the adjusted value of the acquired assets and liabilities and the deemed purchase price. Goodwill is recorded as an asset in the Statement of Financial Position and negative goodwill is recorded in the Income Statement.
Gross capital	Represents the aggregate of general reserve, hedging reserve, available for sale reserve, subordinated liabilities and subscribed capital.
Group Asset and Liability Committee	This committee is responsible for, under delegated authority of the Board, managing the Group's liquidity, market and currency risks.
Group Credit Committee	A committee which oversees credit risk management in one of two key areas of retail lending and investment in liquid assets in wholesale counterparties.
Group Operational and Regulatory Risk Committee	The committee monitors the risk management framework put in place by the Group for identifying, assessing and managing operational and regulatory risks. The Group identifies operational risk to include the following; legal and regulatory, product and service, governance and security, process and system, people and resources and theft and financial crime.
Group Risk Committee	The Group Risk Committee has responsibility to the Board and detailed ownership of the Group's risk appetite, risk monitoring, and risk and capital management framework.
Impaired loans	Loans which have been assessed and there is evidence to suggest that the Group will not receive all of the cash flows or there is an expectation that these will be received at a later date.
Impairment allowances	Anticipated losses on loans assessed by the arrears status of each mortgage and the anticipated losses over the remaining life of the loans.
Individual Liquidity Adequacy Assessment (ILAA)	The Group's internal assessment of the levels of liquidity that need to be held by the Society to meet its regulatory liquidity requirements.
Individually and collectively assessed	At each statement of financial position date the Group assesses whether or not there is objective evidence that individual financial assets (or groups of financial assets with similar credit characteristics) are impaired.
Integration/merger costs	The expenses incurred from merger activity within the year.
Internal Capital Adequacy Assessment Process (ICAAP)	The Group's internal assessment of the levels of capital that need to be held by the Society to meet its regulatory capital requirements.
Internal ratings methodology	An assessment of wholesale counterparties and the risks they pose to the Group with limits set accordingly.
International Financial Reporting Standards (IFRS)	International Accounting Standards as adopted by the European Union.
Investors in People	An accreditation which recognises the support the Group provides for its people.
Lending limit	The proportion of business assets not in the form of loans fully secured on residential property.
Liquid assets	Total of cash in hand and balances with the Bank of England, loans and advances to credit institutions, debt securities and other liquid assets.

GLOSSARY continued

Liquidity risk	The risk that the Group does not hold sufficient liquidity, in terms of quantity and quality, to meet its liabilities as they fall due.
Loan-to-value ratio	A ratio showing a mortgage as a percentage of the value of the property.
Management expenses ratio	A ratio that represents the management expenses as a percentage of mean assets.
Market risk	Risk to earnings and capital arising from changes in interest rates, foreign currency exchange rates and the price of financial instruments.
Mean total assets	The amount produced by halving the aggregate of mean assets at the beginning and at the end of the year.
Medium-term notes (MTN)	Corporate notes continuously offered by a company to investors through a dealer. Investors can choose from differing maturities.
Member	A person who has a share account or a mortgage with the Society.
Mortgage backed securities	Assets which are referenced to underlying mortgages.
Net interest income	The difference between the interest received on assets and the interest paid on liabilities.
Net interest margin	This ratio calculates the net interest income as a percentage of mean assets.
Nominations Committee	A Board committee which considers matters relating to the composition of the Board and succession planning.
Non-prime lending	Mortgage lending to borrowers with adverse credit histories or self-certification lending where borrowers are not required to provide their income levels.
Operational risk	The risk of direct and indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
Other income	The income received from selling non-mortgage and savings products (e.g. home and contents insurance, investment products and other insurances).
Permanent Interest Bearing Shares (PIBS)	Unsecured and denominated in sterling. PIBS are repayable at the option of the Society and are Tier 1 capital instruments.
Possessions	Property taken back into ownership by the Society as a result of borrowers inability to make contractual loan repayments.
Prime lending	The Group's core business of providing residential mortgages to customers with no known default history.
Probability of default	The likelihood of an account hitting a particular default definition in a 12 month period. This is used when calculating impairment provisions on loans.
Provisions	A measurement of how far assets have failed to perform from a credit risk perspective. This includes actual losses incurred as a result of defaulting borrowers, and our estimate of potential losses on mortgages and other assets that are deemed to be already impaired.
Prudential Regulation Authority (PRA)	A new prudential regulator (replacing the FSA from April 2013), which will be a part of the Bank of England and alongside the FCA will have the responsibility for the oversight of building societies, banks and insurers. The PRA's objective will be to promote the safety and soundness of regulated firms.

Remuneration Committee	This committee is responsible for considering and approving the remuneration of executive directors and other General Managers as well as agreeing the remuneration policy for the whole organisation.
Repo/reverse repo	A repurchase agreement that allows a borrower to use financial security as collateral for a cash loan at a fixed rate of interest.
Residential Mortgage Backed Securities (RMBS)	An asset-backed security that represents a claim on the cash flows from residential mortgage loans through a process known as securitisation.
Retail credit risk	The risk of financial loss arising from a failure of a retail loan customer to settle their financial and contractual obligations as they fall due.
Risk appetite	The level of risk that the Group is willing to take (or not take) in order to safeguard the interest of members whilst achieving business objectives.
Risk weighted asset	A regulatory measure that adjusts the value of assets to reflect their level of risk when calculating capital requirements.
Shares	Money deposited by members in a retail savings account with the Society and held as a liability in the Statement of Financial Position.
Shares and borrowings	The total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue.
Small Change Big Difference (SCBD)	Our unique scheme which allows each member to donate the pence of their interest to the Yorkshire Building Society Charitable Foundation.
Solvency ratio	The ratio of total capital to risk weighted assets.
Standardised approach	A method of calculating capital requirements under Basel II.
Structured credit investments	A small percentage of Group liquidity invested in high risk and higher yielding treasury investments
Subordinated liabilities	Tier 2 capital that is subordinated to the claims of all depositors, creditors and members holding shares in the Society (other than holders of PIBS).
Tier 1 capital	A measure of high quality regulatory capital, comprising retained earnings and PIBS, less regulatory adjustments.
Tier 1 ratio	The ratio of Tier 1 capital to risk weighted assets.
Tier 2 capital	A measure of regulatory capital that includes subordinated liabilities and general provisions, less regulatory adjustments.
Total capital	The total capital resources, including retained earnings, PIBS, general provisions and subordinated liabilities, less regulatory adjustments.
UK Corporate Governance Code	The UK code on corporate governance, published by the Financial Reporting Council in June 2010, which sets out standards of good practice in relation to Board leadership and effectiveness, remuneration and accountability.
Value at Risk (VaR)	A risk management tool which evaluates the potential losses that may be incurred as a result of movements in market conditions over a specified holding period and to a given level of confidence.
Weighted average maturity	Provides a measure of the weighted average remaining term of outstanding wholesale funding.

GLOSSARY continued

Wholesale credit risk	The risk that counterparties with whom the Group invests liquid assets fail to repay those investments when they fall due.
Wholesale funding	The funding that is available between banks and other financial or commercial institutions. Examples of wholesale funding include covered bonds, cash and government guarantees.
Wholesale ratio	A ratio that calculates the proportion of the total funding that is from wholesale sources, from banks and other financial or commercial institutions.
YBS Share Plans	Saving Related Share Option schemes which allow employees of a company to buy company shares with money they have contributed to a savings scheme.

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Auditors:

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