# YORKSHIRE BUILDING SOCIETY REPORT & ACCOUNTS 2014

YBS GROUP

# Contents

# A CLEAR VISION FOR THE FUTURE

In his final annual review Chairman, Ed Anderson reports another year of strong financial performance with solid capital and liquidity positions, robust levels of profit and continued long-term value delivered to members through our products and services.

It was announced in November 2014 that I will be stepping down as Chairman of the Board at the conclusion of the Annual General Meeting on 21 April 2015, and therefore this will be my final report on the Group's performance.

For a considerable part of the eight years I have been Chairman, the global financial sector has experienced the most challenging economic crisis in living memory. During this time, whilst not immune to the impact of the recession, the Group's financial strength has enabled us to weather the storm confidently and emerge a larger and stronger organisation with a clear vision for the future. I am proud that in this time we successfully completed mergers with the Barnsley, Chelsea and Norwich & Peterborough building societies and acquired the savings and mortgage book of Egg Banking plc, and the Group's assets have grown from £20bn to £37.6bn.

For the last 150 years it has been our mutual values that have guided how we do business and we have continued to prosper and have grown in strength and size.

As an organisation owned by its members, who are also our customers, we are able to prioritise customer service and the provision of long-term value and we have no need to chase short term profit or undertake risky financial activities in order to generate greater returns to satisfy external shareholders. It is this approach to business that keeps members at the heart of everything we do, which has enabled us to earn and maintain our members' trust. This is demonstrated in our strong customer advocacy levels, where we continue to significantly outperform the majority of our competitors. Our Net Promoter Score®, which measures customers who would recommend us less those who wouldn't, of 40%[1] compares to an industry average of just 3%[2]. Another measure of how well we are serving our members is the Financial Ombudsman Service overturn rate[3] where the Ombudsman decided we had made the wrong decision on just 7% of complaints referred to them, compared to the industry average of 57%.

Our priority is to strike the right balance between maintaining our financial strength, providing excellent value and service to our members and generating sufficient profit to allow continued investment for the future. Our 2014 financial results demonstrate that this has been another successful year for the Group and we remain one of the UK's strongest financial institutions.

I am delighted that this performance was recognised externally with credit rating upgrades from both Moody's[4] and Fitch[5] during the year. Further external recognition was demonstrated by the industry awards we received across our brands, reflecting the quality of the products and service we provide.

## Economic conditions

The UK economy has continued to strengthen throughout 2014. Unemployment is far lower than many commentators expected, as the year ended with 400,000 fewer people out of work compared to the previous year[6]. Wage increases remain low at just under 2% for 2014[7], but inflation is even lower[8]. Crucially, the level of household debt remains relatively high and therefore we expect that the Bank of England will take a gradual approach to tightening monetary policy once the Bank Rate begins to increase.

In the housing market there was strong evidence of recovery in 2014, with average house prices increasing around 7.8%[9], largely, but not solely, driven by the London market.

1 Source: Nunwood Consulting – Customer Experience Tracker, 12 month rolling score for January 2014 to December 2014, based on 29,415 customers.

2 Source: Nunwood Consulting - 2014 annual Customer Experience Excellence survey of 7,500+ customers. Study was conducted in October 2014.

3 Financial Ombudsman Service complaints data 1 January – 30 June 2014 resolved cases.

4 Moody's Press Release 13 March 2014.

5 Fitch Published Press Release 24 September 2014.

6 ONS MGSC series, Dec 2013 – Nov 2014.

7 ONS KAI8 series, Jan 2014 – Dec 2014.

8 ONS D7G7 series, 0.5% in Dec 2014.

9 Halifax House Price Index, January 2015.

However, towards the latter part of the year, there were some signs of cooling and more modest house price inflation is predicted for 2015.

In the 2014 Autumn Statement the Chancellor announced action to address long standing concerns on the structure of stamp duty [10]. We strongly welcomed this change which will benefit the majority of our house purchase borrowers. Similarly, we welcomed the changes to the ISA rules which should encourage an increased level of savings.

## Borrowers

The Mortgage Market Review (MMR), which came into effect in April 2014 [11], introduced new regulation to how the mortgage market operates. As a responsible lender, our assessment of mortgage applications already incorporated many of the requirements of MMR. We were therefore able to implement the changes required ahead of the deadline and without affecting our business volumes.

In 2014 we delivered record lending reflecting the great demand for our competitive mortgage products, which were featured consistently in national best buy tables. I am delighted that we maintained a focus on supporting first time buyers, providing funding for over 8,000 people to get onto the housing ladder, whilst using robust affordability models to ensure their long-term protection. Whilst we achieved this without the support of the Government's Help to Buy scheme, as we were able to offer our own 95% loan–to-value mortgages, we recognise the positive impact the scheme has had on the wider housing market.

## Savers

Savers have experienced another tough year as the Bank of England Bank Rate remained at a record low and the availability of cheap funding through the Government's Funding for Lending Scheme reduced competition for savers' deposits. We have always tried to protect our savers from the impact of low rates, however it is essential to balance this with maintaining financial security, ensuring that we do not attract more money than we can safely and sensibly lend.

Competitors continued to cut their savings rates in 2014 which made it necessary for us to take the difficult decision to also reduce our average savings rates. However, whilst implementing this action we were able to demonstrate the value of our mutual model as our average savings rate was 1.60% compared to the rest of the market equivalent of just 1.34% [12]. In addition, we made changes to ensure all our customer savings accounts pay at least an interest rate of 0.5% gross p.a/AER. As a consequence of this approach, around 900,000 savers saw an increase in their rates. We also protected the rates on our Children's and Regular Saver accounts and recognised the value of loyalty by ensuring that, on a number of our other savings accounts, existing members benefit from a higher interest rate than those offered to new customers.

Unfortunately, conditions are likely to continue to be difficult for savers as the Bank Rate is expected to remain low throughout 2015.

## Conduct issues

Being an organisation driven by mutual values and placing customers at the heart of our business, means that if things do go wrong we will always deal with them in a way that continues to focus on the best possible outcome for our members.

10 HM Treasury (2014) Autumn Statement 2014.

11 FCA.org.uk, Mortgage Market Review (MMR), Published: 12/09/2014.

12 Average rates based on Savings stock from CACI's Current Account and Savings Database (CSDB), currently covering 85% of retail savings market (based on stock value). Data as at 31 October 2014.

In 2014 two issues, where regrettably we had fallen short in previous years, came to a conclusion;

- **Mortgage customers in payment difficulties** – the Financial Conduct Authority (FCA) imposed a financial penalty of £4.1m [13] for our failure to promptly identify the cause of some customers' payment difficulties and to establish their future financial prospects.

  As noted in our 2013 financial statements, prior to the Regulator's action we voluntarily and proactively refunded all mortgage arrears administration fees charged since 2009, plus interest, deciding this to be the fairest approach for our customers.

- **Promotion of structured deposit accounts** – the FCA found that the promotional material used for some structured deposit accounts that we had previously offered to our customers, fell short of the required standard and imposed a financial penalty of £1.4m [14].

  Following this action all of the affected customers have been given the option to exit their account without charge and receive an appropriate rate of interest, or to retain their account until maturity. Again we believe this to be the fairest approach for our customers.

We agreed with the conclusions of the FCA on both of these issues and, as I have outlined, have taken action to put things right for members who may have been affected. All the costs associated with these actions have been fully provided for in our 2013 and 2014 financial accounts.

To ensure that we do everything possible to prevent any similar situations occurring in the future, we have made the investment necessary in order to continue to improve our oversight of conduct risk. This will strengthen our levels of risk control and auditing, provide new technology, support the recruitment of additional specialist management and increase colleague training.

## Regulation

Whilst the UK is no longer in recession and economic conditions continue to improve, the legacy of the financial crisis is still evident. Regulation of the UK financial services industry has changed significantly and is expected to develop further. We implemented the requirements of the Retail Distribution Review (RDR) in 2013 and MMR in 2014 and continue to monitor the development of other key policies which may have an impact on how we do business.

Whilst economic stability is, and must remain, a priority we are keen that policy makers ensure new regulation is proportionate, relevant and reflective of the building society model and the contribution it has in maintaining diversity in the market place.

## Local communities

Our 150th birthday celebrations provided a reminder of the important role building societies have in their local communities. With our heritage and a strategic priority focused on being Locally Famous, the communities where our members live and work remain very important to us as demonstrated in 2014 by our:

- **Charitable donations**
  £464,000 was donated to charities and good causes from our Charitable Foundation in the year.
- **Other community donations**
  £1.2m was donated primarily as a result of our popular affinity accounts and a £150,000 community legacy fund created to celebrate our 150th anniversary.
- **Employee volunteering**
  colleagues provided more than 10,000 hours sharing their skills and time on local community activities.
- **Support of Marie Curie**
  we have raised over £200,000 for this fantastic charity.
- **Environmental activities**
  a number of initiatives have been implemented which help us to reduce our waste and energy usage.

[13] FCA, Final Notice 'YBS', 28 October 2014.
[14] FCA, Final Notice 'YBS', 16 June 2014.

## People

The success outlined in this report would not have been possible without the enthusiasm, commitment and hard work of the Group's 4,600 people, who strive to provide outstanding customer service in every area of the business. On behalf of the Board, I thank the entire team for their performance.

## Board changes

As mentioned in last year's report, Mike Regnier was appointed to the new role of Chief Commercial Officer and Executive Director. Joining in June 2014, Mike has responsibility for leading the commercial activities of the Group, which include product development and customer experience.

Alison Hutchinson was appointed a non-executive director in February 2015. Alison brings additional IT and change programme skills to the Board and is a member of the Audit Committee.

Simon Turner retired from the Board as a non-executive director following the 2014 Annual General Meeting (AGM). Simon made an extremely valuable contribution to the Society during his nine years' service, particularly in his role as Chair of the Remuneration Committee.

Philip Johnson, who has been a non-executive director since 2007, is due to retire from the Board at the conclusion of the 2015 AGM. Philip's depth of knowledge in the financial services industry, and his role as Chair of the Audit Committee, have been of great value. Mark Pain will replace Phillip as Chair of the Audit Committee.

I would like to record our thanks and appreciation to both Simon and Philip for their support and commitment during their service with us.

As I have mentioned, I will retire from the Board after the 2015 AGM and I am delighted that John Heaps, who joined the Board in November 2014 as Chairman Designate, will become my successor. John is the former Chairman of corporate law firm Eversheds. In this role he was ultimately responsible for the firm's compliance with the legal sector's regulatory regime and contributed significantly to the development of its long-term strategy. I am confident that I leave the Board in a very strong position and that John will continue to take the Group forward successfully in the years ahead.

# IN 2014 WE DELIVERED RECORD GROSS LENDING.

Finally, I would like to add that it has been an immense privilege to have served the Society as its Chairman. Leading the organisation through the financial crisis has at times been challenging, but also extremely rewarding. I am proud that the Society is in such good shape and well placed to face future challenges.

The most enjoyable part of this role however, has been the times when I have had the pleasure of meeting members. These opportunities provided an excellent insight into their priorities and helped drive member-focused decisions in the boardroom. I would like to thank my Board colleagues and the Executive Team, past and present, for their continued support over the years and I wish you all success for the future.

**Ed Anderson**
**Chairman**
23 February 2015

# DELIVERING STRATEGIC PRIORITIES

Throughout 2014, as we celebrated our 150th birthday, we looked back at our heritage and the reasons why we were established, and reflected on how we have, and will continue, to serve our members based on a foundation of trust.

I'm delighted to introduce the Group's Strategic Report which provides a comprehensive review of our 2014 performance and how this has supported the delivery of our strategic priorities, together with our outlook for 2015.

I'm extremely pleased with how the Group has performed in the year and confirm that we'll continue to build on this by remaining committed to our investment programme and delivering on the strategic priorities. This in turn will ensure we continue to provide good long-term value and excellent service to our current and future members, helping us to achieve our vision to be **'the most trusted provider of financial services in the UK'**.

**Chris Pilling**
**Chief Executive**
23 February 2015

**Highlights of the Group's activity, which is underpinned by a strong financial position, include:**

**OVER 8,000 FIRST TIME BUYERS**

### INCREASED MORTGAGE LENDING

Helping more people own their home and enabling over 8,000 first time buyers to take a step on the housing ladder.

**OPENED ALMOST 200,000 NEW SAVINGS ACCOUNTS**

### INCREASED SAVINGS BALANCES

- We continued providing savers with competitive products opening almost 200,000 new accounts.
- We rewarded member loyalty by protecting children and regular savers from any rate cuts and paying a number of existing savers a greater rate of return than is offered to new customers.

**MORE THAN 2,900 BEST BUY MENTIONS[15]**

### INDEPENDENT RECOGNITION

Across all our brands we received more than 2,900 best buy mentions and were awarded 14 industry accolades for our products and service.

[15] Source: Presswatch Financial from Kantar Media.

1
50
YEARS
BUILDING
TRUST

**STRONG**
**CUSTOMER ADVOCACY**

## CUSTOMER SATISFACTION

Strong customer advocacy [16] and satisfaction levels [17], considerably above industry averages.

**£65M**
**INVESTED IN THE FUTURE**

## INVESTED IN THE FUTURE OF THE BUSINESS

To provide members with improved products and services across all channels, including the refurbishment of over 50 branch and office sites to create a modern environment for our customers and colleagues.

**ALMOST**
**£2M**
**PROVIDED**

## INCREASED SUPPORT

Increased support provided to the communities we serve with almost £2m provided to charities and good causes, in addition to the provision of 10,000 hours of skills sharing volunteered by our colleagues.

[16] Source: Nunwood Consulting – Customer Experience Tracker, 12 month rolling score for January 2014 to December 2014, based on 29,415 customers.
[17] Source: Nunwood Consulting - Nunwood Customer Experience Excellence Centre Top 100 UK Brands 2014.

# OUR STRATEGY

150 years ago we were established to help people safeguard their hard-earned savings and to borrow the money to buy their own homes. This remains our core purpose.

## 1. Our Strategy

By combining sustainable financial strength and security with an understanding of what customers need, we believe our approach can help both existing and future customers. By building the Group on this heritage and our strong shared values we look to do this as a genuine alternative to banks.

Driven from this basis, our vision is 'to be the most trusted provider of financial services in the UK'. As a building society, we:

- Are owned by our members and everything we do should reflect the trust that they place in us.
- Don't have to balance the interest of external shareholders and customers, since they are one and the same for us.
- Balance the need to retain sufficient earnings to ensure the security of our business, invest in our products and services, and to deliver an exceptional customer experience.

This means that we must price our products so that they deliver long-term value to our customers and help us to grow the Group at the same time. Retained profits are our primary source of capital and we have to balance two sets of member requirements; having a strong capital position to ensure financial sustainability and achieve optimum (not maximum) profit levels to enable us to invest in the business and deliver a leading customer experience.

To succeed, we believe we must deliver on our five strategic priorities, which remain:

1. To deliver a market leading **customer experience** built on empathy, simplicity and trust.
2. To attract and retain the best talent, with a leading **people experience** built on our cultural foundation of mutual trust.
3. To deliver products, processes and systems for all our channels and brands which are **easy and simple** to use.
4. To deliver **sustainable financial performance** that ensures real financial security for our customers, within our risk appetite.
5. To be **locally famous** and meaningfully engaged in our communities.

We strive to always deliver for our customers and to behave within a set of very clear values, the most important of which is **"Customers at our heart"** – a simple but powerful principle that guides everything we do and, more importantly, one that encapsulates how we have always behaved as an organisation. To support this we aim to:

- **Be trustworthy**
  keeping our promises so people can rely on us when it counts most.
- **Keep it personal**
  putting people first with humanity, decency, warmth and care.
- **Be passionate**
  loving what we do today and sharing our ideas to make things better for tomorrow.

## 2. Business models

Our strategy is reflected in a simple business model focused on the provision of retail financial services in the UK which can be divided into three segments.

The primary segment represents the core focus of the Group in terms of customers, resources, people, leadership and management time:

- Reflecting the traditional building society model, we concentrate on residential mortgages funded through retail savings and, to a lesser extent, wholesale funding.
- Together the business units in this area offer retail savings products, direct and introduced residential mortgages, buy to let mortgages for landlords, current accounts and a range of third party investment and insurance products and services.

The secondary segment includes profitable and active businesses which support the Group's financial sustainability and/or primary businesses. This includes:

- A few, smaller business units that do not fit with our core focus but which are successful, profitable and safe and as such add significant value to the Group.
- Our Share Plans business which runs employee savings and share schemes for employers and generates both stable, long-term funding and healthy income streams for the Group.
- Our low risk, but profitable, commercial and social housing lending operations which provide loans to commercial customers and housing associations.

The final segment consists of portfolios that are no longer open for new business, and which were either inherited through mergers and acquisitions or are areas in which the Group no longer wishes to operate. We are managing down these areas, which include our structured credit portfolio, our credit repair mortgage portfolio, and a number of other small loan portfolios.

## 3. Investment programme

In 2012, we embarked on an ambitious investment programme to create a modern business, fit for the fast-paced technological world we live in, whilst retaining our strong commitment to face to face customer contact. Our aim is to ensure we provide the best customer service possible whichever channels our customers choose to use.

In doing so we recognised the need to replace or modernise many of our systems and processes.

There are four main areas in the programme:

- **Re-engineering**
  to establish a more efficient, effective and cohesive platform for the Group's operations with simplified processes and systems. **These projects are designed to enable us to operate and grow more efficiently and deliver a customer experience which is simpler and easier to use**.

- **Web & Mobile**
  to develop the Group's internet and mobile channel capabilities, to improve security, customer experience and commercial performance. This includes the introduction of online appointment booking across all channels, enhanced web-chat capabilities and investing in Share Plans' online functionality. **Initiatives in this area are designed to improve and simplify the online customer experience.**

- **Insight**
  to enhance our management information systems and processes. We are also working towards an Internal Ratings Basis (IRB) capital management status. **These improvements will allow more efficient and effective decision making and utilisation of our financial resources across the Group.**

- **Branch, Property and Brand**
  to invest in the physical environments, in our branches and administrative offices. **This investment is aimed to provide a more pleasant and modern environment for both our customers and people.**

In 2014 we started to deliver projects within our transformation programme as well as continuing to build the foundations for future growth. Details of our performance are set out on the next page.

## 4. Review of 2014

We measure progress against our vision, strategy and shorter term plans using a set of key performance indicators (KPIs). These are reported to the Board on a monthly basis and are central to the Board's monitoring of the Group's performance and to its decision making. This table details KPIs.

| Strategic priority | Operational area | KPI | Page number |
|---|---|---|---|
| **Customer Experience** | **Customer/Brand experience** | Net Promoter Score®<br>FOS overturn rate | 11<br>13 |
| **People Experience** | **People experience** | Internal hire ratio<br>Colleague turnover<br>Absenteeism | 13<br>13<br>13 |
| **Easy & Simple** | **Change/Project delivery**<br>**Operational effectiveness** | Measured on a RAG basis [18]<br>Measured on a RAG basis | n/a<br>n/a |
| **Financial Sustainability** | **Trading performance** | Profit before tax<br>Core operating profit<br>Net interest margin<br>Cost:income ratio<br>Net lending<br>Three months arrears<br>Retail inflow/(outflow) | 16<br>16<br>16<br>17<br>18<br>19<br>19 |
| | **Sustainability** | Common Equity/Core Tier 1 Capital ratio<br>Liquidity ratio | 19<br>20 |
| | **Risk appetite** | Please see the Risk Management Report | 49 |
| **Locally Famous** | **Corporate social responsibility** | Please see the Corporate Social Responsibility Report | 24 |

## 4.1. Customer Experience

Key to the delivery of an outstanding customer experience is our core mortgage and savings products, and this is the main focus of the Group.

In 2014 we continued to support people buying their own home and helped over 8,000 first time buyers to become property owners. In doing so, rather than participating in the Government's Help to Buy Scheme, we offered a competitive alternative to first time buyers by re-introducing 5% deposit mortgages. We also lent to a further 26,600 other borrowers, and our gross mortgage lending increased by 13% to £7.6bn, representing a market share of 3.7%[19]. Our mortgages featured consistently in national best buy tables, with over 2,100 mentions during the year [20].

During the year the housing market showed clear signs of recovery, largely fuelled by London and the South East, but with positive impacts nationwide. However, by the end of the year some indicators were casting doubt on the robustness of the market with house price falls being registered in some regions and confidence falling. The general election in 2015 will increase uncertainty and it's possible that many people will delay housing decisions until they have a little more certainty.

2014 was another difficult year for savers with the Bank of England Bank Rate remaining at a record low and continued reduced competition from

[18] An assessment of status between Red, Amber or Green based either on pre-determined thresholds or a subjective assessment.
[19] Source: Bank of England at 31 December 2014.
[20] Presswatch Financial from Kantar Media.

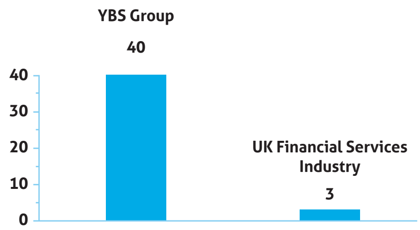
financial services providers for savers' deposits. This inevitably impacted interest rates on savings accounts, and we are not immune from the general conditions prevailing in the market. We cannot afford to attract savings if we cannot subsequently lend them on to mortgage borrowers since holding excess cash on our balance sheet is expensive – to do so would critically damage our financial strength and hence the safety of those deposits. During 2014 we therefore had to reduce our savings rates in order to remain in line with the market. However, where possible, we tried to offer better rates than the market average.

Within this context we continually look to deliver value to our savers wherever possible. During 2014:

- We have consistently sought to pay better than average rates across our products portfolio, and as at 31 October 2014 the average rate on our saving products was 1.60% against a market average of 1.34% [21].
- During the year we opened 199,559 new saving accounts, with the most popular account being the Triple Access Saver.
- We have continued to align the interest rates paid on existing products within the different product ranges and increased some rates against the market average for example all our Cash Variable Rate ISAs now pay a minimum of 1% and no instant access account pays less than 0.50% (neither of these rates are linked to the Bank of England Bank Rate).
- We have launched a consistent Monthly Regular Savings account across Yorkshire Building Society, Barnsley Building Society, Chelsea Building Society and Norwich & Peterborough Building Society and we hope to announce further Group-wide products in 2015.
- We looked to design products to reward customer loyalty – for example our Celebratory Children's Saver paying 5% to young savers who have been with us for two years or more.
- We achieved 869 best buy mentions [22] for our savings products, and our savings balances grew by 2.4% to £28bn.

How we deliver our products and services is equally important to us - delivering a leading customer experience is at the core of what we do. To ensure that we deliver on our promises the Board looks at a range of customer metrics, of which the Net Promoter Score ® (NPS) is key. Experience NPS is a monthly, independently conducted survey of customers from across the whole Group who have transacted with us in the previous month. With an annual sample size of around 29,000 customers, this provides a robust measure of our customers' experience and at 40% [23] we have performed much better than the industry average of 3% [24].

**% | Experience Net Promoter Score®**




During 2014 we continued to invest in all of our customer channels:

- We brought our brands together with a new visual identity for the Group. This gives a consistent and contemporary look across the Group, and emphasises the strength that each brand draws from being part of that Group whilst still retaining the individual identities of the different brands.
- As customers are shifting more of their activity to digital channels, we have committed to invest significantly in this area.
- We firmly believe that there remains a need for a strong branch presence and therefore we have:
  - Continued to invest in our branches to provide a modern, pleasant and effective environment for our customers and people.
  - Refurbished and/or refreshed the look of 51 branches, as well as replaced signage in 115 branches in line with our new visual identity.

[21] Source: Average rates based on Savings stock from CACI's Current Account and Savings Database (CSDB), currently covering 85% of retail savings market (based on stock value). Data as at 31 October 2014.

[22] Source: Presswatch Financial from Kantar Media.

[23] Source: Nunwood Consulting – Customer Experience Tracker, 12 month rolling score for January 2014 to December 2014, based on 29,415 customers.

[24] Source: Nunwood Consulting - 2014 annual Customer Experience Excellence survey of 7,500+ customers. Study was conducted in October 2014.

We believe that the quality of our products and customer service is demonstrated by the number of awards we have won in 2014:

| Award | Accolade | Brand |
|---|---|---|
| Moneynet Awards 2014 | Best Offset Mortgage Provider<br>Best First Time Buyer Mortgage Provider | Yorkshire Building Society |
| Consumer Moneyfacts 2014 | First Time Mortgage Buyers' Choice | Yorkshire Building Society |
| Moneyfacts Finance Awards 2014 | Best Building Society Savings Provider<br>Best Longer Term Fixed Rate Mortgage Provider | Yorkshire Building Society |
| Business Moneyfacts 2014 | Best Buy to Let Mortgage Provider | Accord Mortgages |
| Moneynet Awards 2014 | Best Debit Card for Use Abroad | Norwich & Peterborough Building Society |
| SavingsChampion.co.uk Awards 2014 | Best Regular Savings Account Provider | Norwich & Peterborough Building Society |
| Moneyfacts Finance Awards 2014 | Best Building Society Mortgage Provider<br>Best Short Term Fixed Rate Mortgage Provider | Norwich & Peterborough Building Society |
| Moneywise Mortgage Awards 2014 | Best Lender for Fixed Rate Mortgages<br>Best Lender for Offset Mortgages | Accord Mortgages |
| International CSR Excellence Awards | Gold – Charity Support | Yorkshire Building Society |
| Mortgage Finance Gazette Awards | Best Buy to Let Lender | Accord Mortgages |

While celebrating these successes we know that we don't always get it right, and that some of our processes and systems were not always as robust as they should have been. This became especially evident in relation to our arrears procedures and the promotional material used for some of our structured deposit accounts:

**Mortgage customers in payment difficulties**

- The Financial Conduct Authority (FCA) imposed a financial penalty of £4.1m for our failure to promptly identify the cause of some customers' payment difficulties and to establish their future financial prospects.
- We accepted the FCA's decision and as noted in our 2013 Financial Statement, prior to the Regulator's action we voluntarily and proactively refunded all mortgage arrears administration fees, plus interest, that had been charged since 2009, deciding this to be the fairest approach for our customers.
- 33,900 borrowers were repaid a total of £8.4m.

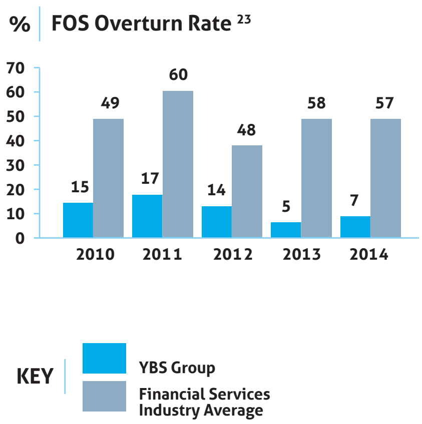
**Structured deposit account**

- Our promotional literature for some of our structured deposit products fell short of the required standards. The FCA concluded that the promotional materials did not meet the information needs of customers.
- We accepted the FCA's decision, and have implemented a process where affected customers have the option to exit the product and receive an appropriate rate of interest or retain their investment.

- In this case the FCA imposed a financial penalty of £1.4m on the Group.

To ensure that we do everything possible to prevent similar situations occurring in the future we are investing in our people, systems and processes. This investment will look to ensure that all our activities are carried out in the best interests of our customers.

No organisation will get everything right all the time, and to track our own performance we monitor a range of complaints data, as well as looking closely at the cause of complaints to ensure we can learn and adapt. One of the best measures to assess how well we do at putting things right when they go wrong is the Financial Ombudsman Service (FOS) overturn rate. In 2014, the percentage of cases where FOS decided we had made the wrong decision on complaints (referred to them by customers and FOS therefore made a change in favour of the customer) was 7% [25] against an industry average of 57%.



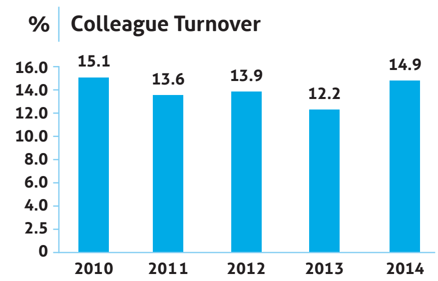

## 4.2. People Experience

Our people are central to us achieving our strategy and delivering an exceptional customer experience. We strive to attract and retain the best talent with a leading people experience. As part of this, we are:

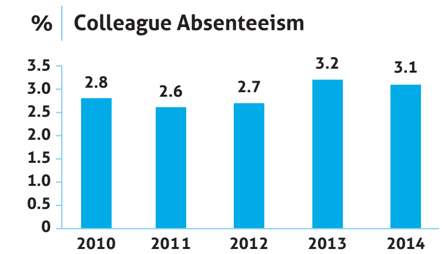
- Redesigning many of our management and remuneration policies and practices to ensure we optimise the performance of, and the rewards for our people.
- Continuously improving people engagement and communications to ensure everyone understands our vision and strategy and the role they play in delivering them.
- Continuing to invest in people's capabilities through training and development.
- Ensuring we provide a great working environment where our people can flourish through our branch and head office refurbishment programme.

We measure our performance in this area through an independently run annual survey. The latest engagement score was 78% compared to the financial services industry average of 72% [26].

During the year, the total number of people employed increased by 264 (6.1%) with the increase being needed to support the Group's wide range of projects and programmes in addition to our overall growth. As well as recruiting externally to bring in fresh perspectives and new talent, we are continually developing our people and we keep a close eye on our internal hire ratio, which measures our success at attracting, retaining and developing the right calibre people. At December 2014 this ratio was 31% across all our roles. Of course, people have also left us throughout the year and the Group's annual turnover rate was 14.9%, including redundancies and resignations. This did increase in 2014 but we consider it is an acceptable level for an organisation of our size. We will continue to work with our people to balance their aspirations with the needs of an organisation which is growing in both size and complexity.




We also monitor absenteeism, the percentage of working days lost through sickness and other forms of absence. A lower ratio suggests a more committed, healthy and satisfied workforce. 2014 saw the overall Group sickness absence rate decrease to 3.1% from 3.2% in 2013.




[25] Source: Financial Ombudsman Service complaints data. Full year data for 2010 -2013 and six months of data for 2014. 1 January – 30 June 2014.
[26] Source: ORC International benchmark.

## 4.3. Easy & Simple

Our Easy and Simple priority is aimed at providing systems and processes that are just that – easy and simple for our customers to use, and easy and simple for our people to use so they can concentrate on helping our customers.

In 2013 we laid the foundations of our transformation agenda, and developed our people as well as our systems to be able to deliver the changes needed. In 2014 we continued this, but also started to deliver against some of our key projects.

One significant success in this area was the delivery of the changes required by the new Mortgage Market Review (MMR) regulations, which introduced new requirements around dealing with mortgage applications and assessing borrowers' ability to afford their repayments. The Group implemented the new procedures ahead of many our competitors; with minimal disruption to our systems and processes.

Many of the principles that the new rules are based upon were already built into our lending criteria, reflecting our long-standing commitments to being a responsible lender.

Looking across the four main areas of our investment programme, we can show where we made real progress in 2014 and where we will be investing in 2015:

### Re-engineering

**Delivering more efficient, effective and cohesive systems and processes:**

| 2014 - Delivered | 2015 - Working on |
|---|---|
| • **Complaints handling**<br>a new system meeting regulatory obligations and improving service.<br><br>• **Mortgage processing**<br>started moving all brands into one area for better service and efficiency.<br><br>• **Single Multi-Brand Platform**<br>building the system to allow us to consolidate customer data, system management, maintenance and change capabilities onto one simple platform.<br><br>• **Share Plans online system**<br>providing enhanced service to existing customers and greater ability to attract new ones.<br><br>• **N&P systems**<br>further consolidation delivering efficiency and control.<br><br>• **Intranet**<br>a new system improving colleague communication, engagement and knowledge sharing. | • **Complaints systems**<br>further improvement to customer service and efficiency.<br><br>• **Mortgage processing**<br>further consolidation and redesign of policy and processes to enhance service and efficiency.<br><br>• **Single Multi-Brand Platform**<br>migrating all brands' data onto a single platform.<br><br>• **Group services**<br>moving more activities into a Shared Services team for better service and efficiency.<br><br>• **Arrears systems**<br>a new system and processes meeting regulatory obligations and improving customer service. |

### Web & Mobile

**Delivering improvements to security, customer experience and commercial performance:**

| 2014 - Delivered* | 2015 - Working on |
|---|---|
| • Enabling customers to easily re-set their passwords without the need to call an advisor.<br><br>• **Web-based chat**<br>analysing solutions to give customer new ways to deal with Mortgage Advisers. Launched to Accord customers.<br><br>• Improvements in how we tackle e-crime, including increased colleague training in this area to keep our customers' savings safe.<br><br>• **Web analytics systems**<br>a new system giving better understanding of what our online customers want from us.<br><br>• Improvements to our online mortgage application process. | **Ongoing development of the Group's internet and mobile channel capabilities, including:**<br>• Delivery of YBS mobile app.<br>• Greater use of social media.<br>• Web-based transactions for YBS.<br>• Online appointment booking.<br><br>**Other initiatives include**:<br>• Enabling customers to purchase insurance products as part of an integrated online mortgage application.<br><br>• Having a greater range of savings accounts available online. |

*Some of these changes have not been implemented across all our brands.

## Insight

**Enhancing our management information and decision making processes:**

| 2014 - Delivered | 2015 - Working on |
|---|---|
| • **Margin and cost management** new systems giving greater insight and efficiencies.<br><br>• **Credit Risk** progress in our Internal Ratings Based capital project to improve risk management and efficiency. | • Making improvements to business processes to result in greater automation of controls and lower cost to deliver insight in the organisation.<br><br>• Progressing our Internal Ratings Based capital project. |

## Branch, Property and Brand

**Investing in the physical environment in our branches and administrative offices:**

| 2014 - Delivered | 2015 - Working on |
|---|---|
| • Completed the refurbishment of our Bradford head office (Yorkshire Drive).<br><br>• Refurbished and/or refreshed the look of 51 branches, as well as replacing signage in 115 branches in line with our newly launched visual identity.<br><br>• Installed solar panels at our Bradford and Peterborough sites. This is expected to save an average of 130 tonnes of $CO_2$ emissions per year. | • Refurbishment of our administrative office in Peterborough.<br><br>• Complete the roll out of our new visual identity programme to a further 180 branches by August 2015.<br><br>• Roll out the new brand signage to the remaining branches/ brands. |

In parallel with all of these, we will continue to invest in the business to ensure compliance with new regulations as required.

In 2014 we invested £65m in our change programme, of which £46m was charged to the Income Statement. The balance consisted of assets purchased or capitalised software development. We expect a similar level of spend in each of 2015 and 2016.

Outside major investment projects, the Group made 221 smaller improvements to its IT systems during the course of the year. These have improved efficiency and customer service by making our systems easier and simpler to use.

We also made full use of a new online tool for capturing suggestions from colleagues, through which a range of improvements to the Group's customer-facing and internal processes have been identified. A number of these are being progressed as part of ongoing business improvement initiatives which will be delivered throughout 2015.

## 4.4. Financial Sustainability

In 2014 the Group recorded another year of strong financial performance, with robust profits underpinned by continued strong capital and liquidity positions.

### Trading performance

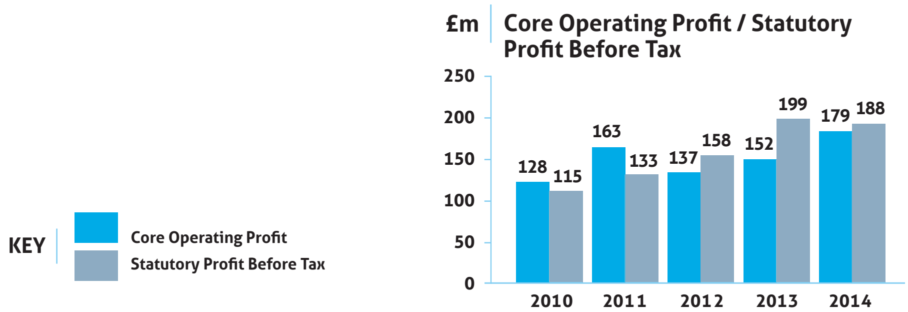
The Board monitors the Group's performance on both a statutory profit and core operating profit basis. Whilst statutory profit is defined by accounting regulations and provides a clear comparison between organisations, core operating profit measures longer-term underlying performance by excluding non-core items, both positive and negative, such as timing differences that reverse over time (e.g. fair value adjustments) or items of a one-off nature (e.g. merger related transactions).

Both measures show a strong financial performance in 2014, continuing the successes of the last four years.

Statutory profit before tax for 2014, at £188m, was down 6% but remained healthy. Our core operating profit grew by 18% to £179m, a strong performance in the view of the Board.

| £m | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Net interest income | 273 | 329 | 346 | 532 | 549 |
| Fair value volatility | (10) | (10) | (12) | 16 | (11) |
| Net realised gains/(losses) | 15 | 4 | 78 | (42) | 1 |
| Other income | 60 | 53 | 48 | 37 | 26 |
| **Total income** | **338** | **376** | **460** | **543** | **565** |
| Management expenses | (173) | (210) | (250) | (300) | (331) |
| | **165** | **166** | **210** | **243** | **234** |
| Loan loss provisions | (41) | (30) | (39) | (23) | (20) |
| Other provisions | (9) | (3) | (13) | (21) | (26) |
| **Statutory profit before tax** | **115** | **133** | **158** | **199** | **188** |

| £m | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| **Statutory profit before tax** | **115** | **133** | **158** | **199** | **188** |
| Add back: | | | | | |
| FSCS Levy | 4 | 3 | 5 | 12 | 12 |
| Non-core investments | 10 | 5 | (1) | (14) | (11) |
| Timing differences - fair value volatility | 6 | 5 | 13 | (2) | 22 |
| Mergers - adjustments to balances required | - | - | 6 | (94) | (32) |
| Mergers and acquisitions - costs | 10 | 20 | 16 | 2 | - |
| Mergers - goodwill | (17) | (6) | - | - | - |
| Mortgage book disposal | - | - | - | 13 | - |
| Balance sheet structured debt buy back | - | - | (62) | 30 | - |
| Other non-core items | - | 3 | 2 | 6 | - |
| **Core operating profit** | **128** | **163** | **137** | **152** | **179** |




The key movements and trends within the Income Statement were as follows:

- Interest income was up 3% at £549m (2013 - £532m) but most importantly at 1.52% (2013 - 1.56%), it was stable as a percentage of mean assets. This ratio is known as Net Interest Margin and it is a key measure used by the Board as it accounts for growth in the underlying assets and liabilities that drive interest income and expense. In essence it reflects how an institution manages the income from its assets and the interest paid for its funding. This reflects the broadly unchanged conditions during the year, including:
  - The continued availability of relatively low-cost retail funding to the Group as savings rates have been impacted by a number of factors, including the record low Bank of England Bank Rate (unchanged since March 2009) and the impact of the Government's Funding for Lending Scheme (FLS). We have participated in this scheme, using the money to fund £3bn of new lending.
  - Whilst aiming to protect our customers from the impact of low rates we can only do this within the context of maintaining our financial security, ensuring we do not attract more money than we can safely and sensibly lend.
  - For this reason, we reduced some of our savers' rates mid-way through the year. However at the same time, following our rates review exercise we increased the interest rate on approximately

900,000 accounts to ensure that they pay a minimum of 0.50% interest.

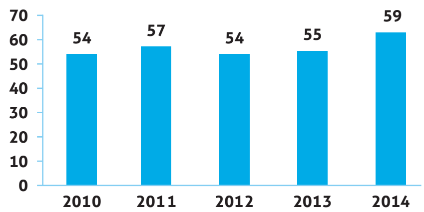
- The cost of raising funds in the wholesale markets remained low due to the continued availability of cheap, government-backed funding in both the UK and the Eurozone.
- We were able to successfully re-enter the senior unsecured debt and Euro Covered Bond markets with a €600m five year public issue and a €500m seven year public issue respectively and we continued to access the UK securitisation market with a £300m public issue.
- The continued strong lending performance of the Group over the last 18 months meant that lending income was maintained.
- Net new lending was £2.6bn for the whole of 2014 (2013 - £2.0bn), representing a market share of 11.4% [27].

- Fair value volatility represents adjustments to the value of some of our assets and liabilities to reflect changes in underlying market rates. These are almost entirely timing differences which will reverse in future years as the assets and liabilities themselves mature. As such this figure could move materially year on year, and we aim to minimise its impact. In 2014 it shifted from a £16m gain to a £11m loss, both within our expectations.
- Net realised (losses)/gains were minimal in 2014 (£1m gain) as opposed to 2013 which saw a material loss of £42m. As previously reported, the 2013 loss related mainly to early buy back of some of the Group's capital at a premium but with future interest savings that outweigh that premium over time.
- Together these two non-core items improved profit before tax by £16m (a £27m negative movement in fair value offset by a £43m positive movement on net realised losses and gains).
- Other income declined by £12m to £26m reflecting an increase in fees payable under the FLS and lower recoveries from inherited merger related issues. Underlying income from the sale of investment and insurance products declined from £19.6m to £17.9m.
- Management expenses increased by £31m, driven by a combination of:
  - General inflationary pressures and growth in the size of the business.
  - The impact of changing regulation, which added an estimated £7m to our ongoing cost base.
  - Continued spend on our strategic investment programme.

The investment programme is aimed at further enhancing our service and product delivery and we continue to believe that the level of investment in systems, networks, people and products is right for the Group and will deliver sustainable benefits for our customers and our people.

A key measure used by the Group to manage its overall cost position is the cost:income ratio. This ratio looks at the relationship between income generation and our costs. The lower the ratio, the less an institution is spending to generate every pound of income. However, it is important to look at this ratio over a number of years to see the trend as opposed to an individual year in isolation. We continue to focus strongly on our cost base and have initiated a full review of our existing cost base and underlying management processes.

**% | Cost:Income Ratio**




The charge made for impairment on our mortgage portfolios fell by £3m to £20m compared to £23m in 2013. This reflects our continued efforts to manage the quality of our loan portfolios and the improved economic and housing market conditions during the year.

Charges for other provisions of £26m represent two main items:

- Provisions for customer redress, which at £11m were at a similar level to 2013. The 2014 charge relates to customer remediation in respect of the promotional material of some structured deposit products following finalisation of the remediation process with the FCA. Financial penalties imposed by the FCA in respect of arrears collection procedures and structured deposit

[27] Source: Bank of England, as at December 2014

account promotional material were fully provided in 2013.

- The cost of the Financial Services Compensation Scheme, whereby we, and other retail savings institutions, fund the wind down of a number of failed institutions. This charge remained stable at £12m in 2014.

Overall we believe that these results represent a strong performance, especially as we are investing heavily in the future of the business.

### Balance Sheet strength

**Group Balance Sheet**

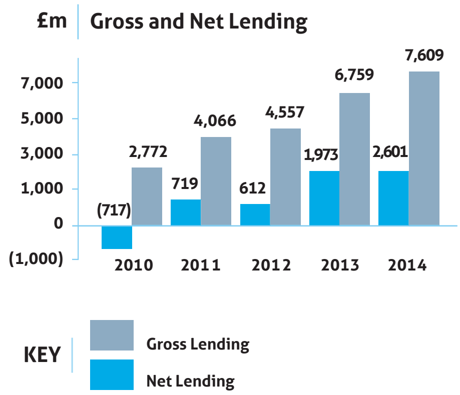
| £m | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Liquid assets | 5.9 | 4.9 | 5.2 | 4.4 | 4.8 |
| Mortgage and other loans | 23.4 | 27.0 | 27.6 | 29.5 | 32.2 |
| Other assets | 0.8 | 0.7 | 0.7 | 0.6 | 0.6 |
| **Total assets** | **30.1** | **32.6** | **33.5** | **34.5** | **37.6** |
| Retail savings | 21.4 | 26.0 | 26.8 | 26.3 | 27.2 |
| Wholesale funding | 6.3 | 3.9 | 4.2 | 5.9 | 7.5 |
| Other liabilities | 0.7 | 0.7 | 0.8 | 0.4 | 0.6 |
| | **28.4** | **30.6** | **31.8** | **32.6** | **35.3** |
| Remunerated capital | 0.4 | 0.4 | 0.1 | 0.1 | 0.3 |
| Reserves | 1.3 | 1.6 | 1.6 | 1.8 | 2.0 |
| **Total liabilities** | **30.1** | **32.6** | **33.5** | **34.5** | **37.6** |

Providing mortgages is at the core of being a building society and we primarily focus on lending for owner occupied properties within the prime residential mortgage market.

In 2014 growth returned to the UK mortgage market, and within that context we delivered:

1. Record gross lending of £7.6bn - up from £6.8bn in 2013.
2. Net lending of £2.6bn – compared to £2.0bn in 2013.
3. Stable market share of gross lending at 3.7% [28] compared to 2013's level of 3.8%.

Net lending is a key measure to monitor the Group's lending performance. It is gross lending less repayments of principal and measures our effectiveness in both new mortgage lending and in retaining borrowers. Looking at our performance in 2014, we achieved positive net lending in each calendar quarter, maintaining momentum throughout the year. We did experience slightly higher levels of redemptions (up from £4.8bn in 2013 to £5.0bn), reflecting increased market activity and our own balance sheet growth.

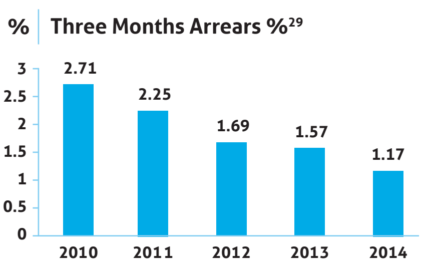



[28] Source: Bank of England, as at December 2014.

This meant that our mortgage balances across all portfolios grew by 9% to £32.2bn.

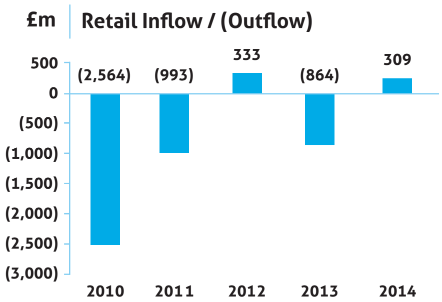
This mortgage growth has been achieved without taking inappropriate risk. The average loan-to-value (LTV) on new lending was 71.03% (2013 - 70.40%). The average indexed LTV for the overall residential portfolio was 50.89% (2013 - 54.06%), and indeed for this portfolio the position remains resilient with 80.01% of the book having an LTV of 80% or less (2013 - 88.20%).

The quality of our mortgage portfolios continues to be a critical element of our balance sheet management and the Board monitors the Group's arrears performance on a monthly basis, using a number of indicators, the most important being the percentage of our outstanding retail mortgage balances in arrears by three months or more (including possessions). The value of loans in arrears by three months or more (including possessions) reduced from 1.57% in 2013 to 1.17% in 2014.




The industry average for mortgage arrears is measured as the number of accounts more than three months in arrears (including possessions) – and at 1.21%, (2013 - 1.45%) our performance remains healthily below the CML industry average of 1.39% [30] (2013 - 1.76%).

The Board monitors the Group's retail savings performance by tracking the net amount by which retail savings balances grow in any period. This is referred to as net retail inflow. Our overall savings portfolios grew modestly in 2014, representing an underlying net inflow of £309m compared to an outflow of £864m in 2013.




Our funding base is still predominantly comprised of retail savings, and this return to net inflows, albeit modest, is consistent with our long-term strategy, and we continue to offer rates that are higher than the market average. At the end of 2014, 92% of mortgages were funded by retail savings and retained profits (2013 - 97%).

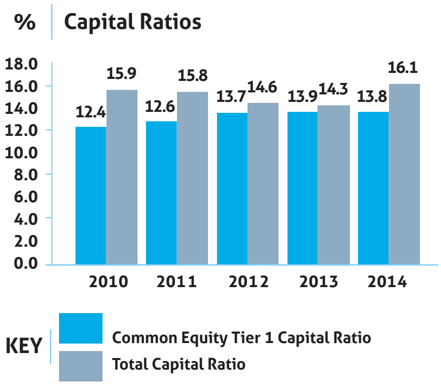
### Sustainability

Whilst achieving this growth we have maintained the Group's strong capital position. One key measure that the Board monitors on a monthly basis is the Common Equity Tier 1 ratio, which represents the strongest form of capital. For us it is essentially our accumulated profits built up over time. The ratio compares this to the Group's assets, weighted according to how much risk they carry.

On 1 January 2014, the European Capital Requirements Regulation and Directive (commonly referred to as CRD IV) came in to force. The new regulations included additional capital requirements, redefined the instruments that qualify as regulatory capital and increased the quality of capital that financial institutions are required to hold against their risks. The Group had carried out buy-backs of capital instruments in 2012 and 2013 in anticipation of this change and was therefore well positioned for the new regulation.

As at 31 December 2014:

- Our Common Equity Tier 1 (CET1) capital ratio (similar to the previous Core Tier 1 ratio) was 13.8%, marginally down from the Core Tier 1 ratio of 13.9% at the end of 2013.
- Our Total Capital Ratio increased from 14.3% in 2013 to 16.1% in 2014 following the Group's issuance of £250m Tier 2 capital securities. This issuance was undertaken to meet changing regulatory requirements for the types of capital available to absorb unexpected losses.




[29] The percentage of outstanding mortgage balances in arrears by more than three months (including possessions).

[30] Source: Council of Mortgage Lenders, as at December 2014.

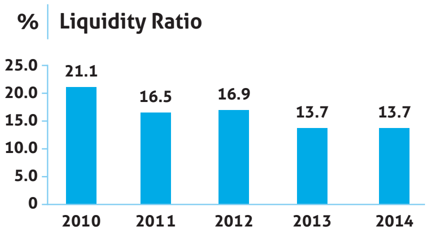
Another measure of capital strength is the leverage ratio. Whilst this measure removes the risk weighting used in the CET1 ratio, it also adds in a measure of off-balance sheet exposures to the asset side of the equation, requiring capital to be held against features such as mortgage offers that have yet to complete.

In October 2014, the Financial Policy Committee (FPC) of the Bank of England set a minimum leverage ratio of 3%, with systemic leverage buffers added at 35% of the risk weighted buffer. These requirements currently only apply to the UK's eight largest institutions until 2017. The requirement will become mandatory for all other institutions (including the Group) in 2018. At the end of 2014, our leverage ratio was 4.8% which we believe compares favourably with most high street banks and our peers in the mutual sector.

The strong financial performance of the Group was recognised by external rating agencies as we received upgrades in 2014 from both Moody's Investors Service and Fitch Ratings. In upgrading the Society both agencies commented on the improving financial performance, capital strength and improving asset quality.

One of the key measures that we are required to report to the Prudential Regulation Authority (PRA) is the liquidity ratio. This expresses the total cash in hand and balances with the Bank of England, loans and advances to credit institutions, debt securities and other liquid assets as a percentage of our shares and borrowings. It is inefficient to hold significantly more liquidity than is required as excess liquidity earns less than it costs to raise.

The Group continues to maintain prudent levels of liquidity to meet the demands of borrowers and savers and other commitments. Throughout the year we remained comfortably above the liquidity thresholds set by our regulator.




At the end of 2014, 83% of total liquidity, £4.0bn, was high quality (albeit low yielding) assets deposited with the Bank of England or invested in UK Government gilts and were eligible for inclusion in our regulatory liquid assets buffer (high quality instruments, readily realisable as cash). Liquidity is also available through the FLS, allowing institutions to pledge mortgage assets in return for treasury bills which can be converted to liquidity.

## 4.5. Locally Famous

It is important to us that the Group plays a role in local communities.

Whether it's a one-off monetary gift or a benefit-in-kind donation, it's another way that we're giving back to the communities our members and employees live and work in. In 2014 the Group donated £1.7m to charities, good causes and community groups across the UK. We also contributed over 10,000 hours of employees' time to local projects and causes. Highlights include:

- To mark our 150th anniversary, we created a Lasting Legacy Fund allocating £150,000 to be shared equally between 15 successful charities chosen by colleagues, members, customers and members of the public, the projects chosen will make a lasting difference to their communities.
- We launched our most ambitious charity drive - the Marie Curie 'The Hour of Need' campaign – which will enable Marie Curie nurses to provide vital support for terminally ill people and their families. Every £20 raised will fund one hour of care and we are aiming to raise £500,000 by December 2016, which equates to funding an hour of care for every hour of the campaign. As at 31 December 2014 we had already raised funds to cover over 10,000 hours of nursing care.
- We were proud to support the Tour de France Grand Départ, a once in a lifetime opportunity to demonstrate our pride in our heritage in Yorkshire and across the UK, as the Tour travelled from Yorkshire to East Anglia and London. The Tour passed many of our branches giving us chance to both participate in the spirit of the occasion and raise our profile in the local area.

## 5. Principal risks and uncertainties

The principal risks and uncertainties faced by the Group can be classified into three categories; macroeconomic risks, business model risks and risks relating to our investment programme. The Group has constructed its systems of monitoring and control around the risks identified below. Details of these categories and our risk management infrastructure are included in the Risk Management Report, see pages 49 to 55.

## 5.1. Macroeconomic risks

At the end of 2014 and the beginning of 2015, the principal macroeconomic risks and uncertainties faced by the Group can be summarised as follows:

- **Faltering economic recovery**
  Slowing growth, disinflationary pressures and stagnation in key export markets may undermine the UK's economic recovery. Cuts to date in public spending are only a fraction of those planned, which could further dampen future growth. This may all impact on the housing market, threatening affordability and mortgage customers' ability to pay.

- **Housing market slow-down**
  There are conflicting indicators around the robustness of the market with some house price falls being registered and confidence falling. There has been direct Bank of England intervention in the housing market around loan to income ratios and this type of action may become more extensive. Any risks to the economic recovery or falling house prices may impact the Group's profitability and growth plans.

- **UK general election**
  The uncertainties around the forthcoming election create a range of risks for the Group for example the chance that no major party wins a clear majority introducing material economic and policy uncertainties. For the Group, the major risk is the possibility of further intervention to restrict lending, or economic measures which could result in spending cuts dampening any further economic recovery. This could knock on to our growth levels, profitability and borrowers' financial resilience.

- **European matters**
  Recent European elections have seen an increase in support for Eurosceptic parties. This, coupled with generally poor economic conditions in Europe poses a further threat to the UK's continued economic recovery. Should a UK referendum take place on EU membership there is a risk that investment and economic activity slow due to the resulting uncertainties. This could impact on our growth levels, profitability and borrowers' financial resilience. Additionally, whilst the UK is not a member of the Euro, instability within the currency union, such as the ongoing issues with Greece, also provides a source of risk to both UK economic performance and financial markets.

- **Further regulatory changes**
  There are further changes to come on capital and liquidity risk management, and on some accounting rules, the impact of which remains unclear. There are also changing requirements around remuneration and the responsibilities of senior management in the financial services industry. The growing burden of regulation may affect institutions' ability to operate effectively, will further increase costs and may make it harder to attract people into the industry. All of this will put further pressure on our resources and cost management.

## 5.2. Business Model risks

There are principal risks inherent within the business, which are:

- **Credit risk**
  The risk that a borrower or counterparty fails to pay interest or to repay principal on a loan or other financial instrument (e.g. a bond) on time.

- **Market risk**
  The risk that the value of, or the income derived from, the Group's assets and liabilities changes unfavourably due to movements in interest rates and foreign currency rates.

- **Conduct risk**
  The risk that the organisation fails to design and implement operational arrangements, systems and controls such that it can maintain legal and regulatory compliance, deliver fair customer outcomes and achieve a positive experience for customers.

- **Financial risk**

  The risk of the Group having inadequate earnings, cash flow or capital to meet current or future requirements and expectations. It includes loss or damage to the earnings capacity, market value or liquidity of the Group, arising from mismatches between the Group's assets, funding and other commitments, which may be exposed by changes in market rates, market conditions or the Group's own credit profile.

- **Operational risk**

  The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events such as cyber-attacks.

The management and control of these risks is explained in the Risk Management Report on pages 49 to 55.

## 5.3. Investment programme risks

We are confident in our ability to achieve our plans, but the Board recognises that the successful management of risks and uncertainties in the delivery of this programme is key.

We closely monitor all risks and uncertainties, and remain confident that with our financial strength, passion for customers and our mutual heartbeat, along with investment in the business and focus on our strategic priorities, we are well placed to continue to succeed.

## 6. Outlook for 2015

We expect the UK economy to continue to improve over the coming year, although the outlook is not perhaps as positive as it was just six months ago. The Eurozone is again suffering from economic and political uncertainty which is likely to impact the UK economy.

Europe is also suffering from a deflationary environment and the recent dramatic falls in the price of oil will exacerbate this situation. Given the close links between the UK and Europe in terms of both trade and financial markets, any weakness in Europe has the potential to impact UK Gross Domestic Product growth. The UK has seen inflation as measured by CPI fall to a record low and it is expected to remain very low for some time. Given the Bank of England's mandate to use monetary policy to achieve a Consumer Price Index target of 2%, there may be no urgency for any Bank Rate increase. Markets are now indicating that a Bank Rate increase may not occur until 2016 and from that point onwards the pace of monetary tightening will be very slow. Correspondingly long-term swap rates have fallen to all-time lows and shorter length swap rates fell significantly over the second half of 2014 driving down the pricing of mortgage products.

### Savings market

The environment has not been favourable for savers for some time, driven by the record-low Bank of England Bank Rate (for nearly six years) and the reduced need for financial services providers to compete for savers' deposits. However, we expect this to improve in 2015. The Chancellor's proposals as introduced in the 2014 Spring Budget, notably the changes to the ISA rules (allowing savers to use their new £15,000 ISA allowance entirely in cash from July 2014) and the pensioner bonds may well encourage growth in savings balances. The latest proposals in the Chancellor's Autumn Statement such as; Stamp Duty becoming more progressive by introducing marginal tax rates; increasing the tax free allowance and allowing people to inherit their husbands' or wives' ISA tax free could also help savers. Additionally, the FLS will be coming to an end which will in time increase competition for retail deposits. Overall competition for savings may become harder, benefiting savers.

### Housing market and mortgage approvals

Whilst transaction activity and prices remain above 2013 levels, forward sentiment indicators are much less positive than they were twelve months ago and the pace of mortgage approvals also appears to be cooling down. Much of the signs of slowdown are focused on the London and South East regions which experienced the highest rates of price growth in 2014. Given the backdrop of weaker house price inflation in 2015, uncertainties around the outcome of the general election and timing of the first upward move in interest rates, this seems likely to present a continued restraint on the market over the first half of 2015.

**Regulatory environment**

The regulatory environment is expected to remain challenging and there could be some further intervention from the Financial Policy Committee (FPC) and/or the Prudential Regulation Authority (PRA) should concern about a 'housing bubble' in the property market materialise. We expect any intervention to be via some macro-prudential tools such as limiting the proportion of lending at high loan-to-income and/or loan-to-value ratios.

We also expect the regulators to further focus on capital requirements, which could result in more reporting and stress testing requirements.

The FPC has proposed an approach in the UK that would include additional leverage buffer requirements for systemically important firms as part of countercyclical measures. Whilst this leverage ratio requirement will not apply for the Group, we will continue to monitor and disclose our leverage position. At the end of 2014, the Group's leverage ratio was 4.8%, compared to a proposed baseline requirement of 3%.

The European Commission also proposed changes to the Liquidity Coverage Ratio (LCR), which becomes binding from 1 October 2015, meaning that financial institutions may include a wider range of instruments in the liquid asset buffer than originally proposed.

The Competition and Market Authority has launched an investigation into the supply of personal current accounts and into banking services to small and medium-sized enterprises. The investigation is likely to take up to 18 months and could result in a major shake-up in retail banking. We view this investigation as a positive step towards promoting competition in the UK banking industry.

**Competition and challenger banks**

Recently building societies benefitted as many of the major banks deliberately shrunk their mortgage books in the wake of the financial crisis in order to repair their balance sheets. However, when the repair work has been completed banks will probably look to increase their mortgage lending, intensifying competition in the market.

The challenger banks could further deepen this competition and provide innovative customer experience as they intend to fill the gaps left by the big players. These challengers are likely to use their relative strengths to outperform the traditional banks in specific sectors.

**Overall, the Board believes that 2014 was a good year of progress and performance for the Group. We believe that 2015 will bring fresh opportunities and challenges, and that the Group is well positioned for both.**

**Robin Churchouse**
**Chief Operating Officer**
**& Finance Director**
23 February 2015

# SOCIETIES TOGETHER

Our involvement in our local communities goes far deeper than just our physical presence. We play an increasingly active role in being part of and supporting the communities around us.

## Actively involved in the community

**We have a number of initiatives that offer support and funding in a range of ways.**

### Yorkshire Building Society Charitable Foundation

Set up in 1998 the Charitable Foundation has donated over £6m through 20,172 donations and in the last year 91% of Charitable Foundation donations were to causes recommended by our members. The Charitable Foundation focuses on supporting registered charities and good causes that help those who are vulnerable (particularly the elderly, children and people with disabilities) in the communities we serve.

### Small Change Big Difference®

Many of our members donate the pennies of interest from their account(s) once a year to the Charitable Foundation. It's thanks to them that the Foundation can support so many charities each year. Since the scheme launched in 2000 all these pennies have amounted to over £3m for good causes.

### Marie Curie campaign

In June 2014 we launched our 'Hour of Need' campaign with Marie Curie, the charity chosen by our members and colleagues. We aim to raise £500,000 by December 2016 - funding an hour of nursing care for every hour of the campaign and we got off to a flying start with over £200,000 raised by the end of 2014 – that's 40% of our target already achieved. This money will allow Marie Curie nurses to provide even more vital support for terminally ill people and their families across the UK. We've deepened our partnership with Marie Curie through employee volunteering activities to support their charity shops and hospices in particular, which our colleagues have enthusiastically supported.

### Actionteering

The time and skills we share with our local communities are just as important as funding. That's why we give all our colleagues 14 hours of paid volunteering time each year. In 2014 over 1,100 colleagues used their skills to help a charity or good cause of their choice, donating more than 10,000 hours to their local community. In monetary terms this is the equivalent to a donation of nearly £150,000.

### Lasting Legacy Fund

To commemorate the Society's 150th year we donated £150,000 which was shared between 15 charitable projects across the UK, selected by colleagues, customers and members of the public. This money will help each charity support their community for many years to come – just as the Society has been doing for the past 150 years.

### Affinity partnerships

Thanks to our members supporting our Yorkshire Air Ambulance savings account we donated over £612,000. The RSPCA also received over £168,000.

## Doing our bit to help the environment

**We have an ongoing programme of environmental initiatives.**

During 2014 we continued our commitment to reducing the Group's impact on the environment by taking substantial steps to:

- Improve our waste management practices.
- Reduce our energy consumption and associated carbon emissions.
- Embed sustainability into our operations.

*Small Change, Big Difference® is a registered trademark of Yorkshire Building Society.


### Energy saving

The specific measures we have taken include:

- Incorporating energy saving initiatives during the refurbishment of our main office sites, reducing our energy usage by over 1.5 million kWh - equivalent to the energy used by approximately 350 UK households over a year.
- Installing 1,400 solar panels at two office sites to reduce our annual carbon emissions by 130 tonnes.
- Purchasing 100% green electricity throughout 2014.
- Monitoring energy usage on a monthly basis across the property portfolio, with large anomalies investigated and actions taken to eliminate inefficient use.

### Sustainable travel choices

We have encouraged our colleagues to take advantage of a number of options that will reduce travel emissions. These include:

- Participating in the Government's cycle to work scheme.
- Discounted annual travel tickets for staff.
- Our Liftshare scheme, putting colleagues in touch with others who live nearby so they can travel to work together.
- Business travel initiatives, such as selecting low emission vehicles for the Group's car fleet and minimising business travel through tele/video-conferencing facilities.

### Minimising waste and water use

With the introduction of a new waste disposal contract, we now offer colleagues more opportunities to recycle. Across our branch network an average of 83% of the general waste is sent for recycling.

We are reducing our use of paper through avoidance, reduction and recycling. One of the ways we are doing this is through new pull print facilities, where printing is only done as and when a colleague accesses the printer, rather than printing automatically.

Our efforts towards water conservation include various initiatives including the installation of flow restrictors and automatic sensors. We have also installed leak detection systems at our main head office site.

### The future

We're looking forward to continuing to make a real and lasting difference to the lives of those in our local communities. Our focus will be on providing educational and specialist skills support, supporting vulnerable people and fostering community spirit.

We will also further reduce our environmental impact through our office refurbishment programme and by carrying out regular energy savings audits in line with the Energy Savings Opportunity Scheme.

**ALMOST £2M**
**provided to charities, good causes and communities**

**£200,000**
**raised for Marie Curie, 'Hour of Need' campaign**

**10,000**
**volunteering hours completed through our Actionteering programme**

**1,400**
**solar panels installed at main office sites**

# Non-Executive Directors


Ed Anderson

John Heaps

Dame Kate Barker

**Ed Anderson, BSc, CPFA**
Chairman

Ed Anderson joined the Board in 2003 and was appointed Chairman on 1 January 2007. He also chairs the Board Governance and Nominations Committee.

He 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 is also involved in various other local organisations and charities.

Ed is to retire from the Board at the conclusion of the Society's Annual General Meeting on 21 April 2015.

**John Heaps, LLB**
Chairman Designate

John Heaps joined the Board on 20 November 2014 as Chairman Designate (a non-executive director role) and will succeed Ed Anderson as Chairman at the conclusion of the Society's Annual General Meeting on 21 April 2015.

John, who is a lawyer by training, is the former Chairman of corporate law firm Eversheds, having served on its Board since 2008 and before that its Senior Management Team since 1999. During his time as Chairman of Eversheds he was ultimately responsible for the firm's compliance with the legal sector's regulatory regime. John contributed significantly to the development of the firm's long-term strategy and helped drive considerable change as it grew from a group of affiliated UK offices into a major international law firm.

Since standing down as Chairman of Eversheds in early 2014, he has continued his role as a litigation partner and will remain with the firm until April 2015.

John is a member of the Business and Oversight Board of the Law Society, serves on the Risk and Audit and Constitutional Committees of the International Bar Association and is a trustee of the Garden Bridge Trust, a project to build a new Thames crossing between Blackfriars and Waterloo.

**Dame Kate Barker, DBE, CBE**
Non-executive Director

Dame Kate Barker joined the Board in November 2010 and is a member of the Group Risk Committee, the Remuneration Committee and the Board Governance and Nominations Committee. She is also a trustee of the Society's pension scheme.

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 (MPC) in 2001. Prior to her appointment to the MPC she was Chief Economic Adviser to the CBI.

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 and was appointed a Dame in June 2014 for services to the economy. She is a non-executive director of Electra Private Equity Plc and Taylor Wimpey plc, a senior adviser to Credit Suisse and was recently appointed as Chairman of the British Coal Staff Superannuation Scheme.

Lynne Charlesworth

Alison Hutchinson

Philip Johnson

**Lynne Charlesworth, BA, MBA**
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.

Lynne has a background in risk management, particularly within the financial services and property sectors. She also has experience within the building society industry becoming Group Risk Manager with Abbey National Plc when it acquired 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.

**Alison Hutchinson, BSc**
Non-executive Director

Alison Hutchinson joined the Board on 4 February 2015 and is a member of the Audit Committee.

Alison has a strong background in both the IT and financial services sector having started her career at IBM where she became Global Director of Online Financial Services. In 2000 she joined Barclays Bank where she held a number of senior management positions including Head of its B2B online business and Marketing Director of Barclaycard. Her retail financial services experience was further extended in 2004 when she moved to the specialist mortgage provider, Kensington Group where she was Managing Director and then Group Chief Executive, leading the successful sale to Investec in 2008.

Alison is currently the CEO of the charity, The Pennies Foundation. She is also a trustee of the Charities Aid Foundation and a non-executive director of Aviva Life Holdings Ltd.

**Philip Johnson, FCA**
Non-executive Director

Philip Johnson joined the Board in 2007 and is Chairman of the Audit Committee. He 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 Deloitte partner, Philip specialised in providing advisory and assurance services to large corporate clients. He has considerable experience of financial services having led some major investigations in the sector. Philip is a member of the Audit Committee of the Wellcome Trust and, until December 2012, he was President of the Federation of European Accountants. In January 2014 he was appointed a member of the Standing Advisory Group of the Public Company Accounting Oversight Board in the USA. He is also a non-executive director of Lakeland Ltd.

Philip is to retire from the Board at the conclusion of the Society's Annual General Meeting on 21 April 2015.

# Non-Executive Directors

David Paige

Mark Pain

Guy Parsons

**David Paige, BSc, FCA**
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 Chairman of trustees for 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.

**Mark Pain, BSc, FCA**
Non-executive Director

Mark Pain joined the Board in August 2013 and is a member of the Audit and Group Risk Committees. He will take on the role of Chair of the Audit Committee on the retirement of Philip Johnson on 21 April 2015.

Mark has 15 years' experience at director-level roles within FTSE 100 companies across the financial services and residential properties sectors. He spent 16 years with the Abbey National Group, including seven years as Group Finance Director, Chief Executive of Abbey National Treasury Services, and Customer Sales Director. He was then appointed Group Finance Director at Barrett Developments Plc where he worked until 2009.

Mark holds a number of other directorships; he is a non-executive director of Aviva Insurance Ltd and the Spirit Pub Company Plc, the Senior Independent Director at Johnston Press Plc and Chairman of London Square Developments Ltd.

**Guy Parsons, BA**
Non-executive Director

Guy Parsons joined the Board in May 2013 and is Chair of the Remuneration Committee. Guy has more than 20 years' experience of director-level roles with major UK companies, including eight years with Travelodge where he became Chief Executive. Prior to joining Travelodge, he held a number of senior positions with Whitbread Plc, including Managing Director of the restaurant chain, T.G.I. Friday's.

Guy holds a number of other directorships which include non-executive director of the heating manufacturer, Warmup Plc. He is also Chairman of Commercial Services Ltd and Chairman of the North East Surrey College of Technology Consortium LLC.

# Executive Directors

Chris Pilling

Ian Bullock

Andy Caton

**Chris Pilling, MA**
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 variety of senior roles 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**
Chief Customer Officer and Executive 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 Executive Management team in 2004 and became an executive director responsible for sales and marketing in April 2007.

Ian is responsible for the Group’s branch networks, customer operations and customer relations functions. He is also Chairman of Accord Mortgages Ltd, the Society's intermediary lending subsidiary.

**Andy Caton, BA**
Chief Treasury and Corporate Affairs Officer and Executive Director

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

Andy is a trustee of Yorkshire Building Society Charitable Foundation. He is Vice President of the Bradford Chamber of Commerce and a director of West & North Yorkshire Chambers of Commerce.

# Executive Directors

Robin Churchouse

Mike Regnier

**Robin Churchouse, MA, ACA**
Chief Operating Officer and Finance Director

Robin Churchouse joined the Society in 2004 as Head of Finance. He was promoted to the Executive Management team in June 2006 and was appointed Finance Director in June 2010 and appointed as Chief Operating Officer in January 2014. He now has responsibility for the Corporate Strategy and Planning, Finance, Shared Services and Property functions. Before joining the Society, 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.

**Mike Regnier, MEng, MBA**
Chief Commercial Officer and Executive Director

Mike Regnier joined the Society on 3 June 2014. Previously, he was with Lloyds Banking Group where he held a number of senior commercial positions, including Personal Current Accounts & Credit Card Director and most recently as the Products and Marketing Director for TSB where he was responsible for the re-launch of the TSB brand on the UK high street in 2013. Prior to Lloyds Banking Group, he held management positions at ASDA and the Boston Consulting Group.

Mike is responsible for leading the Group's product development, marketing and customer experience through all our channels.

# Other Chief Officers

Jane Hanson

David Henderson

Richard Wells

**Jane Hanson, BA, MBA, MCIPD**
Chief People Officer

Jane Hanson joined the Society in March 2013 to lead the Human Resources (HR) and Internal Communications functions. Jane has 20 years' experience within HR and financial services, having worked with Alliance & Leicester, HSBC and First Direct - who regularly featured in the Sunday Times 'Top 100 Employers' list under her tenure as Head of HR.

**David Henderson, BSc**
Chief Information and Change 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. David started his career in the building society sector, and prior to joining the Society held a range of senior IT positions within a major UK banking group.

**Richard Wells, FCIB**
Chief Risk Officer

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. He is also responsible for the Legal & Secretarial function.

# 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 2014.

## 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 Strategic Report on pages 8 to 23.

## Principal risks, uncertainties and going concern

The principal risks and uncertainties faced by the Group are set out in the Strategic Report on pages 8 to 23 and our approach to managing them is set out in the Risk Management Report on pages 49 to 55.

As set out on page 68, the directors are required to consider whether it is appropriate to adopt the going concern basis in preparing these financial statements and identify any material uncertainties to the ability of the Group to continue to do so over a period of at least twelve months from the date of approval of the financial statements.

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.

The metrics considered in the latest review, performed in February 2015, included:

- Sustainability – review of business performance against specific exposure limits and key risk indicators.
- Liquidity & Funding – review of projected future surplus liquidity against both regulatory and internal thresholds.
- Capital & Profitability – stress testing of the Group's capital plans.
- Enterprise Risk Management – review of the risk map identifying future events/conditions that could impact achievement of the Group's objectives.

As a result of this review the Board concluded that the Group has sufficient resources for at least the next fifteen months and that there are no material uncertainties that challenge the assessment that the Group's financial statements should be prepared 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 (CRD IV) and holds well in excess of its regulatory requirement. The Pillar 3 disclosures required under CRD IV 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.

## Disclosure requirements under CRD IV country-by-country reporting

In compliance with the Regulations of Article 89 of the Capital Requirements Directive IV (CRD IV) country-by-country reporting (CBCR) we disclose the following information:

a) Name, nature of activities and geographical location
   Yorkshire Building Society is the parent company and a list of the subsidiaries can be found in Note 10 of these accounts. The principal activities of the Group can be found in the Strategic Report and in Note 22.

   All group companies operate in the United Kingdom only.

b) Average number of employees

   The average number of employees is disclosed in Note 7.

c) Annual Turnover

   Net operating income is set out in the Group Income Statement.

d) Pre-tax profit or loss

Pre-tax profit is set out in the Group Income Statement.

e) Corporation tax paid

Corporation tax paid is set out in the Group Statement of Cash Flows.

f) Public subsidies received

No public subsidies were received in 2014.

## Business review and future developments

Key developments and the future outlook are reviewed by the Chairman on pages 2 to 5 and in the Strategic Report on pages 8 to 23. The Strategic Report identifies and explains the Group's Key Performance Indicators and sets out how the Group has performed against each during 2014.

## Profit and capital

Profit before tax for the year was £188.2m (2013 – £199.3m) and after tax the amount transferred to Group general reserves was £147.4m (2013 – £148.1m).

Total Group reserves at 31 December 2014 were £1,960.3m (2013 – £1,809.4m). Details of reserves movements are given in the Statements of Changes in Members' Interest on page 78.

Gross capital at 31 December 2014 was £2,266.7m (2013 – £1,864.9m) including £299.5m (2013 – £48.7m) of subordinated liabilities and £6.9m (2013 – £6.8m) of subscribed capital. Expressed as a ratio to shares and deposits gross capital was 6.52% (2013 – 5.79%) and free capital was 6.05% (2013 – 5.27%). These ratios are explained on page 147.

Further information about the Group's capital strength is outlined in the Strategic Report on pages 19 and 20.

## Mortgage arrears

Details of the Group's mortgage accounts which were 12 months or more in arrears at 31 December 2014 were as follows:

| | **2014** | 2013 | **2014** | 2013 |
|---|---|---|---|---|
| | | | % of mortgage accounts/balances | |
| Number of accounts | **395** | 435 | **0.15** | 0.17 |
| Balances outstanding on accounts | **£56.8m** | £62.4m | **0.18** | 0.21 |
| Amount of arrears included in balances | **£6.7m** | £7.3m | **0.02** | 0.03 |

Further details of the Group's arrears position and the various provisions made against potential losses are set out in the Strategic Report on pages 8 to 23. Note 39 on page 139 describes the various forbearance measures offered by the Group to borrowers experiencing difficulties in meeting their repayments.

## Colleagues

Our colleagues are key to our operations and to building trust with our members and customers. Attracting and retaining the best talent, with a leading people experience is a strategic priority for the Group.

The Group's management meet colleague representatives regularly to discuss a wide range of topics. Communication with and between all colleagues is subject to regular review and includes annual and monthly engagement surveys, team briefings, an intranet, in-house magazines and bulletins. The Group's overall engagement score in 2014 was 78%, a 2% increase from 2013.

An equal opportunities policy is followed and the Group gives full consideration to applicants and colleagues with disabilities. In 2014 the Group had its Investors 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 colleagues through regular analysis of learning needs and by the provision of a broad range of development 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 35 to 43.

At the 2015 Annual General Meeting (AGM), John Heaps, Chairman Designate, Alison Hutchinson, Non-executive Director and Mike Regnier, Chief Commercial Officer and Executive Director will be put forward for election by the members. At the same meeting, all existing directors will retire and put themselves forward for re-election, with the exception of Ed Anderson, Chairman, and Philip Johnson, Non-executive Director, who will retire at the conclusion of the AGM. Biographical details of all directors are outlined on pages 26 to 31.

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.

## Auditor

The reappointment of Deloitte LLP as auditor is to be proposed at the AGM.

On behalf of the Board

Ed Anderson
Chairman
23 February 2015

# Corporate Governance Report

## Chairman's statement

Dear Member

As Chairman of your Board I have the responsibility to ensure that the Society maintains high standards of corporate governance. Good corporate governance, which provides a framework for the way in which the Board (and the rest of the Yorkshire Building Society) operates, is also vital in providing effective leadership and 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 considerations:

- 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, including all our customers, 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 Group.

The approach is based on the principles and provisions of the UK Corporate Governance Code published by the Financial Reporting Council (the FRC) in October 2012 (the Code), 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 Conduct Authority (the FCA) and the Prudential Regulatory Authority (the PRA) also encourage each building society to explain in its Annual Report and Accounts whether, and to what extent, it adheres to the Code.

This Report sets out how the Board has operated in 2014 and applied the Code provisions using the Code section headings.

In the Corporate Governance Report for 2013, I reported upon two areas where we did not comply with the Code in 2013 and explained the reasons for the non-compliance. These related to the full Board being subject to annual election by members and external facilitation of the evaluation of the Board at least every three years. The following is an update on these two areas:

- Annual election of all Directors – as explained in my last report, the Board considered this provision in respect of the Society's AGMs held in 2011 to 2014 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. Thus, in 2014 we did not comply with this Code provision. The Board has once again given careful consideration to the adoption of this provision at the 2015 AGM and, 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, it has agreed to put forward all directors for election or re-election at the AGM (with the exception of myself and Philip Johnson who both retire at the conclusion of the AGM) so our members have the opportunity to vote on all Directors.
- External Board evaluation every three years – to comply with this provision, an externally facilitated review would have been undertaken in 2013. As reported in the 2013 Corporate Governance Report, in 2013 the Board was in a transition phase in respect of non-executive director recruitment and deferral of the review enabled the new directors to have time to gain a greater understanding of how the Board operated and thereby contribute more fully to such a review. In addition, it was felt that such a review would more usefully be conducted once the Chairman Designate had been identified. In 2014 the Board agreed, on the recommendation of the Board Governance & Nominations Committee to undertake such an externally facilitated Board effectiveness review. Details of this review are set out on page 40 of this report.

In all other aspects, it is the Board's view that we have continued to comply with the Building Societies Association's guidance on the Code.

Ed Anderson
Chairman

## Section A of the Code: Leadership

### The role of the Board

The Group is headed by the Board whose principal role is to:

- Safeguard the interests of members, ensuring the long-term success of the Society.
- 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 executive team.

### 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 Chief Officers (collectively known as the Executive Team). Other matters are delegated to the Executive Team or to other specified colleagues or committees, including the Board committees referred to below. Details of all the directors and other members of the Executive Team are set out on pages 26 to 31.

### Board committees

Certain matters are referred to Board committees in order that they can be considered in more detail by those directors with the most relevant skills and expertise. The committees are:

- The Audit Committee – details are contained in the Audit Committee Report on pages 44 to 48.
- The Board Governance and Nominations Committee – details are contained in the section on 'Appointments to the Board' on page 39 of this Report.
- The Group Risk Committee – details are contained in the Risk Management Report on pages 49 to 55.
- The Remuneration Committee – details are contained in the Directors' Remuneration Report on pages 56 to 67.

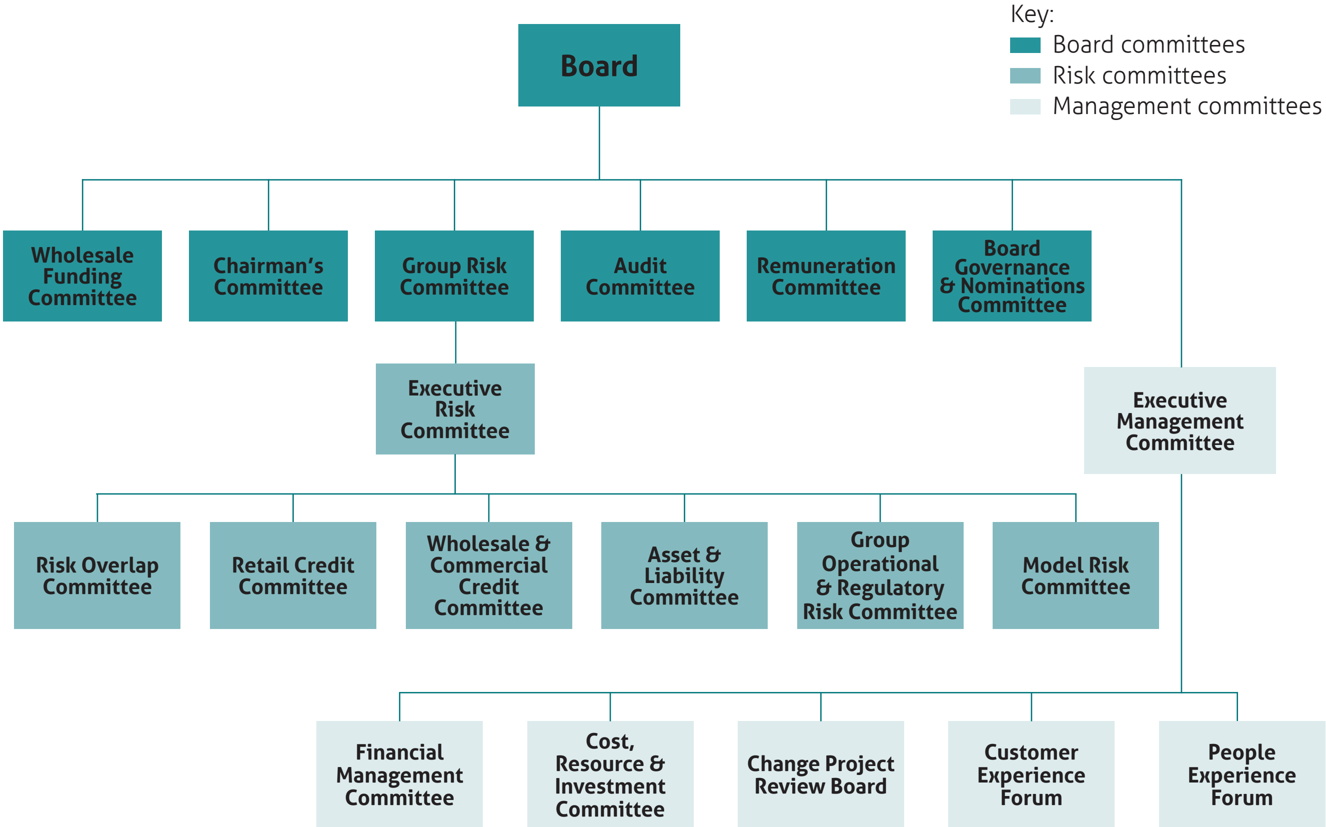
Members of these committees are set out in the table on page 43. The terms of reference of the committees are available on request from the Group Secretary or on the Society's website at www.ybs.co.uk/committees. The chair of each committee reports to the subsequent Board meeting on the matters discussed 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, Chairman Designate and the 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.

In 2014 a Wholesale Funding Committee was established which is made up of two executive directors, namely the Chief Operating Officer and Finance Director and the Chief Treasury and Corporate Affairs Officer and Executive Director. The main remit of this committee is to consider certain matters in respect of proposed wholesale funding transactions.

The Board and executive committee structure is set out below.

**Board committees and executive committees**




## Board meetings

The Board held 10 meetings in 2014. The attendance record of each director at these meetings and at relevant Board committee meetings is set out on page 43. 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 outside of West Yorkshire where the Group has an administrative centre which gives the non-executive directors an opportunity to meet local management and colleagues, including branch colleagues. In October 2014 the meeting was held at the administrative offices in Peterborough (which was the head office of the former Norwich & Peterborough Building Society).

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 Chief Officer 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.
- A report from the Chief Executive which highlights the current trading and financial performance and any other relevant matters considered by the Executive Team since the previous Board meeting.
- Minutes of the meetings of the monthly Executive Management Committee meeting 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 2014 the matters that the Board considered included the following:
  - Progress of the Group's Strategic Initiatives.
  - The regulatory actions including the remediation actions on the Structured Deposit products and the Arrears and Collections process as well as the 're-engineering' of the Arrears and Collections process and the Complaints process.
  - The marketing strategy including the new Group-wide visual identity and branch refurbishment.
  - The Mortgage Market Review.
  - Interest rates and the approach to be taken when the Bank Base Rate changes.
  - The management of conduct risk including regulatory dialogue and correspondence.
  - Results of the Colleague survey.
  - A revised corporate plan covering the next five years.

If a major item will require further detailed consideration then the Board may delegate this to an appropriate Board Committee.

## 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 Executive 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 Executive 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.

## 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 Executive Team and through a suite of management and risk committees.

## Section B of the Code: Effectiveness

## Composition of the Board

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.

As at the date of this report, the total number of directors on the Board is 14 consisting of five executive directors and nine non-executive directors. This number will reduce to 12 at the conclusion of the AGM on 21 April 2015 when Ed Anderson, the Chairman, and Philip Johnson, Non-executive Director and Chair of the Audit Committee, retire. The Board accepts that there needs to be flexibility in the number of directors (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 details of all the directors are set out on pages 26 to 31.

## 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) and Dame Kate Barker (Non-executive Director). As mentioned above, 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.

In late 2013 the Board appointed Egon Zehnder to assist in the search for candidates for two new non-executive director appointments as part of the ongoing non-executive director succession planning process. Egon Zehnder has no other connection with the Society. The search processes were as follows:

- Chairman Designate – the Board Governance & Nominations Committee agreed that there should be a separate selection panel made up of three non-executive directors including the Vice Chairman, Lynne Charlesworth, who led the process. A role specification was drawn up with a 'long list' of candidates considered by the selection panel who then conducted interviews with the selected short list of candidates. The other non-executive directors and the Chief Executive then met with the two preferred candidates with the Board making the final decision resulting in the appointment of John Heaps as Chairman Designate on 20 November 2014.
- Non-executive director – a similar process took place to recruit a non-executive director with IT and change programme skills with the process being led by Mark Pain, non-executive director. This resulted in the appointment of Alison Hutchinson on 4 February 2015 who is also a member of the Audit Committee.

The above directors are subject to election by members at the AGM to be held on 21 April 2015. They have both received approval from the Society's regulators, the FCA and the PRA, as Approved Persons to fulfil their controlled function as a director. Subject to his election by members, John Heaps will become Chairman of the Society at the conclusion of the 2015 AGM when Ed Anderson will retire.

Philip Johnson, Non-executive Director and Chair of the Audit Committee, is also to retire at the conclusion of the 2015 AGM. Mark Pain, an existing non-executive director, is to become Chair of that committee on Philip's retirement.

As referred to in the 2013 Corporate Governance Report, the Board appointed Mike Regnier to take up the new role of Chief Commercial Officer which commenced on 3 June 2014. Mike is therefore also subject to election by members at the forthcoming AGM.

As part of the on-going succession planning of non-executive directors, the Board has commenced the search for two non-executive directors with risk experience. Korn Ferry, which has no other connections with the Society, has been engaged to assist in this recruitment. Further announcements on this recruitment will be made later in the year.

## Diversity

The Board gives consideration to all aspects of diversity, including gender, on the Board although it continues to adopt the principle that all appointments should be based on merit and the skills and experience that the individual can bring and take into account the composite make-up, skills and experience on the Board. In November 2013 the Board approved a recommendation of the Board Governance and Nominations Committee that there should be an aspirational target to have 25% female directors by the end of 2015. The percentage of females on the Society's Board at 31 December 2014 was 15.4%. The aspirational target will be met at the conclusion of the 2015 AGM following the retirements of Ed Anderson and Philip Johnson and taking into account the appointment of Alison Hutchinson in February 2015. However, this figure is expected to fluctuate during the ongoing recruitment phase referred to above.

By way of further information, as at 31 December 2014 the equivalent percentage for all colleagues was 66%. As an additional disclosure in keeping with the Society's focus on diversity, 33% of the Executive Team (excluding executive directors) and 31% of next level senior managers (i.e. those managers who report directly to a member of the Executive Team, excluding any vacant roles) were female.

The Group is committed to creating a leading People Experience for its colleagues through ensuring equality, diversity and inclusion for all. It takes into account diversity at all levels of recruitment and supports colleagues through various initiatives, including taking on voluntary roles such as trusteeship and non-executive roles in local voluntary organisations, to enable colleagues 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 2014 an external Board effectiveness review was carried out by Praesta Partners LLP. This included individual interviews with all of the Directors and Chief Officers and the Group Secretary and a round-table discussion with a number of other senior managers, observation of a Board meeting, a review of 2014 Board papers and representative packs of the Group Risk Committee and Audit Committee. In addition, the Directors and Chief Officers completed two questionnaires which were forward looking as well as providing a current view on how the Board spends its time and energy and the role and culture of the Board. The results were presented to the Board by Praesta at the Board meeting in January 2015.

The review confirmed that the Society has an effective Board that has worked well in demanding times with an open culture that encourages constructive challenge. Following discussion by the Board, there were a number of matters that are to be considered to ensure that it becomes even more effective. These include a further review of the presentation and content of Board papers and management information to the Board and a review of more routine matters that could be delegated to an appropriate Board committee to provide more capacity for the Board to consider key items.

In 2014 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 2014 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 Chief Officers. The written results of the questionnaire were given to each such director by the Chairman in appraisal meetings held in January 2015. The Vice Chairman conducted the appraisal meeting with the Chairman.

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

## Non-executive directors

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 a director takes up have to first be referred to the Board so that the time commitment and any potential conflict of interest can be considered. The Board has a conflict of interest policy which sets out procedures for regularly reviewing, through the Board Governance and Nominations Committee, and if appropriate, authorising any potential conflicts as they arise. This applies to executive as well as non-executive directors.

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 a 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.

## 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 below and on page 42. In November 2014, for example, Deloitte LLP presented their annual update on accounting, 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 Executive Team to discuss any queries that they may have and to undertake branch and department visits on an ad hoc basis in order to deepen their understanding of the business.

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.

## Section C of the Code: Accountability

The Board is responsible for the system of internal control. The Audit Committee Report on pages 44 to 48 sets out the internal control framework which is designed to safeguard member and Group assets and to facilitate the effectiveness and efficiency of operations which helps to ensure the reliability of internal and external reporting and assists in compliance with applicable laws and regulations.

The Board is also responsible for setting the risk appetite of the Group and ensuring that there is a robust system for risk management in place to ensure the security of members' funds. The Group's risk management framework is set out in the Risk Management Report on pages 49 to 55.

The Board has delegated to the Audit Committee oversight of the relationship with the external auditor to ensure that they remain independent and objective. Further details can be found in the Audit Committee Report on pages 44 to 48.

## Section D of the Code: Remuneration

The Board has delegated to the Remuneration Committee the policy on remuneration for the Chairman, the executive directors and other members of the Executive Team and the senior leadership team. A review of its activities and the remuneration policy is set out in the Directors' Remuneration Report on pages 56 to 67.

## Section E of the Code: Relations with Members

## 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 colleagues. 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 My Voice, a new online research community. My Voice gives customers the chance to voice their opinions on how we design our products, services and communications. It was launched in November 2014 and currently has 1,500 members. It enables the Society to conduct quick surveys and discussion boards on key business topics. My Voice will enable the Society to have a much better and faster two way dialogue with our customers about what they need, what they like and what they don't – putting customers at the forefront of decision making.

In addition, a monthly customer perception tracker with over 2,500 customers across all Group brands is undertaken to monitor the strength of the relationship customers have with the Group. The results provide a key performance indicator of customer advocacy (called the Net Promoter Score®) which is monitored by Board on a monthly basis. We also contact approximately 30,000 members every year through our customer experience and brand tracker surveys to understand how they perceive the organisation and how we can improve our products and services.

The Society's member engagement process is under review to ensure that it remains relevant and to make it as easy as possible for the Board and the Executive Team to listen to our members and better meet their needs.

## The AGM

At the AGM, the Chairman, Chief Executive and Finance Director give presentations on the previous year's financial performance and on future plans. The Chairman of the Remuneration Committee also gives a presentation on the directors' remuneration. 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 (unless they have opted to receive the AGM pack by email) 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 2014

Set out below are details of the directors during 2014 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 2014.

| Director | Board Meetings | Board Committees | | | | |
|---|---|---|---|---|---|---|
| | | Audit | Chairman's | Nominations | Remuneration | Risk |
| **Ed Anderson**<br>Chairman | 10(10) | – | 2(2) | 3(3) | – | – |
| **Dame Kate Barker**<br>Non-executive Director | 10(10) | – | – | 3(3) | 4(4) | 5(5) |
| **Ian Bullock**<br>Chief Customer Officer & Executive Director | 10(10) | – | – | – | – | – |
| **Andy Caton**<br>Chief Treasury & Corporate Affairs Officer & Executive Director | 10(10) | – | – | – | – | – |
| **Lynne Charlesworth**<br>Vice Chairman | 10(10) | – | 2(2) | 3(3) | – | 5(5) |
| **Robin Churchouse**<br>Chief Operating Officer & Finance Director | 10(10) | – | – | – | – | – |
| **John Heaps**<br>Chairman Designate<br>(Appointed 20 November 2014) | 2(2) | – | 0(0) | – | – | – |
| **Philip Johnson**<br>Non-executive Director | 9(10) | 9(9) | – | – | – | – |
| **David Paige**<br>Non-executive Director | 10(10) | 7(9) | – | – | 7(7) | 5(5) |
| **Mark Pain**<br>Non-executive Director | 10(10) | 8(9) | – | – | – | 5(5) |
| **Guy Parsons**<br>Non-executive Director | 10(10) | – | – | – | 7(7) | – |
| **Chris Pilling**<br>Chief Executive | 10(10) | – | 2(2) | – | – | – |
| **Mike Regnier**<br>Chief Commercial Officer & Executive Director<br>(Appointed 3 June 2014) | 6(6) | – | – | – | – | – |
| **Simon Turner**<br>Non-executive Director<br>(Retired 15 April 2014) | 4(4) | 3(3) | – | – | 3(3) | – |

**Notes**:
In addition, the written resolution procedure under the Society's Rules was used on two occasions by the Board to conduct business.

On behalf of the Board

Ed Anderson
Chairman
23 February 2015

# 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 during 2014 is shown on page 43. David Paige, Mark Pain and myself all have recent, relevant financial experience. All three meet this statement through either current or previous roles, other current non-executive directorships and our relevant qualifications. More information on the skills and experience of the members can be found in the Directors' Biographies on pages 26 and 31.

The committee invites the presence of internal and external auditors and members of management when it is felt that this would help them discharge their duties.

The committee meets with the internal and external auditor without management present on a number of occasions during the year.

## Roles and responsibilities

The roles and responsibilities of the committee are set out in its Terms of Reference which are reviewed and approved by the Board each year. They can be found in the Corporate Governance section of our website (www.ybs.co.uk/ committees).

## Financial reporting issues and judgements

Our role in monitoring financial reporting issues is key to 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.

We considered the following main issues during 2014:

- Revenue recognition. The Group recognises interest income by reflecting a constant yield over the expected behavioural life of the mortgage loan. The rate of revenue recognition is derived from models which are maintained by management. These models are most sensitive to assumptions of the life of the mortgage loan including any prepayment of the loan. The committee reviewed the assumptions made in the model and the sensitivity of changes to these assumptions before concluding that revenues were fairly stated.
- Strategic initiatives. The Group has invested significantly in the strategic initiative programme mentioned elsewhere in the Annual Report and Accounts. The committee have reviewed the cost allocation and ensured that the capitalisation of costs associated with the initiative are in compliance with IAS 38 Intangible Assets. As a consequence of the work undertaken the committee is satisfied that a prudent approach has been taken when considering which costs should be capitalised and which charged through the Income Statement.
- Loan loss provisions – residential. The most critical of the judgements used in the provisioning models which affects the level of provision held in this category is future forecasts of house price movements. Management have reviewed the outputs of these models and subjected the results to additional provisioning overlays where they believed that the underlying credit risk facing the Group wasn't being reflected fully. The committee reviewed the approaches used, assumptions adopted and the overlays applied by management and agreed with the overall level of provisions held.
- Run-off of fair values associated with acquired books including revenue recognition. The Group has mortgage books which were acquired following the mergers with the Chelsea and Norwich & Peterborough building societies where the life time fair value of these books on acquisition was estimated by management. As these acquired assets run off over time, any adjustments to their fair values are recognised as revenues in the Income Statement. Management regularly review all fair value adjustments and consider the underlying economic assumptions that are pertinent to each of the categories. The committee reviewed all the judgments made in this regard and discussed these at length with management and the external auditor. As a consequence, we are comfortable that a cautious but appropriate approach has continued to be taken.
- Customer provisions. The Group's vision is to be the most trusted provider of financial services in the UK. It aims to achieve this by putting customers at the heart of everything it does. Occasionally it does not get things right first time but seeks to rebuild trust through acting quickly to remedy outcomes for customers. The committee paid careful attention to the provisions held at the year end in respect of issues which it inherited with past mergers (e.g. FAS mis-selling) as well as those arising from regulatory interventions in 2013 and 2014 (e.g. where we took the decision to proactively refund historic arrears fees). We were comfortable with the overall level of provisions held.

- Hedge accounting. The Group holds derivative financial instruments in order to mitigate various risks as set out in Note 34 on pages 122 to 124. International Financial Reporting Standards require changes in the value of these instruments to be recognised in the Income Statement unless it can be proven that they are offset by the fair value of the underlying items being hedged. The committee has overseen management's control activities in this area and is confident that amounts recognised in the Income Statement are fairly stated and that appropriate disclosures have been made.
- Going concern. When preparing the Group's Annual Report and Accounts the Directors are required to confirm in the Directors' Responsibilities Statement on page 68, that the Group is a going concern, unless it is inappropriate to presume that the Group will continue in business. The committee reviewed and challenged a comprehensive paper prepared by management in this regard and, as a consequence of the work undertaken, were in a position to recommend to the Directors that the Annual Accounts should be prepared on a going concern basis.

The Group's Annual Report and Accounts are required to be fair, balanced and understandable as well as providing the necessary information for members to assess the Group's performance, business model and strategy. At the request of the Board, we considered whether these requirements were met. The process to draft and review the Annual Report and Accounts is undertaken alongside the external audit undertaken by Deloitte. Key elements of our process include:

- Guidance is issued to colleagues involved in the process by the Finance function.
- Development of the Annual Report and Accounts is overseen by a group which considers disclosures made.
- Verification takes place to ensure there is appropriate supporting evidence of the content of the Annual Report and Accounts.
- A range of reviews of drafts of the Annual Report and Accounts takes place to ensure consistency of disclosures and an appropriate level of balance.
- Formal oversight and sign off by the Executive Team.

The committee was satisfied that, taken as a whole, the Annual Report and Accounts is fair, balanced and understandable.

## Internal controls

The Board 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. It is the view of the committee that the leadership style and management structure, HR policies and reward systems support the risk management and internal control systems.

The committee's role in reviewing the effectiveness of the system of internal controls is particularly important as the Group looks to deliver its strategic change programme and faces a more intensive regulatory environment. An effective control framework is vital to manage risk and to maintain the trust of all our stakeholders. We review this framework through regular reporting from management, Internal Audit and our external auditor who set 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 compliance monitoring, provide formal reports to that committee.

The information received and considered by the committee provided reasonable assurance that during 2014 there were no material breaches of control or regulatory standards and that, overall, the Society maintained an adequate internal control framework that met the principles of the Code.

Further details of actual risk management practices are provided in the Risk Management Report on pages 49 to 55.

The main internal control areas considered and reviewed in detail during 2014 were:

- Conduct and prudential related matters. Internal Audit (IA) reviews have focused on how the Group meets the value of 'customers at our heart' through considering the treatment of customers in areas such as arrears and complaints handling. They also provided assurance to the committee over its financial sustainability through reviews of capital and liquidity management processes and a detailed assessment of compliance with prudential rules and guidance specific to the building society sector.
- Strategic change programme. The committee is conscious of the impact on the Group's risk profile arising from the strategic change programme. It received updates on management's oversight of the programme and oversaw the implementation of changes to enhance the approach across all three lines of defence. This included the internal audit approach being strengthened for the approval of budgets for external resources.
- As the Group continues to develop an effective "Three Line of Defence" internal control model, the committee monitors the role of IA in this important area. There was significant investment in this model throughout the Group during 2014 and this will continue. Some areas of improvement within IA have been identified and these will be addressed during the coming year.
- Internal audit plans. The committee provided oversight and direction for the development of the internal audit plan. IA has developed a model to prioritise risk areas for their reviews. The committee was able to provide a clear view on the priority areas for assurance by sense checking the outputs of the model through comparison to the Group's risk framework (as defined in the Risk Management Report) and approving the resources needed to deliver the plan. Our external auditor provides us with internal control reports in respect of key financial reporting processes and systems arising from the external audit review. During the year, Deloitte did not highlight any material control weaknesses.
- We track the status of issues raised in control reports, both from our internal and external auditors, closely. During the year, the volume and age profile of control issues has remained within our risk appetite. The vast majority of issues were resolved within their original deadlines.
- The committee reviews the use of the confidential reporting channels in the Group each year. Colleagues who receive reports through these channels, including the Audit Committee Chairman received training from the whistleblowing charity, Public Concern At Work, in March 2014.

## Oversight of internal audit

The committee receives regular reports from IA setting out the results of their assurance activity including their opinion on the effectiveness of the internal control environment and performance against a range of measures included in their balanced scorecard. The function also reports annually on the skills and resources necessary to discharge its role.

The IA function is governed by a Charter which is approved annually by the committee and can be found on the Group's internet site (www.ybs.co.uk/committees).

The IA function has deployed an internal quality assurance programme that meets the requirements of the Chartered Institute of Internal Auditors' Guidance for internal audit in the financial sector. The committee received the outputs from these reviews to assist in its on-going assessment of the effectiveness of the Group's IA approach. This oversight will be further strengthened from 2015 with the addition of a rolling programme of annual externally sourced oversight.

The committee approved the IA function's 5 year strategic plan and will be monitoring progress against the strategy to ensure that the Group continues to have an effective, independent internal audit function.

## Oversight of external audit and the external audit process

Each year the committee approves the proposed audit plan presented by the external auditor including a discussion of key risk areas to ensure that there is agreement on the focus of work and materiality measures.

The external auditor provides regular reports to the committee on their work on the interim financial statements and the Annual Report and Accounts prior to the committee recommending approval. These reports include:

- Work performed in areas of significant risk and their conclusions for each area.
- Their views on the judgements made in applying accounting policies.
- Summary of any misstatements which they have identified.
- Internal control related issues.

The committee carries out a formal assessment of the effectiveness of the external audit process each year. This assessment is facilitated by IA and is based on a framework published by the Audit Committee Institute. It comprises:

- The completion of a formal questionnaire by members of the committee and regular attendees at meetings with follow up interviews as appropriate.
- Workshops with colleagues who have been involved with the audit process.
- A report from IA summarising strengths and issues raised.

The committee takes into account the performance of the external auditor when considering their reappointment as well as their length of tenure and the date of rotation of the audit partner. Deloitte were appointed in July 2009 following a competitive tender process and the external audit partner rotated off the audit following the 2013 year end.

During 2014, the committee considered the need for a competitive tender and concluded this was not necessary given the performance of Deloitte throughout the year and the level of change within the Group. The committee recommended that they be reappointed at the AGM for the current year.

New corporate governance code requirements mean that the audit contract should be put out to tender at least every ten years. Under the transitional arrangements, this means that the contract will need to be re-tendered no later than 2019.

## External auditor objectivity and independence

The Group has a policy on the use of the external auditor for non-audit work which is overseen by the committee. The purpose of this policy is to ensure the continued independence and objectivity of the external auditor and this policy can be found as an Appendix to the Audit Committee Terms of Reference which is available on our internet site. 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 considers whether formal committee approval is required. The level of fees incurred is regularly monitored. The external auditor undertook a number of non-audit related assignments for the Group during 2014.

Details of the fees paid for non-audit services during the year can be found in Note 7 on page 91. Included in the fees charged by Deloitte is £820,000 for the provision of contractors to assist with the resolution of the matter relating to the structured deposit account investment product mentioned in the Strategic Report. The work undertaken by the contractors did not put them in any decision making position nor were they involved in the management of the project. The committee is satisfied that this and other pieces of non-audit work were conducted within the limits set out in the policy and did not impair the external auditor's objectivity and independence.

The committee reviewed the approach to non-audit services in November 2014 in light of proposals issued by the European Union in April 2014 and made some amendments to the policy for implementation in 2015.

## Audit Committee effectiveness

The effectiveness of the committee is assessed annually. A self-assessment exercise, co-ordinated by Internal Audit, is performed and the results are reported to the Board. The 2014 review concluded that the committee operated effectively during the year.

Committee members are expected to undertake relevant training as part of their on-going development as an individual Board member. Each year, as well as undertaking individual training as members consider appropriate, the committee as a whole receives training on current topics. In 2014, this comprised updates on future changes to IFRS 9 'Financial Instruments', cyber security, regulatory themes, conduct risk and financial statement disclosures.

On behalf of the Board

Philip Johnson
Chair of the Audit Committee
23 February 2015

## 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.

## Risk Governance

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, made up of non-executive directors and attended by senior executives, considers all risk matters relating to the Group, including credit risk, operational risk, market risk, liquidity risk, funding risk, business risk, and regulatory risk (including prudential and conduct) 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, ensuring the sustainability of YBS Group and thereby ensuring that no stakeholder suffers 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 function 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 Group's Chief Risk Officer provides a formal update to each Board meeting covering all areas of risk management, including both routine reporting and ad hoc issues.

## Risk Vision and Strategy

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 gives high-level strategic direction on matters of risk taking and risk management to ensure that the Group:

- Delivers good outcomes, including fair conduct outcomes for customers.
- Makes prudentially sound risk decisions.
- Assists the Group's regulators in delivering their objectives.
- Provides a vision for best risk management practice.
- Provides dynamic direction for when it is appropriate to take fewer risks or greater risks in return for the achievement of Group objectives and plans.
- Has direction on the most critical risk management tool – risk appetite.

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 how each risk sits against the Group's risk management capability. 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 the Group's Chief Officers, and the Group Risk Committee also reviews the dashboards relating to the most significant risks on a quarterly basis.

## Risk Culture

The risk framework of appetite statements, risk map and dashboards, risk management information, and the risk committee structure testify to a robust and embedded risk culture that continues to mature. The Group continues to evolve to a "Three Lines of Defence" model for risk management as follows:

**1st Line of Defence (Responsible):**

- Day to day responsibility for running the business.
- Develop a clear risk and control framework including responsibility for initiating risk appetite, policy, controls and outcome testing with the capability to identify, assess, control, mitigate and report risk.

**2nd Line of Defence (Accountable):**

- Accountability for ensuring competent risk management across the Group within risk appetite and the reporting of risks to Board.
- Support, coach, facilitate, independently monitor, challenge, report and if necessary give direct instruction.
- Manage regulatory relationships and ensure Board briefed.

**3rd Line of Defence (Internal Audit):**

- Help the Board and Executive Management to protect the assets, reputation and sustainability of the organisation by independently assessing whether all significant risks are identified and appropriately reported by management and the Risk function to the Board and Executive Management; independently assessing whether they are adequately controlled; and by challenging Executive Management to improve the effectiveness of governance, risk management and internal controls.

Stress and scenario testing are also widely used throughout the Group and involve a large number of colleagues. Such testing ranges from the stress testing required of the capital and liquidity regulatory submissions (the Internal Capital Adequacy Assessment Process, the "ICAAP"; and the Individual Liquidity Adequacy Assessment, the "ILAA") together with the annual reverse stress tests which attempt to produce illustrative scenarios that might cause the Group to fail, to regular scenario analysis, and the daily stress testing of liquidity and market risk.

## Group Risk Committee (GRC)

The Group Risk Committee oversees the Group's risk governance framework and provides an entity-wide perspective on all risk matters. It normally meets four times a year but will meet more frequently when the need arises. Its membership comprises four non-executive directors: Lynne Charlesworth (Committee Chair), Dame Kate Barker, David Paige, and Mark Pain; and it is also attended by senior executives including the Chief Executive Officer, Chief Operating Officer and Finance Director, and the Chief Risk Officer. It has delegated responsibility for the Group's risk strategy, risk appetite, risk monitoring, and capital management. Its duties in 2014 have included:

Monitoring of:

- The prudential risk environment.
- The conduct risk environment.
- The risk horizon, both from the perspective of risks to the Group's objectives, and from the perspective of tail risks.

Approval of:

- The risk management strategy.
- The Group's risk appetite.
- The regulatory capital submission (ICAAP) ahead of approval by the board.
- The regulatory liquidity submission (ILAA) ahead of approval by the board.
- Recovery and resolution plans.
- Conduct risk oversight plan.

- The project to implement Internal Ratings Based (IRB) approach to capital requirements for retail credit risk.
- Money Laundering Reporting Officer's annual report.
- Delegation of mandates and sub-committees.

Oversight of:

- Risk appetite adherence.
- Conduct risk.
- Periodic investigative deep dives into ad hoc areas.

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

During 2014, the committee met five times in the execution of its responsibilities and, in particular, considered the following matters:

- External economic, political and market risks, and assessment of their potential impact on the Group, in particular the London and South-East property markets.
- Regulatory oversight including the programme of submissions to the PRA (ICAAP, ILAA, and reverse stress tests) and also approval and monitoring of the programme of conduct risk oversight.
- Conduct risk, including its quality assurance.
- Market/basis risk issues including any raised by the Prudential Regulation Authority (PRA).
- Agreement of a qualitative and quantitative risk appetite and performance indicators, framing the parameters for risk acquisition and risk management for 2015.
- Agreement of a risk management strategy directing 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.
- Self-evaluations to ensure that the committee is fulfilling its responsibilities.
- Recommendation of a risk overlay impacting the level of senior management bonus payable.
- Oversight of the project to implement IRB (Internal Ratings Based approach to capital requirements) approach to capital requirements for retail credit risk.
- Model risk governance – approving the set-up of a new committee.
- Cyber threats and the Group's defences against them.

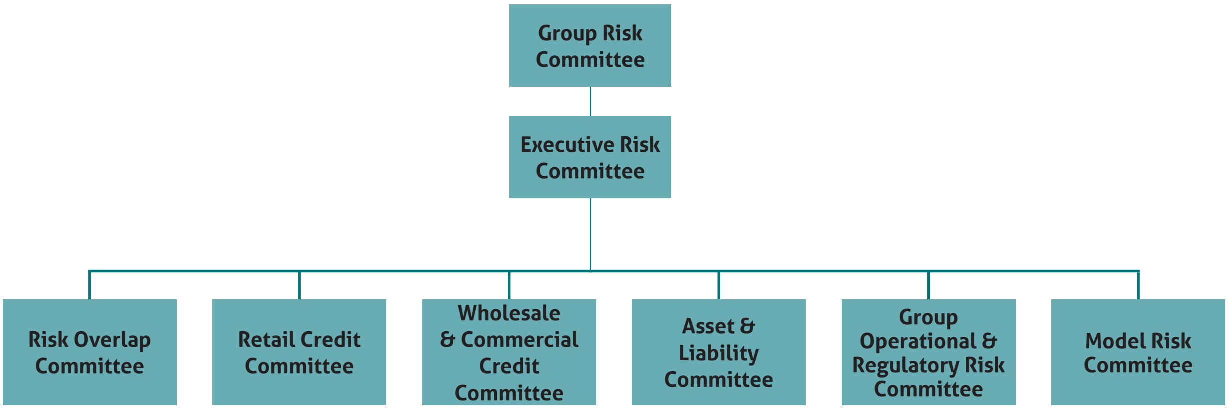
In 2013, in line with recommended best practice, GRC approved changes to its structure, limiting the membership of GRC to non-executive directors, thus ensuring that the committee takes a sufficiently strategic view of the Group's activities and risk environment. In 2014, this structure has been continued and enhanced. The Executive Risk Committee (ERC), which is a sub-committee of the Group Risk Committee, acts as an umbrella for six sub-committees. ERC takes place once a month and runs for an entire day: the sub-committees meet in sequence on that day (with the exception of Model Risk Committee), making risk management oversight a focus of attention for the Group. The component committees of ERC and their areas of coverage are as follows:

- Risk Overlap Committee: issues that straddle more than one committee, and higher-level areas such as the macro-economic environment, enterprise-wide risk and control, and capital.
- Retail Credit Committee: exposure limit setting and monitoring, arrears monitoring, forbearance, probability of possession, possessions, impairment provisions and losses, affordability, scorecard and model effectiveness, lending controls, current accounts, and approval of relevant policies.
- Wholesale and Commercial Credit Committee: counterparty limit setting and monitoring, structured credit, RMBS, commercial lending, housing association lending, and approval of wholesale credit and commercial lending policies.

- Asset & Liability Committee (ALCO): net interest margin, interest rate risk, interest rate view, Treasury performance, mortgages and savings performance, liquidity and funding, retail and wholesale markets, and approval of the financial risk management policy.
- Group Operational and Regulatory Risk Committee (GORRC): product governance, processes and systems, people and resources, business continuity and disaster recovery, regulatory risk, conduct risk, financial crime, information security, health & safety, supplier management, complaint handling, Quality Assurance and Training and Competence frameworks, project risk, and approval of relevant policies including those of its sub-committees.
- Model Risk Committee (MRC): risk models and IRB rating system management information, adherence to IRB rating system policies and procedures, monitoring of material changes or exceptions that may materially impact the operations of the Group's models or planned IRB rating systems.

The structure of Executive Risk Committee is shown diagrammatically, below.

**Board committee, executive risk committee and executive sub-committees**




## Risk Overlap Committee

This committee covers issues that cut across the responsibilities of more than one committee, or that are more enterprise-wide in their nature, such as capital (review of the ICAAP, Pillar 3 disclosures, and monitoring of changes to regulations affecting capital etc.), the group risk profile, or the risk management strategy. The chairs of the other risk sub-committees form part of the membership of Risk Overlap Committee.

## Asset and Liability Committee (ALCO)

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 Statement of Financial Position, 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, 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, a total of 11 scenarios assessed over two timeframes. The worst-case three month scenario forms the basis of our liquidity adequacy assessment. The Group's liquidity and funding risk appetite triggers a warning whenever liquidity falls to within 15% of our total liquidity or regulatory requirements.

The stress test that ensures regulatory liquidity is adequate, and within our risk appetite, is run daily and reported within the business. The whole range of liquidity stress tests that prove our overall liquidity adequacy are also run, reviewed and reported daily. The weekly ALCO meeting reviews an extended projection of funding and liquidity against a longer-term forecast for the measures outlined above. All three views of liquidity adequacy are reported monthly to ALCO and to the Board, with quarterly reporting to GRC.

The Group has also participated in a number of quantitative impact studies for the CRD IV (European Capital Requirements Directive IV) requirements, as well as several smaller data collection exercises focused on the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Both the LCR and NSFR have been above the fully phased minimum requirements for these metrics in every study completed. Further, following the adoption by the European Commission of a delegated act on the LCR, the Group has calculated its LCR in line with this act, and has again been in excess of the fully phased minimum requirements at all times. Following this publication, work is ongoing to integrate LCR reporting into the daily reporting package distributed to the business, and LCR compliance forms part of the 2015 liquidity and funding risk appetite statement.

The Group's liquidity and funding risk appetite also 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.

Detail of actual exposures at the year end is contained in Note 35.

**Market risk**

Market risk is the risk to earnings and capital arising from changes in interest rates, foreign currency exchange rates, structural mismatches within the Statement of Financial Position (basis risk), 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 ALCO at least monthly. The Board receives monthly summaries of risk positions and ALCO activity.

The Group's policies for the management of risks arising from movements in interest or currency exchange rates and the composition of the Statement of Financial Position provide the framework for the Group's Asset and Liability Management (ALM) activities. The primary purpose of the Group's ALM process is to ensure the accurate and timely identification, measurement and control of market risk faced by the Group on its entire Statement of Financial Position.

Market risk arises primarily from the activities within the Group's retail business units and the Group's Treasury function. The Group's ALM process will ensure that risks connected with these areas of activity are identified and that suitable measures and risk management practices are applied. The responsibility for mitigating this risk through a hedging strategy and within the agreed risk appetite is the responsibility of Group Treasury. Group ALM 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.

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 Statement of Financial Position to a one basis point (0.01%) parallel shift in interest rates.
- Statement of Financial Position structural analysis monitors the composition of the Statement of Financial Position in terms of the different interest rate bases of assets and liabilities.
- Re-pricing 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.

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 Statement of Financial Position. 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.
- 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.

**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.

## Retail Credit Risk 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.

**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 and landlords across the UK and does not consider there to be any undue concentration of credit risk in any particular part of the UK. Nevertheless, similar to many mortgage lenders, the Group has taken steps to reduce the level of lending that it had been doing in London where house prices had been rising rapidly. In addition, the Group has unsecured credit risk exposures to current accounts and a closed unsecured personal loan portfolio.

The Group ensures the credit risk of its lending portfolios is appropriately managed, in line with the Board approved risk appetite, via its lending criteria, its pricing, and its monitoring and management processes and techniques accordingly. Retail credit exposures are managed in accordance with the Statement of Lending Policy and through the use of credit scoring, affordability assessments and credit policy 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. Actual and forecast retail exposures are monitored and managed against risk appetite limits by the Retail Credit Risk Committee. In particular the committee monitors arrears, loan-to-value ratios, expected losses, scorecard performance and affordability. Retail Credit Risk Committee has three sub-committees that oversee lending criteria, interest-only exposure and collections and recoveries.

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

Detail of actual retail credit risk exposures is contained in Note 39.

## Wholesale and Commercial Credit Committee

**Wholesale and commercial credit risk**

The Wholesale and Commercial Credit Committee 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 analysis presented to the committee. Limits are also set against the aggregate exposure to equally-rated institutions and to all institutions based in any one country. Historically, the Group has suspended a significant number of lines to other institutions, radically reducing the number of firms it is prepared to have exposure to and has maintained this prudent approach over the last few years. 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 Wholesale and Commercial Credit Committee also maintains oversight of the Group's commercial lending activities. Wholesale and commercial credit risk management information is reported to Wholesale and Commercial Credit Committee and the Board on a monthly basis, and quarterly to Group Risk Committee.

Details of actual exposures are contained in Note 38.

## Model Risk Committee

**Model risk**

Model Risk is the potential risk of adverse consequences arising from decisions based on incorrect or misused model outputs. The Group has a range of models in place which are used in the control and assessment of various risks, and the Model Risk Committee has recently been introduced to centralise the approval and ongoing review of the Group's models.

Model Risk Committee is responsible for providing oversight of the performance of risk models, as well as approval of new risk models which are deemed to be highly material to the Group. In addition, the Group is currently undertaking a project to deliver the Advanced IRB approach to Credit Risk. Post IRB approval, the Model Risk Committee will act as the Group's Designated Committee for IRB purposes, which will involve the approval and oversight of all material aspects of the Group's IRB Rating System.

## Group Operational and Regulatory Risk Committee

**Operational and regulatory risk**

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.

Regulatory risk (including prudential and conduct) is the risk of non-compliance with the rules, regulations and expectations of the regulatory authorities.

Group Operational and Regulatory Risk Committee oversees the functioning of the operational risk framework and compliance with regulatory requirements. It has nine sub-committees which oversee areas of risk such as data governance, financial crime, cyber security, and supplier management to a greater level of detail, and it also receives information from three additional committees relating to change, people experience, and reward.

The Group's operational risk management framework sets out the group-wide strategy for identifying, assessing and managing operational risk. The framework 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 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 conduct risk strategies and controls in response to increasing expectations of regulatory authorities.

2014 has continued to see this 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 conduct risk strategic framework was developed in 2012 with a defined, and now continually refined board-approved risk appetite. Outcome testing and monitoring of the five core pillars (customer treatment, product governance, sales suitability, complaints & redress, and reward) of conduct behaviour is also in place. This continues to be an area of significant focus for the Group during the coming years.

On behalf of the Board

Lynne Charlesworth
Chair of Group Risk Committee
23 February 2015

# Directors' Remuneration Report

## Dear Member

This report is the second produced under the new disclosure regulations that are applicable for publicly listed companies, reflecting our commitment to corporate governance best practice.

Following feedback from our members, we have aimed to make this report as transparent as possible, making the information contained within it easy to understand and follow.

This report details our annual report on the remuneration for the Group's executive directors in 2014.

The Society's aim is to be truly market competitive so that we can attract the best talent for each role. The central aim remains the same, whether we are talking about senior executives or the thousands of colleagues that work for the Group.

The Group's strategy, to keep our customers at our heart by striking the right balance between long-term value and exceptional service to our members whilst generating sufficient profit to ensure financial sustainability is stretching. If delivered successfully it will create significant value for our members. The Remuneration Committee (the committee) believes that the Executive Team, as well as the wider colleague population, should be rewarded for the achievement of that strategy.

## 2014 – key outcomes

The Group enjoyed another successful year in 2014 in a strengthening UK economy. At the same time it was an environment that continues to provide challenges from competitive and regulatory perspectives.

It is against this backdrop that annual bonuses of between 11.9% and 44.5% have been proposed for the executive directors, including the Chief Executive Officer, who has been awarded an annual bonus of 44.5% of salary. These amounts reflect achievement against the annual bonus performance criteria - annual bonuses for executive directors are based on profit before tax, costs, customer service scores and personal objectives.

For Chris Pilling and Andy Caton, 60% of the 2014 annual bonus will be deferred and 20% paid in each of the three years from 2016. Both elements of the bonus will be delivered as follows - 50% as cash and 50% via a share equivalent instrument which is subject to a six month retention requirement.

The delivery of bonus in this way reflects best practice and complies with the Prudential Regulatory Authority's (PRA) remuneration code where colleagues whose total remuneration is above £500,000 per annum, or whose bonus equates to more than 33% of their total remuneration, are required to have their bonus paid over a longer period, and delivered via a share equivalent instrument.

For Ian Bullock, Mike Regnier and Robin Churchouse, 50% of the 2014 annual bonus will be deferred, with 25% being paid in equal cash amounts in 2016 and 2017.

Bonuses for 2014 have been calculated on profit and cost measures that reflected the fines imposed and associated costs of remediation on the Group pertaining to the promotional material used for some structured deposit accounts and issues in arrears (as detailed on page 4 of the Chairman's Report).

As a result of the enforcement action linked to the Group's promotional material used for some of the structured deposit accounts, reductions have been made to the 2011 bonus award for some of the executive directors, Chief Officers and MRTs of between 5% and 10%. These reductions have been applied to the final deferred element of the 2011 bonus, which is due for payment in 2015.

On 1 May 2014, the Chief Executive Officer's (CEO) basic salary increased by 4.30%, from £532,314 to £555,204. The basic salaries of the other executive directors increased by an average 3.03% from the same date. These increases are a result of the same pay review process used for all YBS Group colleagues (who received an average increase of 2.61% of salary across a range of 1.2% to 5.3%) and were guided by the principles of individual performance, affordability and retaining talent in a challenging environment.

## Looking ahead – 2015

The committee will continue to monitor remuneration across the Group, ensuring that the remuneration policy remains consistent with the Group's risk appetite and that it encourages appropriate risk taking and sound risk management behaviours. At the same time the committee will ensure that the policy reflects the Group's culture and values and the business challenges that the Group faces and against the backdrop of continuing regulatory change.

The design of the Chief Officer and Senior Management remuneration structure will remain unchanged in 2015. We will look to ensure that executive remuneration is made as simple as possible for our members to understand and that it is competitive.

**2015 Base Salary**

Any changes to base salaries for executive directors will be determined in May 2015, at the same time as other colleagues (except in cases, as with all colleagues, where circumstances prompt an out of cycle review). Any increases will be based upon the prevailing economic and market conditions and individual performance.

**2015 Bonus**

The maximum bonus opportunity for executive directors in 2015 will remain unchanged at 50% of salary. 'On-plan' achievement against our set performance criteria and personal objectives will result in a bonus payment of 30%. Neither amount is impacted by the Capital Requirements Directive IV (CRD IV) cap on variable pay as the variable component of total remuneration (bonus) to the fixed component (salary) does not exceed 1:1. Rules pertaining to deferral, malus[1] and clawback[2] will continue to apply.

I trust that our members will endorse the report via an advisory vote on the Remuneration Report at the AGM.

Guy Parsons
Chair of the Remuneration Committee

## Remuneration Committee (RemCo) attendance

Details pertaining to non-executive director attendance at RemCo can be found on page 43 in the Corporate Governance Report.

## Annual Report on Remuneration

This section of the Annual Report & Accounts details the implementation of the Group's remuneration policy for the YBS Group's executive and non-executive directors throughout 2014. The report has been prepared in line with disclosure requirements applicable to listed companies under the Large and Medium Sized Companies and Groups Act (Accounts and Reports) Regulations 2008 and the UK Corporate Governance Code, requirements that have been used to guide disclosures in relation to directors' remuneration. For 2014, additional disclosures have been made in line with CRD IV, specifically relating to the ratios between fixed and variable pay.

The remuneration policy is voted on every three years and was approved at the 2014 AGM. A copy of the remuneration policy can be found on our website at www.ybs.co.uk/remuneration. The next remuneration policy vote will take place at the 2017 AGM unless a change to the Group's remuneration policy is proposed in the intervening period, aside from any changes made due to regulatory requirements.

1 Malus – Where issues associated with colleague conduct are evident, or where the Group or business unit in which a colleague is engaged suffers a material downturn, a material failure of risk management , or misstatement of the Group's audited results. The committee may reduce whole or part of a bonus and/or any unvested awards.

2 Clawback – Where issues associated with colleague conduct are evident, or where the Group or business unit in which a colleague is engaged suffers a material downturn, a material failure of risk management , or misstatement of the Group's audited results. The committee, at its discretion , will be entitled to seek recovery of bonus payments already paid for a period of at least seven years from the date on which it is awarded.

## Voting on the Remuneration Report

A summary of this report will be sent to all members eligible to vote at the 2015 Annual General Meeting and members will have the opportunity to vote on the Remuneration Report. This vote is taken on an advisory basis, meaning that member views will be taken into account prior to any bonus award being granted in respect of 2014 performance.

## The role of the Remuneration Committee

The committee determines the Group's remuneration policy, focusing on setting remuneration for the executive directors, Chief Officers and other Senior Managers. The full Terms of Reference for the committee can be found at www.ybs.co.uk/committees.

The committee takes independent external professional advice as appropriate, and monitors comparative remuneration packages within the financial sector. The committee is made up of at least three non-executive directors. In 2014, they were Dame Kate Barker (from 1 May 2014), Guy Parsons (Chair since 16 April 2014), and David Paige. Simon Turner, Non-executive Director, was Chair of the committee until his retirement on 15 April 2014, following last year's AGM.

## Pay at YBS Group – an overview

Reward for each role in the Group is informed by the market and colleagues have the opportunity to increase their pay (against their benchmark) as they develop in their role. All colleagues are eligible for a bonus, which is paid upon achievement of both Group performance criteria and personal objectives.

- An element of the remuneration of executive directors, Chief Officers and other MRTs is variable, based primarily on the Group's financial, risk and service performance (in particular, the Net Promoter Score®) and is also based on individual performance using pre-determined objectives to motivate and reward successful business and personal performance in the interests of current and future members. The proportion of variable pay is designed to ensure that it is feasible for none to be paid in years when business or personal performance does not merit payment.
- Personal reviews of executive directors, Chief Officers and other MRTs are carried out at least annually to assess their performance and behaviours in meeting individual and Group objectives. These reviews are formally approved by the committee and reflected in pay reviews which take effect from 1 May each year as well as in awards of variable pay.
- The remuneration of senior colleagues 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, Chief Officer or MRT colleague is involved in deciding his or her own remuneration.
- The policy complies with the Prudential Regulation Authority (PRA) Remuneration Code.

## Annual Report on Remuneration

**Individual elements of remuneration**

**Base salary and fees**

Executive directors

At the annual pay review, the approach to the review of salaries for senior roles is the same as for all colleagues in the Group. Dependent upon individual market position and individual performance in 2014, colleagues were eligible to receive a pay award of between 0% and 5.30%.

The base salaries from 1 May 2014 are as set out below:

| | £ | Increase % |
|---|---|---|
| Ian Bullock | 325,494 | 4.30 |
| Andy Caton | 303,009 | 0.00 |
| Robin Churchouse[1] | 328,365 | 3.50 |
| Chris Pilling | 555,204 | 4.30 |
| Mike Regnier[2] | 312,000 | n/a |

[1] In January 2014, Robin Churchouse's salary was increased by 2.25% from £310,257 to £317,257. This increase was made to reflect changes to his responsibilities.

[2] Mike Regnier's salary is stated as at the date he joined the Group on 3 June 2014.

## Change in CEO pay

The table below sets out the percentage change in salary from the prior year at pay review for the CEO compared to the wider colleague population. This includes all colleagues, as well as other executive directors.

| Pay Review Percentage Change 2014 | 2014 Pay Review Salary Increase |
|---|---|
| CEO | 4.30% |
| Colleague average (including executive directors) | 2.61% |
| Overall change in CEO pay (including salary, bonus, benefits and pension) in 2014 | 6.00% |

## Benefits

For 2014, each executive director was provided with benefits that comprised a company car (or an equivalent allowance), private medical insurance and permanent health insurance. No significant changes are envisaged for 2015.

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

## Pension

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

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

### Defined Contribution Plan

For those executive directors receiving contributions under the defined contribution section (Chris Pilling, Ian Bullock, Robin Churchouse and Mike Regnier) a total payment equal to a maximum of 16% of base salary is paid. Part of this employer contribution is paid directly into the pension scheme and the remainder as a cash allowance due to prevailing tax restrictions.

### Defined Benefit Plan

The table below shows the pension benefits under the defined benefit pension plan.

| | Contributions from directors £000 | Increase in accrued pension £000 | Accrued pension as at 31 Dec 2014 £000 | Transfer value of accrued benefits as at 31 Dec 2013 £000 | Transfer value of accrued benefits as at 31 Dec 2014 £000 | Movement in transfer value less directors’ contributions £000 |
|---|---|---|---|---|---|---|
| Andy Caton | – | 9 | 148 | 2,312 | 2,599 | 287 |

Similar benefit structures exist for Chief Officers and other Code Staff.

### Executive director remuneration

The remuneration of the executive directors of the Group for the year ended 31 December 2014 and the previous year is set out in the tables below. This is audited information.

| Director | Salary/ fees £000[1] | Variable pay £000[2] | Deferred variable pay from previous years £000 | Taxable benefits £000[3] | Increase in accrued pension £000[4] | Group’s contribution to pension scheme £000[5] | Total £000[9] |
|---|---|---|---|---|---|---|---|
| **Year ended 31 December 2014** | | | | | | | |
| **Executive director** | | | | | | | |
| Ian Bullock | 358[6] | 57 | 79[11,12] | 9 | – | 14 | 517 |
| Andy Caton | 303 | 43[7] | 60[11,12] | 11 | 9 | – | 426 |
| Robin Churchouse | 363[6] | 19 | 87[11,12] | 11 | – | 14 | 494 |
| Chris Pilling | 635[6] | 97[7] | 175[7,8] | 15 | – | 1 | 923 |
| Mike Regnier[10] | 183[6] | 36 | 140[7,8] | 6 | – | 26 | 391 |
| **Total** | **1,842** | **252** | **541** | **52** | **9** | **55** | **2,751** |

| Director | Salary/ fees £000[1] | Variable pay £000[2] | Deferred variable pay from previous years £000 | Taxable benefits £000[3] | Increase in accrued pension £000[4] | Group's contribution to pension scheme £000[5] | Total £000[9] |
|---|---|---|---|---|---|---|---|
| **Year ended 31 December 2013** | | | | | | | |
| **Executive director** | | | | | | | |
| Ian Bullock | 333[6] | 68 | 93[12] | 8 | – | 25 | 527 |
| Andy Caton | 300 | 18 | 88[12] | 10 | 21 | – | 437 |
| Robin Churchouse | 331[6] | 61 | 91[12] | 11 | – | 25 | 519 |
| Chris Pilling | 601[6] | 93[7] | 153[7,8] | 15 | – | 8 | 870 |
| **Total** | **1,565** | **240** | **425** | **44** | **21** | **58** | **2,353** |

## Notes

1 Refers to salary and cash pension allowance paid over the course of the calendar year, see note 6 below.

2 Includes proposed payments for the performance year in which they were earned (actual payment due the following year).

3 Principally the provision of a company car (Ian Bullock and Andy Caton). Directors have elected to take a cash allowance in lieu, or partly in lieu, of a company car as follows: Robin Churchouse £10,623, Chris Pilling £14,355 and Mike Regnier £6,141.

4 The increase in accrued pension represents the change in the annual pension to which Andy Caton is entitled as a result of changes in pensionable earnings (excluding inflation) and increases in pensionable service during the year. The value of this defined pension benefit includes those arising from unfunded arrangements.

5 Defined contribution plan contributions only. The defined contribution plan and the defined benefit plan of the YBS pension scheme are 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 delivered via a share equivalent instrument. The value increase of Andy Caton's 2014 accrued pension is shown in the single figure table. Building Societies are required to disclose the increase in the value of any accrued pension during the financial year. However, for purposes of calculating total remuneration to determine whether he has reached the "de minimis"[3] threshold, we have used the employer contributions meaning 50% of his 2014 bonus will therefore be delivered in the form of a share equivalent instrument.

8 Includes payment to compensate for loss of earnings incurred by Chris Pilling and Mike Regnier on leaving their previous employer.

9 For the executive directors other than Andy Caton, the total remuneration stated above is the "single figure for total remuneration" as set out in the new reporting regulations.

10 Mike Regnier was appointed as an executive director on 3 June 2014. The above table therefore outlines his remuneration from that date.

11 The 2011 bonus awards for three executive directors were subject to malus reductions of between 5% and 10% (pro-rated due to time in role) in response to the enforcement action linked to the structured deposit promotional material as referred to on page 4. The reduction has been applied to the final 2011 deferred element due for payment in 2015.

12 Deferred elements in respect of the 2012 performance period for some executive directors were subject to a 5% reduction in 2013 due to the arrears issues detailed in the Chairman's Report.

[3] De minimis – Where a colleague's total remuneration is greater than £500,000 per annum and/or where variable remuneration totals more than 33% of their total remuneration, a proportion of their variable remuneration must be paid in shares or via a share equivalent instrument, subject to malus and clawback provisions.

## Annual Bonus

In 2014, the executive directors and Chief Officers participated in a non-pensionable annual bonus plan, part of which is delivered after the end of the performance period and part of which is subject to deferral.

The potential award under the YBS Group bonus scheme is the same for all executive directors. Individual performance is also considered in determining any bonus payment due.

**Target Bonus Award Levels**

| 2014 Performance Measure | Target |
|---|---|
| Pre-tax profit | 15% |
| Costs | 7.5% |
| Customer Service (measured by the Net Promoter Score®) | 7.5% |
| **Total** | **30%*** |

*In the event all three bonus measures hit their maximum % achievement, bonus would be capped at 50%.

**2014 annual bonus out-turn**

The following provides the pre-tax profit, cost and customer service target reference points for the executive directors for 2014. To ensure that the outcome of the advisory vote of members on the Directors' Remuneration Report at the AGM can be considered before payments are made, the committee will sign-off variable pay awards after the 2015 AGM.

| Performance condition | 2014 target as a % of salary | Calculated pay out as a % of salary (Assuming on-target personal performance) |
|---|---|---|
| Pre-tax profit | 15.0% | 24.9% |
| Cost | 7.5% | 3.2% |
| Customer service | 7.5% | 7.5% |
| **Total** | **30.0%** | **35.6%** |

## Bonus Deferral

All executive director bonus awards are subject to deferral. Deferred elements are in turn subject to future performance conditions, and may be reduced or forfeited as appropriate. If the first deferred element is not paid, this does not impact on the later deferred elements, which standalone and are subject to the relevant performance conditions for that year.

### Executive Directors, Chief Officers and MRTs below the "de minimis" threshold

| | |
|---|---|
| **Percentage of bonus deferred** | 50% of any bonus earned is paid following the end of the performance period and 25% is paid in each of the following two years. |
| **Bonus delivery** | Cash |
| **Performance measures** | Payments will be reduced or forfeited if the sustainable level of capital required to support the Group's growth rate is not generated each year. This is done via a scale adjustment measured against a minimum level of ROMA (Return on Mean Asset) for each year based upon the growth achieved. In addition, a 'risk overlay' process considers the management of specific business risk appetite measures and payment can be amended where material breaches are identified. |

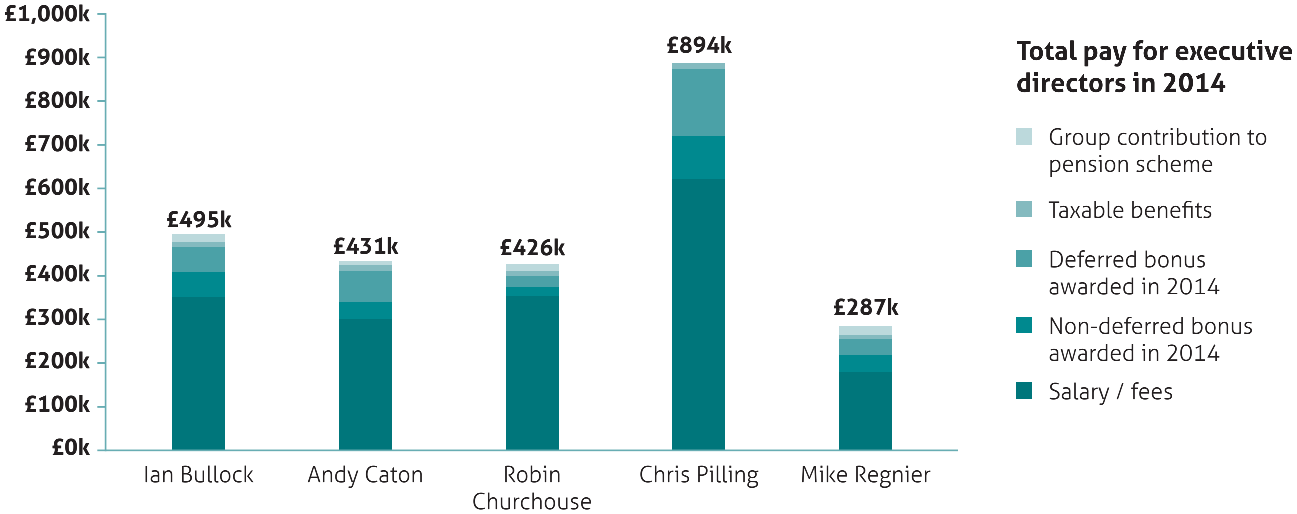
## CEO and Executive Directors above the "de minimis" threshold

| | |
|---|---|
| **Percentage of bonus deferred** | YBS Group's annual bonus complies with the PRA's remuneration code and reflects best practice. Therefore, 40% of any bonus earned is paid following the end of the performance period and 20% is paid in years two, three and four respectively. |
| **Bonus delivery** | Non-deferred element – 50% delivered as cash, 50% paid via share equivalent instrument and subject to a six month retention requirement.<br><br>Deferred element – 50% delivered as cash and 50% delivered via share equivalent instrument and subject to a six month retention requirement. |
| **Performance measures** | Payments will be reduced or forfeited if the sustainable level of capital required to support the Group's growth rate is not generated each year. This is done via a scale adjustment measured against a minimum level of ROMA (Return on Mean Asset) for each year based upon the growth achieved. In addition, a 'risk overlay' process considers the management of specific business risk appetite measures and payment can be amended where material breaches are identified.<br><br>Deferred payments are subject to the same conditions as above. |
| **Share equivalent instrument** | The share equivalent instrument is an award of units, which are valued based upon a ROMA multiplier. The ROMA multiplier is the ratio of the actual ROMA for the relevant financial year divided by the target ROMA for the year. The number of units awarded in 2014 is the element of the bonus earned in 2014 which is to be delivered via the share equivalent instrument divided by the deemed initial unit value of £1. The unit value at the end of the relevant performance period is the initial unit value multiplied by the ROMA multiplier, subject to a cap on unit value of £1.25 per unit. |

It is the committee's view that the Risk Overlay process provides objective business risk and sustainability assessments. These assessments form the basis for any decision by the committee to adjust bonus payments (both deferred and non-deferred elements).

## 2014 Total Remuneration

The proposed bonus pay-outs as a proportion of total remuneration are illustrated in the graph below in respect of 2014 performance:




**Notes**

The categories in the above table relate to the notes listed under the single figure table on page 61.

## Annual bonus for 2015

The 2015 annual bonus for executive directors will be operated in the same way as set out for 2014.

The Group's financial targets are considered commercially sensitive, so will be disclosed in the Group's Report and Accounts for the 2015 financial year.

## Non-executive directors' remuneration

**Fees**

To determine non-executive director fees, the Chief People Officer and executive directors take into account external benchmark data, the responsibilities of each non-executive director, and the skills and time commitment required for the role.

In 2014, the fees for the Chairman and other non-executive directors increased by 2.8% in line with the general pay award for colleagues.

## Non-executive director remuneration

| Director | Basic fees £000 | Committee fees[1] £000 | Total £000 |
|---|---|---|---|
| **Year ended 31 December 2014** | | | |
| **Non-executive director** | | | |
| Ed Anderson (Chairman) | 150 | – | 150 |
| John Heaps (Chairman Designate, appointed 20 November 2014) | 11 | – | 11 |
| Dame Kate Barker | 45 | 15 | 60 |
| Lynne Charlesworth[2] | 66 | 24 | 90 |
| Philip Johnson | 45 | 19 | 64 |
| David Paige[2] | 45 | 26 | 71 |
| Simon Turner (Retired 15 April 2014) | 13 | 6 | 19 |
| Mark Pain | 45 | 16 | 61 |
| Guy Parsons | 45 | 12 | 57 |
| **Total** | **465** | **118** | **583** |

[1] Details of non-executive director committee membership and role-holders are set out in the table on page 43.

[2] The committee fees for Lynne Charlesworth and David Paige include £5,486 for their duties as trustees of the Yorkshire Building Society Pension Scheme in 2014.

| Non-executive director fees (annual equivalents) | Overall fees 2013 £ | 2014 up to 30 June £ | 2014 from 1 July £ | Overall fees 2014 £ |
|---|---|---|---|---|
| Chairman's basic fees | 146,160 | 148,320 | 152,480 | 150,400 |
| Vice-Chair basic fees | 64,485 | 65,440 | 67,290 | 66,365 |
| Non-executive Director basic fees | 43,278 | 44,730 | 45,990 | 45,360 |
| **Additional fee for:** | | | | |
| • Member of Audit Committee | 7,535 | 7,650 | 7890 | 7,770 |
| • Chair of Audit Committee | 18,225 | 18,450 | 19,080 | 18,765 |
| • Member of Remuneration Committee | 4,712 | 5,100 | 5,250 | 5,175 |
| • Chair of Remuneration Committee | 12,180 | 12,300 | 12,720 | 12,510 |
| • Member of Group Risk Committee | 7,535 | 7,650 | 7,890 | 7,770 |
| • Chair of Group Risk Committee | 18,225 | 18,450 | 19,080 | 18,765 |
| • Conduct Risk Oversight Role* | 7,535 | 7,650 | n/a | 3,825 |
| • People Oversight Role* | 4,303 | 4,370 | n/a | 2,185 |

* The Conduct Risk Oversight and People Oversight roles ceased in 2014.

## Aggregate remuneration data (fixed and variable pay) for Material Risk Takers (MRTs)

European Banking Authority CRD IV rules require the publication of aggregate remuneration data for the Group as a whole and in summary form for senior managers and MRTs, as follows:

| | Senior Management £000 | Other MRTs £000 | Total £000 |
|---|---|---|---|
| Fixed pay | 7,466 | 1,127 | 8,593 |
| 2014 variable pay (non-deferred) | 1,068 | 144 | 1,212 |
| 2014 variable pay (deferred) | 1,041 | – | 1,041 |
| 2014 variable pay due via SEI | 327 | – | 327 |
| Deferred variable pay to be paid 2014 | 1,006 | – | 1,006 |
| Outstanding deferred variable pay from previous years | 1,941 | – | 1,941 |
| Sign-on bonus payments – 2014 | 180 | – | 180 |
| **Total** | **13,029** | **1,271** | **14,300** |
| Number of MRT colleagues | | | 58 |
| Number of sign-on bonus recipients | | | 3 |

- Senior managers and colleagues 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.
- All MRTs receive variable pay paid as cash, except a small number of MRTs, including Chris Pilling and Andy Caton who receive 50% of variable pay via a share equivalent instrument.
- Deferred elements in respect of the 2012 performance period for a small number of MRTs were subject to reduction due to the issues identified in arrears in 2013.
- The 2011 bonus awards for a small number of MRTs (and three executive directors), were subject to malus reductions of between 5% and 10% (pro-rated due to time in role) in response to the enforcement action linked to the structured deposit promotional materials as referred to on page 4. The reduction has been applied to the final 2011 deferred element due for payment in 2015.
- Deferred elements in respect of the 2012 performance period for some executive directors and Chief Officers were subject to a 5% reduction in 2013 due to the arrears issues detailed in the Chairman's Report.

## Ratios between fixed and variable pay

YBS Group's fixed:variable pay ratio is not affected by the CRD IV cap on variable pay – the variable component of total remuneration to the fixed component does not exceed 1:1. The split between fixed and variable remuneration for executive directors who earned more than €1m in 2014 is set out below:

| | Proportion (On target achievement) | | Proportion (Max achievement) | | Actual 2014 ratio | |
|---|---|---|---|---|---|---|
| | Fixed | Variable | Fixed | Variable | Fixed | Variable |
| All executive directors | 82.48% | 17.52% | 70.79% | 29.21% | 79.92% | 20.08% |

## Individuals remunerated EUR 1 million or more

| Number of colleagues | Total remuneration band |
|---|---|
| 1 | €1m – €1.5m |

## Payments to past directors

There were no payments made to past directors during the financial year ended 31 December 2014.

## Payments for directors' loss of office

There were no payments made for directors' loss of office during the financial year ended 31 December 2014.

## Remuneration Committee advisers

During 2014, the committee received independent advice from Deloitte LLP (Deloitte). Deloitte is a member of the Remuneration Consultants Group and, as such, voluntarily operates under the Code of Conduct in relation to executive remuneration consulting in the UK. Deloitte's fees for providing reward policy and practice advice to the society amounted to £41,089, inclusive of £6,950 specific to advice to the committee for the year ended 31 December 2014.

## Statement of member voting – 2014

The Group remains committed to on-going member dialogue and takes an active interest in voting outcomes. The following table sets out actual voting in respect of the resolution to approve the Director's Remuneration Report (DRR) at the Group's Annual General Meeting in 2014:

| Resolution | Votes for | Votes against | % in favour | Votes withheld |
|---|---|---|---|---|
| Approval of the Directors' Remuneration Policy | 168,895 | 20,595 | 89.13 | 4,766 |
| Approval of the Directors' Remuneration Report | 170,745 | 18,544 | 90.2 | 4,974 |

On behalf of the Board

Guy Parsons
Chair of the Remuneration Committee
23 February 2015

# Directors' Responsibilities Statement

The following statement, which should be read in conjunction with the statement of the Auditor's responsibilities on pages 69 to 74, 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 Prudential Regulation Authority under the Financial Services Act 2012.

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.

We consider that the Annual Report and Accounts, taken as a whole is fair, balanced, and understandable and provides the information necessary to assess the Group's performance, business model and strategy.

On behalf of the Board

Ed Anderson
Chairman
23 February 2015

# **Independent Auditor's Report**
# to the members of Yorkshire Building Society

## Opinion on the financial statements of Yorkshire Building Society

In our opinion the financial statements:

- give a true and fair view, in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31 December 2014 and of the Group's and the Society's income and expenditure for the year then ended; and
- have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

The financial statements 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 IFRSs as adopted by the European Union.

## Going concern

We have reviewed the directors' statement contained within the Directors' Report on page 32 that the Group is a going concern. We confirm that

- we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- we have not identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.

## Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team:

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **Loan loss provisions** | |
| The Group holds £46.3m of impairment provisions at year-end (2013 – £46.2m) against total loans and advances to customers of £32.2bn (2013 – £29.5bn).<br><br>Determining impairment provisions against loans to customers is a judgemental area requiring an estimate to be made of the losses incurred within the residential mortgage and commercial lending portfolios. This requires the estimation of customer default rates, property value movements, sales costs, forced sale discounts and likelihood of repossession which may be sensitive to changes in the economic environment.<br><br>Loan loss provision balances are detailed within Note 9. Management's associated accounting policies are detailed on page 81 with detail about judgements in applying accounting policies and critical accounting estimates on page 87. | We challenged the appropriateness of management's key assumptions used in the impairment calculations for loans and receivables, including the impairment trigger point, probability of default, the estimation of property values, sales costs, and forced sale discounts, by benchmarking against internal and external data, and testing the effectiveness of controls applied by management in determining these assumptions.<br><br>We tested the mechanical accuracy of the related models, including engaging our IT specialists to test the underlying key controls, including access controls to key spreadsheets, and to test data flows into the models to assess whether the data was complete and accurate.<br><br>We performed substantive testing, including tests of existence and valuation, on the mortgage book, focusing on loans that display characteristics of audit interest.<br><br>For commercial loans, we performed detailed file reviews of a sample of properties across the book, including identifying any breaches against the covenants in place and assessing whether these had been properly reflected within provision calculations by management. We tested the valuation of the underlying collateral using our property valuation specialists. |
| **Fair value adjustments** | |
| The Group's assessment of the utilisation of the fair value adjustments that were established upon the merger of the Society with Norwich & Peterborough Building Society and Chelsea Building Society in prior years is an area that requires the use of significant judgement. The primary judgement relates to the level of lifetime impairment losses that are expected from the acquired loan books, which impacts the effective interest rate model.<br><br>The re-estimation of the fair value adjustment has resulted in a credit to the Income Statement of £20.1m in the year (2013 – £73.4m).<br><br>Management's associated accounting policies are detailed on page 81 with detail about judgements in applying accounting policies and critical accounting estimates on page 87. | We tested the movement in the fair value adjustments that were established at the point the mergers took place and challenged the appropriateness of the utilisation and unwind of these adjustments over time.<br><br>We challenged the key assumptions used in the calculation of the lifetime impairment adjustment, including comparing the key assumptions with industry benchmarks (where available) and externally available data. The principal assumptions include the lifetime probability of default, the estimation of property values, sales costs, forced sale discount, and future unemployment and interest rate predictions.<br><br>We tested the mechanical accuracy of the related models and the controls around them, including assessing whether the data used to compile the models was complete and accurate, as well as engaging our IT specialists to test the underlying key controls including access controls to key spreadsheets. |

| Risk | How the scope of our audit responded to the risk |
| --- | --- |
| **Revenue recognition** | |
| The recognition of revenue on loans using an effective interest rate method requires significant judgement by management to determine key assumptions related to the expected life of each loan and the cash flows relating thereto. Such assumptions are also sensitive to changes in the economic environment.<br><br>The Group held £18.1m of unamortised origination fees on the balance sheet at year-end which will be amortised over the expected life of the associated loan portfolios (2013 – £7.2m).<br><br>Management's associated accounting policies are detailed on page 81 with detail about judgements in applying accounting policies and critical accounting estimates on page 87. | We challenged the appropriateness of management's key assumptions used in the recognition of revenue using the effective interest rate method as described in Note 1 by comparison against historical customer behaviour and by performing analytical procedures to assess the sensitivity of key assumptions used to determine the behavioural lives of products.<br><br>We have reviewed the models and the changes made to those models during the year for compliance with the requirements of IAS 39. We have also considered the associated disclosures in the financial statements for consistency with the Group's accounting policies.<br><br>We tested the mechanical accuracy of the models which are used to determine revenue and the controls around them, including assessing whether the data used to compile the models was complete and accurate, as well as engaging our IT specialists to test the underlying key controls including access controls to key spreadsheets.<br><br>We considered the review and approval process of new products and reviewed new and existing products to assess whether that other income is recognised on a basis that is consistent with the Group's accounting policies and relevant accounting standards. |
| **Provisions for customer remediation** | |
| The assessment of the Group's calculation of provisions for customer remediation in relation to arrears collections operations and the sales of retail products is judgemental due to the uncertainty around complaint volumes, uphold rates and redress and other costs.<br><br>The Group holds £19.8m of customer remediation provisions at year end (2013 – £58.1m).<br><br>Management's associated accounting policies are detailed on page 81 with detail about judgements in applying accounting policies and critical accounting estimates on page 87. | We challenged the appropriateness of management's key assumptions used in estimating the provisions required for customer redress with reference to historical experience and wider market experience with a specific focus on complaint volumes, uphold rates and redress costs. Through review of the remediation log and review of correspondence with the FCA, we sought to understand and assess the potential for any further regulatory fines.<br><br>We tested the mechanical accuracy of the models and the controls around them, including assessing whether the data used to compile the models was complete and accurate.<br><br>We also substantively tested the utilisation of provisions in the period. |

| Risk | How the scope of our audit responded to the risk |
|---|---|
| **Hedge accounting** | |
| The hedge accounting requirements are complex and require significant skilled input and oversight by management, as well as robust systems and controls particularly due to the number of both micro and macro hedge arrangements in the Group.<br><br>Management's associated accounting policies are detailed on page 81 with detail about judgements in applying accounting policies and critical accounting estimates on page 87. | We tested management's application of hedge accounting which comprised testing hedge documentation hedges for compliance with the requirements of IAS 39, and independently re-performing a sample of hedge effectiveness tests conducted by management during the year.<br><br>We independently valued a sample of derivative instruments using our financial instruments valuation specialists and used analytics to identify derivatives which are outliers in the population to focus our testing on those items that exhibit more audit risk. |

Last year our report included four other risks which are not included in our report this year:

## Financial Services Compensation Scheme

IFRIC 21 'Government Levies' was adopted at the prior year end and this has now become embedded in the calculation of the provision, leading to less judgement in the current year.

## Treasury instruments

The judgements involved in the valuation of the treasury instruments are not considered to have the greatest effect on the overall audit strategy or the allocation of resources in the audit as we no longer consider this an area of risk.

## Capitalisation of costs

The prescriptive nature of IAS 38 'Intangible Assets' reduces the area for judgement with regards to capitalisation of costs. Management's processes in this area are more fully embedded in this year, the second year of the programme. In the prior year, this was a relatively new process. In addition, the level of capitalisation has reduced in the current year.

## Deferred taxation

The recoverability of the deferred tax asset is considered in terms of the forecasts that underpin the going concern review. We have not previously identified immediate risks to the going concern status that would impact the recoverability of the deferred tax asset. At the current level of profitability, there is more certainty and therefore less risk in the assessment of recoverability of the deferred tax asset.

The description of risks above should be read in conjunction with the significant issues considered by the Audit Committee discussed on page 44.

Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the financial statements is not modified with respect to any of the risks described above, and we do not express an opinion on these individual matters.

## Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the Group to invest in activities for its members. We have therefore selected profit before tax as the benchmark for determining materiality. We have determined materiality by applying 5.0% of this benchmark. The reduction from 7.5% in the prior year has not impacted the way in which we assess the significant risk areas. We have changed the percentage applied to align more closely with other comparable societies.

We determined materiality for the Group to be £9.4m (2013 - £10.2m) which represents 0.03% of total Group assets (2013 – 0.03%).

We agreed with the Audit Committee that we would report to the committee all audit differences in excess of £0.15m (2013 – £0.1m), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

## An overview of the scope of our audit

As in the prior year, our group audit scope involved performing full audits on the Group's parent and main subsidiaries which accounted for more than 98% of the Group's net assets and 96% of the Group's profit before tax. These audits were performed directly by the group audit team and executed at levels of materiality applicable to each individual entity which were lower than group materiality and ranged from £4.7m to £6.9m.

At the parent entity level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining subsidiaries not subject to audit or audit of specified account balances.

## 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.

## Opinion on other matter prescribed by the Capital Requirements (Country-by-Country Reporting) Regulations 2013

In our opinion the information given in the financial statements for the financial year ended 31 December 2014 has been properly prepared, in all material respects, in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013.

## Matters on which we are required to report by exception

**Adequacy of explanations received and accounting records**

Under the Building Societies Act 1986 we are required to report to you if, in our opinion:

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

We have nothing to report on in respect of these matters.

## Our duty to read other information in the Annual Report

Under the International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the Annual Report is fair, balanced and understandable and whether the Annual Report appropriately discloses those matters that we communicated to the Audit Committee which we consider should have been disclosed.

We confirm that we have not identified any such inconsistencies or misleading statements.

## Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements which give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team and independent partner reviews.

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

## 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 and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Peter Birch ACA (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Leeds
23 February 2015

# Income Statements
for the year ended 31 December 2014

| | NOTES | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|---|
| Interest receivable and similar income | 3 | **1,308.6** | 1,405.6 | **1,248.4** | 1,311.3 |
| Interest payable and similar charges | 4 | **(759.4)** | (874.0) | **(826.6)** | (903.7) |
| **Net interest income** | | **549.2** | 531.6 | **421.8** | 407.6 |
| Fees and commissions receivable | | **31.7** | 33.9 | **28.9** | 31.0 |
| Fees and commissions payable | | **(15.4)** | (8.7) | **(14.3)** | (7.7) |
| **Net fee and commission income** | | **16.3** | 25.2 | **14.6** | 23.3 |
| Income from investments in subsidiaries | 10 | **–** | – | **–** | – |
| Net (losses)/gains from fair value volatility on financial instruments | 5 | **(10.9)** | 15.9 | **(3.5)** | 20.0 |
| Net realised profits/(losses) | 6 | **1.3** | (41.7) | **1.3** | (29.1) |
| Other operating income | | **9.3** | 12.4 | **42.9** | 40.2 |
| **Total income** | | **565.2** | 543.4 | **477.1** | 462.0 |
| Administrative expenses | 7 | **(303.4)** | (263.0) | **(303.4)** | (264.3) |
| Depreciation and amortisation | | **(27.6)** | (37.0) | **(27.3)** | (36.4) |
| **Operating profit before provisions** | | **234.2** | 243.4 | **146.4** | 161.3 |
| Impairment of loans and advances to customers | 9 | **(20.0)** | (22.8) | **(1.9)** | (4.2) |
| Provisions | 28 | **(26.0)** | (21.3) | **(25.8)** | (19.4) |
| Impairment of investments in subsidiaries | 10 | **–** | – | **(1.4)** | (4.2) |
| **Operating profit and profit before tax** | | **188.2** | 199.3 | **117.3** | 133.5 |
| Tax expense | 11 | **(40.8)** | (51.2) | **(24.0)** | (37.2) |
| **Net profit** | | **147.4** | 148.1 | **93.3** | 96.3 |

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

The notes on pages 80 to 146 form part of these accounts

# Statements of Comprehensive Income
for the year ended 31 December 2014

| | NOTES | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|---|
| **Net profit** | | **147.4** | 148.1 | **93.3** | 96.3 |
| **Items that may subsequently be reclassified to profit and loss:** | | | | | |
| Available for sale investments: | | | | | |
| Valuation (losses)/gains taken to equity | | **(3.1)** | 4.0 | **(3.1)** | 4.0 |
| Amounts transferred to Income Statement (included in net realised profits) | | **(3.2)** | (23.0) | **(3.2)** | (23.0) |
| Cash flow hedges: | | | | | |
| (Losses)/gains taken to equity | | **(43.4)** | 68.3 | **(43.5)** | 68.3 |
| Amounts transferred to Income Statement (included in net realised profits) | | **3.6** | 2.5 | **3.6** | 2.5 |
| Tax relating to items that may be reclassified | 11 | **9.3** | (12.1) | **9.3** | (12.1) |
| **Items that will not be reclassified subsequently to profit and loss:** | | | | | |
| Remeasurement of net retirement benefit obligations | 26 | **50.3** | (20.4) | **50.3** | (20.4) |
| Tax relating to items not reclassified | 11 | **(10.0)** | 0.5 | **(10.0)** | 0.5 |
| **Total comprehensive income for the year** | | **150.9** | 167.9 | **96.7** | 116.1 |

The notes on pages 80 to 146 form part of these accounts

# Statements of Financial Position
as at 31 December 2014

| ASSETS | NOTES | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|---|
| Liquid assets | | | | | |
| Cash in hand and balances with the Bank of England | 13 | **3,670.6** | 3,314.6 | **3,670.6** | 3,314.6 |
| Loans and advances to credit institutions | 14 | **599.3** | 482.0 | **262.5** | 120.8 |
| Debt securities | 15 | **524.8** | 624.6 | **4,514.8** | 1,871.2 |
| Loans and advances to customers | 16 | **32,234.1** | 29,515.8 | **18,469.3** | 17,948.1 |
| Derivative financial instruments | 34 | **214.3** | 273.0 | **113.2** | 174.2 |
| Investments | 10 | **1.4** | 1.4 | **14,406.8** | 11,186.1 |
| Intangible assets | 17 | **36.2** | 34.9 | **36.2** | 34.9 |
| Investment properties | 18 | **16.5** | 16.5 | **16.3** | 16.3 |
| Property, plant and equipment | 19 | **136.7** | 124.0 | **136.3** | 106.7 |
| Current tax assets | | **–** | – | **6.9** | – |
| Deferred tax assets | 20 | **42.8** | 47.2 | **39.1** | 45.8 |
| Retirement benefit surplus | 26 | **64.4** | 3.8 | **64.4** | 3.8 |
| Other assets | 21 | **30.9** | 15.6 | **42.6** | 30.8 |
| **Total assets** | | **37,572.0** | 34,453.4 | **41,779.0** | 34,853.3 |
| LIABILITIES | | | | | |
| Shares | 22 | **27,241.4** | 26,290.3 | **27,241.4** | 26,290.3 |
| Amounts owed to credit institutions | 23 | **3,471.3** | 2,621.4 | **3,471.3** | 2,621.4 |
| Other deposits | 24 | **508.0** | 501.4 | **5,788.9** | 1,965.9 |
| Debt securities in issue | 25 | **3,523.2** | 2,793.6 | **2,719.2** | 1,847.9 |
| Derivative financial instruments | 34 | **413.6** | 194.8 | **389.6** | 197.1 |
| Current tax liabilities | | **12.8** | 9.2 | **–** | 6.2 |
| Deferred tax liabilities | 20 | **15.3** | 4.8 | **14.8** | 3.7 |
| Retirement benefit obligations | 26 | **–** | 3.4 | **–** | 3.4 |
| Other liabilities | 27 | **83.5** | 85.6 | **83.0** | 148.0 |
| Provisions | 28 | **36.2** | 84.0 | **35.9** | 82.1 |
| Subordinated liabilities | 29 | **299.5** | 48.7 | **299.5** | 48.7 |
| Subscribed capital | 30 | **6.9** | 6.8 | **6.9** | 6.8 |
| Total liabilities | | **35,611.7** | 32,644.0 | **40,050.5** | 33,221.5 |
| Total equity attributable to members | | **1,960.3** | 1,809.4 | **1,728.5** | 1,631.8 |
| **Total equity and liabilities** | | **37,572.0** | 34,453.4 | **41,779.0** | 34,853.3 |

The accounts on pages 75 to 146 were approved by the Board of directors on 23 February 2015 and were signed on its behalf by:

| | |
|---|---|
| Ed Anderson | Chairman |
| Lynne Charlesworth | Vice Chairman |
| Chris Pilling | Chief Executive |

The notes on pages 80 to 146 form part of these accounts

# Statements of Changes in Members' Interest
## for the year ended 31 December 2014

| | General reserve £m | Hedging reserve £m | Available for sale reserve £m | Total reserves £m |
|---|---|---|---|---|
| **Group** | | | | |
| At 1 January 2014 | **1,805.9** | **(4.9)** | **8.4** | **1,809.4** |
| Current year movement net of tax | **187.7** | **(31.9)** | **(4.9)** | **150.9** |
| At 31 December 2014 | **1,993.6** | **(36.8)** | **3.5** | **1,960.3** |
| At 1 January 2013 | 1,694.4 | (59.3) | 6.4 | 1,641.5 |
| Reallocation of tax* | (16.5) | – | 16.5 | – |
| Current year movement net of tax | 128.0 | 54.4 | (14.5) | 167.9 |
| At 31 December 2013 | 1,805.9 | (4.9) | 8.4 | 1,809.4 |

| | General reserve £m | Hedging reserve £m | Available for sale reserve £m | Total reserves £m |
|---|---|---|---|---|
| **Society** | | | | |
| At 1 January 2014 | **1,628.3** | **(4.9)** | **8.4** | **1,631.8** |
| Current year movement net of tax | **133.5** | **(31.9)** | **(4.9)** | **96.7** |
| At 31 December 2014 | **1,761.8** | **(36.8)** | **3.5** | **1,728.5** |
| At 1 January 2013 | 1,568.6 | (59.3) | 6.4 | 1,515.7 |
| Reallocation of tax* | (16.5) | – | 16.5 | – |
| Current year movement net of tax | 76.2 | 54.4 | (14.5) | 116.1 |
| At 31 December 2013 | 1,628.3 | (4.9) | 8.4 | 1,631.8 |

* Taxation relating to the available for sale reserve has been reallocated to match the underlying transactions.

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 80 to 146 form part of these accounts

# Statements of Cash Flows
for the year ended 31 December 2014

| | NOTES | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|---|
| **Cash flows from operating activities:** | | | | | |
| Profit before tax | | **188.2** | 199.3 | **117.3** | 133.5 |
| Working capital adjustments | 42 | **(28.8)** | 85.8 | **(103.9)** | 92.8 |
| Net increase in operating assets | 42 | **(2,537.1)** | (2,163.2) | **(3,567.0)** | (1,689.6) |
| Net increase in operating liabilities | 42 | **1,807.6** | 1,208.8 | **5,624.0** | 1,153.8 |
| **Net cash flows (used in)/from operating activities** | | **(570.1)** | (669.3) | **2,070.4** | (309.5) |
| **Cash flows from investing activities:** | | | | | |
| Purchase of property, plant and equipment and intangible assets | | **(42.9)** | (48.2) | **(59.1)** | (48.2) |
| Proceeds from sale of property, plant and equipment | | **0.1** | 1.0 | **0.1** | 1.0 |
| Purchase of debt securities | | **(251.7)** | (445.7) | **(3,693.7)** | (945.7) |
| Proceeds from sale and redemption of debt securities | | **346.4** | 292.7 | **1,044.9** | 374.1 |
| **Net cash flows from/(used in) investing activities** | | **51.9** | (200.2) | **(2,707.8)** | (618.8) |
| **Cash flows from financing activities:** | | | | | |
| Redemption of securities | | **(515.6)** | (437.9) | **–** | (37.4) |
| Issue of securities | | **1,281.8** | 500.0 | **906.8** | – |
| Redemption of subordinated capital | | **–** | (114.3) | **–** | (114.3) |
| Issue of subordinated capital | | **250.0** | – | **250.0** | – |
| Interest paid on subordinated liabilities and subscribed capital | | **(7.4)** | (16.1) | **(7.4)** | (16.1) |
| **Net cash flows from/(used in) financing activities** | | **1,008.8** | (68.3) | **1,149.4** | (167.8) |
| Taxation paid | | **(22.9)** | (24.1) | **(19.9)** | (14.6) |
| **Net increase/(decrease) in cash and cash equivalents** | | **467.7** | (961.9) | **492.1** | (1,110.7) |
| Opening balance | | **3,751.9** | 4,713.8 | **3,390.7** | 4,501.4 |
| **Total closing cash and cash equivalents** | | **4,219.6** | 3,751.9 | **3,882.8** | 3,390.7 |
| **Cash and cash equivalents:** | | | | | |
| Cash and balances with central banks | | **3,620.3** | 3,269.9 | **3,620.3** | 3,269.9 |
| Loans and advances to banks | 14 | **599.3** | 482.0 | **262.5** | 120.8 |
| | | **4,219.6** | 3,751.9 | **3,882.8** | 3,390.7 |

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 80 to 146 form part of these accounts

## INTRODUCTION

### Basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) in issue, that have been endorsed by the European Union (EU), and are effective at 31 December 2014, and with those parts of the Building Societies Act 1986 and the Building Societies (Accounts and Related Provisions) Regulations 1998 (as amended) 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 32, 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 became effective for periods commencing on or after 1 January 2014 and have been adopted in the current year:

- Amendments to IAS 36 'Recoverable Amount Disclosures for Non-Financial Assets' reduces the circumstances in which the recoverable amount is required to be disclosed and introduces new disclosure requirements for impaired assets held at fair value less costs of disposal. The application of these amendments did not have a material impact on the financial statements.
- Amendments to IFRS 10, IFRS 12, and IAS 27 'Investment Entities' specify the treatment of subsidiaries for a parent investment entity and the respective disclosure requirements. These amendments did not have any impact on the financial statements.
- Amendments to IAS 32 'Offsetting Financial Assets and Financial Liabilities' provide clarification to the requirements for offsetting financial assets and financial liabilities. These amendments did not have any impact on the financial statements.
- Amendments to IAS 39 'Novation of Derivatives and Continuation of Hedge Accounting' allow an entity to continue hedge accounting when a derivative designated as a hedging instrument is novated under certain circumstances. These amendments did not have any impact on the financial statements.

The following Standards which have not been adopted in these financial statements were in issue but not yet effective for the 2014 year end. Except otherwise stated, the adoption of the following new or amended standards are not expected to have material impact on the financial statements.

- IFRS 9 'Financial Instruments' published in July 2014 is effective for periods beginning on or after 1 January 2018, with early adoption permitted. This standard replaces the existing guidance in IAS 39 'Financial Instruments: Recognition and Measurement' and includes revised guidance on the classification and measurement of financial instruments and new general hedge accounting requirements. The Group is in the process of assessing the impact of adopting IFRS 9 but the calculation of impairment of financial assets on an expected credit loss basis is expected to result in an overall increase in loan loss provisioning.
- IFRS 15 'Revenue from Contracts with Customers' is effective for periods beginning on or after 1 January 2017, with early adoption permitted. IFRS 15 introduces a framework for determining whether, how much and when revenue is recognised and it replaces the existing guidance in IAS 18 'Revenue'. The Group is assessing the potential impact of adopting IFRS 15; however it is not expected to have a material impact on the financial statements.
- Amendments to IFRS 11 'Accounting for Acquisitions of Interests in Joint Operations' are effective for periods beginning on or after 1 January 2016 and provide clarification on how to account for the acquisition of an interest in a joint operation in which the activities constitute a business.

## INTRODUCTION (continued)

- Amendments to IAS 16 and IAS 38 'Clarification of Acceptable Methods of Depreciation and Amortisation' are effective for periods beginning on or after 1 January 2016 and prohibit entities from using a revenue-based depreciation method for items of property, plant and equipment except in limited circumstances.
- Amendments to IAS 19 'Defined Benefit Plans: Employee Contributions' are effective for periods beginning on or after 1 July 2014 which clarify the treatment of the contributions made by employees or third parties that are linked to a series of defined benefit plans.
- Annual Improvements to IFRSs 2010-2012 Cycle are effective for periods beginning on or after 1 July 2014 and include amendments to a number of IFRSs. The following are relevant to the Group; IFRS 8 'Operating Segments', IFRS 13 'Fair Value Measurement' and IAS 24 'Related Parties Disclosure'.
- Annual Improvements to IFRSs 2011-2013 Cycle are effective for periods beginning on or after 1 July 2014 and include amendments to IFRS 3 'Business Combinations', IFRS 13 'Fair Value Measurement' and IAS 40 'Investment Property'.

## 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 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.

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

**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.

**Fair value hedges**

Where the fair value hedging requirements are met, changes in the 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 the 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 reporting 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 for residential loans and two months or more, or other qualitative factors for commercial loans. All other loans and advances are grouped according to their credit characteristics and a collective review is undertaken of any evidence of impairment. In all cases, future cash flows are estimated on grouped credit characteristics. The collective impairment provision includes an allowance against the risk of customer unaffordability arising from circumstances in existence at the reporting date, as these customers may be able to maintain their repayments only whilst interest rates remain low.

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, unemployment rates and adjustments to allow for ultimate forced sale discounts.

The Group grants concessions to assist borrowers who experience difficulties in meeting their obligations to pay their mortgage (referred to as forbearance) as described in Note 39. Forbearance is included in the loan loss provision similar to other debt, whereby debt which is more than two months in arrears is treated as individually impaired. Debt which is less than two months is included in the calculation of the collective impairment provision.

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.

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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 of the issuer or obligor.
- Any significant reduction in market value of the instrument.

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 is 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.

### 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.

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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.

### 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 as such 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 which 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. Interest 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 results and assets and liabilities of the joint ventures are included in these consolidated financial statements using the equity method of accounting. The investment in the joint venture is recognised in the Statement of Financial Position at cost and is adjusted to recognise the Group's share of profit or loss and other comprehensive income of the joint venture, less any impairment losses in respect of the Group's investment in the joint venture.

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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.

**Subsequent costs**

Costs incurred after the 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 20 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**

Computer software includes construction in progress, purchased software and internally generated assets as shown in Note 17.

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. Purchased 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.

Computer software is tested for impairment at each reporting date or when there is an indication of impairment. If such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss. The recoverable amount is the higher of fair value less costs of disposal and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value. If the recoverable amount of the asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. Any impairment in the value of these assets is dealt with through the Income Statement as it arises.

**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.

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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.

**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 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 date 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 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

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. The asset is recorded on the Statement of Financial Position within property, plant and equipment and is stated at an amount equal to the lower of its fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses. Depreciation is provided by the Group to write off the cost over the estimated useful economic life of the asset. Future instalments under such leases, net of finance charges, are included within payables. Rent payable on finance leases is apportioned between finances and the reduction on the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. Operating lease rentals are expensed to the income statement on a straight-line basis over the period of the lease agreement.

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

### Foreign currency

Assets and liabilities denominated in foreign currencies are translated into Sterling at the appropriate rates of exchange prevailing at the reporting 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 on 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 and securitisations 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, the most significant of the Group's accounting policies 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 44 to 48, the Audit Committee has confirmed that the accounting estimates and judgements applied are considered to be appropriate.

### Impairment of loans and advances to customers

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). In relation to retail mortgages the most critical estimate is the future level of house prices where a fall of 5% (from -5% to -10% in 2015) equates to an increase in the provision by £4.5m. Other sensitivities include the emergence period, (where an increase in the emergence period by three months equates to £1.2m additional provision) and the loss given possession rate (where a 10% increase equates to £4.3m additional provision). Retail mortgages account for 98% of our loan book and 96% of our impairment provision. As such, sensitivities around our commercial book and other loans would not have a significant impact on the 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 proportion of the number of customer balances that will remain with the Society for one year following the end of the initial product deal period. A 1% increase in this estimate would increase the value of the loans by less than £1m.

During the year, there was a change in the estimate for calculating the interest margin using the effective interest rate method. This change relates to the de-recognition of the interest discount on products which have been priced at market competitive rates. The impact is a reduction in interest receivable on loans secured on residential property of £12m in the period.

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

### Fair values arising from business combinations

As described on page 83, identifiable assets and liabilities are initially 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. On the basis that both the Chelsea and N&P mergers are outside of the measurement period, the impact of identified changes in underlying assumptions is recognised immediately in the Income Statement. Management has been through an extensive evaluation to identify any significant changes, with any material changes being reflected in the year end results.

The most critical accounting estimate used in the calculation of fair value provision for the impairment of retail mortgage assets is the future level of house prices. An immediate reduction in future house price growth of 5% (from -5% to -10% in 2015) has an impact of £2.2m, which represents an increase in the provision of 3%.

### Regulatory and other provisions

Note 28 provides details of regulatory and other provisions which includes amounts provided in relation to customer redress claims totalling £14.2m (including fair value adjustments made on the merger with Norwich & Peterborough and Chelsea building societies). The customer redress provision is in respect of a range of customer claims and is calculated using management's estimate of the complaint volumes, redress payments, referral levels to the Financial Ombudsman Service, complaint handling costs and other costs. None of these assumptions are expected to be individually material to the provision.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the statement of financial position 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.

### Financial Services Compensation Scheme (FSCS) levy

The FSCS levy in respect of failed financial institutions is calculated using the Group's share of industry protected deposits, historic interest rates and projected forward interest rates. A 100bps increase in the future interest rate assumption would increase the provision by £1.0m. More detail of the FSCS and the Society's provision are contained in Note 28.

### 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 1.0% decrease in the rate used to discount the future value of the liabilities (from 3.7% to 2.7%) would be to increase the present value of the liabilities by £167.7m. 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 £25.4m.

## 3. INTEREST RECEIVABLE AND SIMILAR INCOME

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| | **£m** | £m | **£m** | £m |
| On assets held at amortised cost | | | | |
| Loans secured on residential property | **1,166.6** | 1,240.9 | **683.7** | 785.6 |
| Connected undertakings | **–** | – | **414.4** | 373.1 |
| Other loans | **17.5** | 16.9 | **17.5** | 16.9 |
| Other liquid assets/cash and short-term funds | **17.8** | 18.9 | **17.0** | 18.7 |
| On available for sale securities | **9.0** | 12.9 | **9.0** | 12.9 |
| On held to maturity securities | **0.9** | 1.2 | **35.8** | 12.4 |
| On financial instruments held at fair value through the Income Statement | | | | |
| Derivatives | **96.7** | 113.9 | **70.9** | 90.8 |
| Other assets | **0.1** | 0.9 | **0.1** | 0.9 |
| Total interest receivable | **1,308.6** | 1,405.6 | **1,248.4** | 1,311.3 |

Included within interest receivable and similar income is interest earned on individually impaired loans: Group £5.9m, Society £1.1m (2013 – Group £13.6m, Society £3.3m), which once included in the mortgage and loans balance, is considered within the impairment calculation.

## 4. INTEREST PAYABLE AND SIMILAR CHARGES

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| | **£m** | £m | **£m** | £m |
| On liabilities held at amortised cost | | | | |
| Shares held by individuals | **459.7** | 593.6 | **459.7** | 593.6 |
| Deposits from banks | **18.1** | 6.5 | **18.1** | 6.5 |
| Deposits from other financial institutions | **–** | 0.1 | **–** | 0.1 |
| Deposits from connected undertakings | **–** | – | **23.8** | – |
| Other deposits | **2.4** | 2.8 | **2.4** | 2.8 |
| Other debt securities | **84.3** | 76.2 | **74.2** | 65.0 |
| Subordinated liabilities | **7.1** | 15.7 | **7.1** | 15.7 |
| Subscribed capital | **0.3** | 0.4 | **0.3** | 0.4 |
| Other interest payable | **1.8** | 1.0 | **1.8** | 1.0 |
| On financial instruments held at fair value through the Income Statement | | | | |
| Deposits from connected undertakings | **–** | – | **40.3** | 37.1 |
| Derivatives | **185.7** | 177.7 | **198.9** | 181.5 |
| Total interest payable | **759.4** | 874.0 | **826.6** | 903.7 |

## 5. NET (LOSSES)/GAINS FROM FAIR VALUE VOLATILITY ON FINANCIAL INSTRUMENTS

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Assets held at fair value | **2.5** | 6.1 | **2.5** | 6.1 |
| Embedded derivatives | **8.7** | 8.2 | **8.7** | 8.2 |
| Derivatives and hedging | **(22.1)** | 1.6 | **(14.7)** | 5.7 |
| Net (losses)/gains from fair value volatility on financial instruments | **(10.9)** | 15.9 | **(3.5)** | **20.0** |

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.

## 6. NET REALISED PROFITS/(LOSSES)

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Net realised profit on sale of debt securities | **1.3** | 10.7 | **1.3** | 10.7 |
| Losses on capital repurchase | **–** | (39.8) | **–** | (39.8) |
| Loss on sale of equity release mortgage portfolio | **–** | (12.6) | **–** | – |
| | **1.3** | (41.7) | **1.3** | (29.1) |

## 7. ADMINISTRATIVE EXPENSES

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Staff costs | | | | |
| Salaries and wages | **129.6** | 115.9 | **129.6** | 115.9 |
| Social security costs | **12.5** | 11.0 | **12.5** | 11.0 |
| Pension costs – defined benefit plans | **4.6** | 4.2 | **4.6** | 4.2 |
| Pension costs – defined contribution plans | **6.9** | 4.6 | **6.9** | 4.6 |
| Other staff costs | **1.5** | 1.8 | **1.5** | 1.8 |
| Operating lease rentals | **11.1** | 9.9 | **12.5** | 12.5 |
| Professional consultancy costs | **24.2** | 25.5 | **24.1** | 25.3 |
| Other expenses | **113.0** | 90.1 | **111.7** | 89.0 |
| | **303.4** | 263.0 | **303.4** | 264.3 |

## 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 pension 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 | |
|---|---|---|---|---|
| | **2014 £000** | 2013 £000 | **2014 £000** | 2013 £000 |
| **Fees payable to the auditor and their associates for the audit of the annual accounts** | **376** | 345 | **314** | 292 |
| **Fees payable to the auditor and their associates for other services to the Group** | | | | |
| Audit-related assurance services (including £45,000 for review of interim accounts) | **143** | 90 | **143** | 47 |
| Tax advisory services | **–** | 24 | **–** | 24 |
| Corporate finance services (including due diligence) | **–** | – | **–** | – |
| Other services | | | | |
| Support for customer remediation | **870** | – | **870** | – |
| Regulatory reporting | **–** | 300 | **–** | 300 |
| All other services | **339** | 432 | **310** | 432 |
| | **1,728** | 1,191 | **1,637** | 1,095 |

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 44 to 48.

### Staff numbers

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

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | **Full time** | **Part time** | Full time | Part time |
| Building Society | | | | |
| Central administration | **2,398** | **487** | 2,135 | 438 |
| Branches | **1,179** | **452** | 1,192 | 453 |
| | **3,577** | **939** | 3,327 | 891 |

## 8. REMUNERATION OF AND TRANSACTIONS WITH DIRECTORS

Total directors' remuneration amounted to £3.3m (2013 – £2.9m).

Full details of directors' remuneration, bonuses and pensions are given in the Directors' Remuneration Report on pages 56 to 67. In addition, past directors' pensions in respect of services as directors (closed scheme) amounted to £18,000 (2013 – £18,000).

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 2014 will be available for inspection at the head office for a period of 15 days up to and including the Annual General Meeting. For further information see Note 41.

## 9. IMPAIRMENT

### Loans and advances to customers

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| At 1 January | | | | |
| Collective | **12.7** | 6.3 | **8.2** | 0.3 |
| Individual | **33.5** | 55.8 | **1.5** | 5.8 |
| | **46.2** | 62.1 | **9.7** | 6.1 |
| Amounts written off during the year | | | | |
| Collective | **–** | – | **–** | – |
| Individual | **(21.5)** | (40.2) | **(4.7)** | (1.0) |
| | **(21.5)** | (40.2) | **(4.7)** | (1.0) |
| Impairment adjustment for the year | | | | |
| Collective | **10.6** | 6.4 | **(2.1)** | 7.9 |
| Individual | **11.0** | 17.9 | **4.1** | (3.3) |
| | **21.6** | 24.3 | **2.0** | 4.6 |
| At 31 December | | | | |
| Collective | **23.3** | 12.7 | **6.1** | 8.2 |
| Individual | **23.0** | 33.5 | **0.9** | 1.5 |
| | **46.3** | 46.2 | **7.0** | 9.7 |
| The charge for the year comprises: | | | | |
| Impairment adjustment for loans and advances | **21.6** | 24.3 | **2.0** | 4.6 |
| Recoveries relating to amounts previously written off | **(1.6)** | (1.5) | **(0.1)** | (0.4) |
| Net provision charge for the year | **20.0** | 22.8 | **1.9** | 4.2 |

## 9. IMPAIRMENT (continued)

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

£1.6m (2013 – £3.1m) of the £46.3m (2013 – £46.2m) provision balance shown above, and £1.5m release (2013 – £0.4m charge) within the £20.0m (2013 – £22.8m) net provision charge, relates to the commercial lending portfolio.

### Debt Securities

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| At 1 January | **6.0** | 12.9 | **6.0** | 12.9 |
| Amounts written off during the year | **–** | (6.9) | **–** | (6.9) |
| At 31 December | **6.0** | 6.0 | **6.0** | 6.0 |

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

## 10. INVESTMENTS

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Equities | **1.4** | 1.4 | **1.4** | 1.4 |
| Joint ventures | **–** | – | **0.3** | 0.3 |
| Subsidiaries | **–** | – | **14,405.1** | 11,184.4 |
| | **1.4** | 1.4 | **14,406.8** | 11,186.1 |

### 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.

### Investment in joint venture

The Group does not have material investments in joint ventures. The Group has a 50% interest in a joint venture, MutualPlus Ltd, a branch sharing company incorporated in England and Wales. The carrying amount of the investment at 31 December 2014 and 31 December 2013 was £0.3m.

## 10. INVESTMENTS (continued)

### Investment in subsidiaries

| **Society** | Shares £m | Loans £m | Total £m |
|---|---|---|---|
| Cost | | | |
| At 1 January 2014 | **114.3** | **11,078.6** | **11,192.9** |
| Additions | **–** | **6,035.5** | **6,035.5** |
| Repayments | **(8.0)** | **(2,813.4)** | **(2,821.4)** |
| At 31 December 2014 | **106.3** | **14,300.7** | **14,407.0** |
| | | | |
| Impairment losses | | | |
| At 1 January 2014 | **(8.5)** | **–** | **(8.5)** |
| Written off | **8.0** | **–** | **8.0** |
| Provided in the year | **–** | **(1.4)** | **(1.4)** |
| At 31 December 2014 | **(0.5)** | **(1.4)** | **(1.9)** |
| Net book value | | | |
| At 31 December 2014 | **105.8** | **14,299.3** | **14,405.1** |
| | | | |
| Cost | | | |
| At 1 January 2013 | 114.3 | 9,716.5 | 9,830.8 |
| Additions | – | 2,366.8 | 2,366.8 |
| Repayments | – | (1,004.7) | (1,004.7) |
| At 31 December 2013 | 114.3 | 11,078.6 | 11,192.9 |
| | | | |
| Impairment losses | | | |
| At 1 January 2013 | (0.5) | (30.4) | (30.9) |
| Written off | – | 26.6 | 26.6 |
| (Provided)/released in the year | (8.0) | 3.8 | (4.2) |
| At 31 December 2013 | (8.5) | – | (8.5) |
| Net book value | | | |
| At 31 December 2013 | 105.8 | 11,078.6 | 11,184.4 |

## 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 | 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 Key Services Ltd | Computer services |
| Brass No. 1 PLC | Funding vehicle |
| Brass No. 2 PLC | Funding vehicle |
| Brass No. 3 PLC | Funding vehicle |
| Brass No. 4 PLC | Funding vehicle |
| Norwich and Peterborough Estate Agents Ltd | Non-trading |
| Norwich and Peterborough Insurance Brokers Ltd | Non-trading |
| Norwich and Peterborough (LBS) Ltd | Mortgage finance |
| Tombac No. 1 PLC | Funding Vehicle |

All the companies are registered in England and operate in the United Kingdom.

All the entities are wholly owned except for Yorkshire Building Society Covered Bonds LLP, Brass No. 1 PLC, Brass No. 2 PLC, Brass No. 3 PLC, Brass No. 4 PLC and Tombac No. 1 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.

## 11. TAX EXPENSE

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** **£m** | 2013 £m | **2014** **£m** | 2013 £m |
| Current tax: | | | | |
| UK corporation tax at 21.49% (2013 – 23.25%) | **44.5** | 34.2 | **24.8** | 37.6 |
| Corporation tax – adjustment in respect of prior periods | **–** | (1.0) | **–** | (0.9) |
| Total current tax | **44.5** | 33.2 | **24.8** | 36.7 |
| Deferred tax (Note 20): | | | | |
| Current year | **(3.7)** | 18.1 | **(0.8)** | 0.6 |
| Adjustment in respect of prior periods | **–** | (0.1) | **–** | (0.1) |
| Total tax expense in Income Statement | **40.8** | 51.2 | **24.0** | 37.2 |

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

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** **£m** | 2013 £m | **2014** **£m** | 2013 £m |
| Profit before tax | **188.2** | 199.3 | **117.3** | 133.5 |
| Tax calculated at a tax rate of 21.49% (2013 – 23.25%) | **40.4** | 46.3 | **25.2** | 31.0 |
| Effects of: | | | | |
| Income not subject to tax | **(1.4)** | (0.9) | **(3.0)** | (1.6) |
| Expenses not deductible for tax purposes | **1.6** | 4.6 | **1.8** | 6.4 |
| Adjustment to tax charge in respect of previous periods | **–** | (1.1) | **–** | (1.0) |
| Change in accounting policy | **–** | 2.0 | **–** | 2.0 |
| Change in tax rate | **0.2** | 0.3 | **–** | 0.4 |
| Total tax expense in Income Statement | **40.8** | 51.2 | **24.0** | 37.2 |
| Tax expense/(credit) recognised directly in equity: | | | | |
| Tax on available for sale securities | **(1.4)** | (4.4) | **(1.4)** | (4.4) |
| Tax on pension costs | **11.0** | (4.8) | **11.0** | (4.8) |
| Deferred tax on cash flow hedges | **(8.6)** | 16.5 | **(8.6)** | 16.5 |
| Adjustment to tax in respect of previous periods | **–** | 0.1 | **–** | 0.1 |
| Change in tax rate | **(0.3)** | 4.2 | **(0.3)** | 4.2 |
| | **0.7** | 11.6 | **0.7** | 11.6 |

A reduction in the UK corporation tax rate from 23% to 21% from 1 April 2014 and to 20% from 1 April 2015 was substantively enacted during 2013. Both of these rate reductions are reflected in the financial statements resulting in a charge of £0.2m to the Income Statement and a credit of £0.3m to Other Comprehensive Income in the period, giving an overall net credit of £0.1m in respect of the Group's net deferred tax asset.

## 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. 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 reportable segments are listed below:

- Retail business – comprising prime residential owner occupied lending, non-owner occupied lending through Accord Mortgages Ltd, prime intermediary lending, traditional member savings, non-traditional savings and consumer banking (excluding personal lending). Consumer banking also includes the sale of general insurance, protection and investment products provided by third parties.
- Non-retail business – the prime commercial lending portfolio (including social housing).
- Secondary business – including non-prime residential owner occupied lending, personal lending, non-prime commercial lending and non-owner occupied lending acquired through mergers.
- Central functions – this includes supporting business units, the treasury function and other head office group functions which have not been apportioned across the aforementioned segments.

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

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 expense.

Recharging of funding across the Group has been included using the Group's transfer pricing methodology, which is based on our external cost of funds.

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

The accounting policies for the reported segments are consistent with the Group's accounting policies outlined in Note 1.

| 2014 | Notes | Retail £m | Non-retail £m | Secondary £m | Central £m | Total £m |
|---|---|---|---|---|---|---|
| Net interest income | | **389.6** | **14.6** | **49.1** | **95.9** | **549.2** |
| Non-interest income (net) | a | **27.7** | **4.6** | **–** | **(6.7)** | **25.6** |
| Net realised profits and fair value | | **–** | **–** | **–** | **(9.6)** | **(9.6)** |
| Management expenses | b | **(198.4)** | **(3.3)** | **(0.7)** | **(128.6)** | **(331.0)** |
| Operating profit/(loss) before provisions | | **218.9** | **15.9** | **48.4** | **(49.0)** | **234.2** |
| Impairment and other provisions | | **(19.1)** | **1.5** | **1.6** | **(30.0)** | **(46.0)** |
| Profit/(loss) before tax | | **199.8** | **17.4** | **50.0** | **(79.0)** | **188.2** |
| Total assets | | **30,305.1** | **708.8** | **1,085.5** | **5,472.6** | **37,572.0** |
| Total liabilities | | **28,023.2** | **–** | **–** | **7,588.5** | **35,611.7** |
| Equity | | **–** | **–** | **–** | **1,960.3** | **1,960.3** |

## 12. SEGMENTAL REPORTING (continued)

| 2013 | Notes | Retail £m | Non-retail £m | Secondary £m | Central £m | Total £m |
|---|---|---|---|---|---|---|
| Net interest income | | 467.4 | 10.3 | 41.0 | 12.9 | 531.6 |
| Non-interest income (net) | a | 30.6 | 3.6 | – | 3.4 | 37.6 |
| Net realised profits and fair value | | – | – | 1.7 | (27.5) | (25.8) |
| Management expenses | b, c | (177.6) | (3.2) | (2.7) | (116.5) | (300.0) |
| Operating profit/(loss) before provisions | | 320.4 | 10.7 | 40.0 | (127.7) | 243.4 |
| Impairment and other provisions | | (12.8) | (0.4) | (9.7) | (21.2) | (44.1) |
| Profit/(loss) before tax | | 307.6 | 10.3 | 30.3 | (148.9) | 199.3 |
| Total assets | | 27,675.4 | 582.0 | 1,225.3 | 4,970.7 | 34,453.4 |
| Total liabilities | | 27,380.3 | – | – | 5,263.7 | 32,644.0 |
| Equity | | – | – | – | 1,809.4 | 1,809.4 |

**Notes**

a Non-interest income (net) includes fees and commissions receivable, fees and commissions payable, and other operating income.

b Management expenses include administrative expenses, depreciation and amortisation.

c £18.8m of property, plant and equipment, investment properties and intangible assets were impaired in 2013. This impacts all segments and is included in management expenses.

Total income for the reportable segments can be analysed as follows:

| 2014 | Retail £m | Non-retail £m | Secondary £m | Central £m | Total £m |
|---|---|---|---|---|---|
| External income | **639.3** | **31.5** | **72.1** | **(168.1)** | **574.8** |
| Income from other segments | **(222.0)** | **(12.3)** | **(23.0)** | **257.3** | **–** |
| Total income | **417.3** | **19.2** | **49.1** | **89.2** | **574.8** |

| 2013 | Retail £m | Non-retail £m | Secondary £m | Central £m | Total £m |
|---|---|---|---|---|---|
| External income | 574.2 | 26.5 | 84.1 | (115.6) | 569.2 |
| Income from other segments | (76.2) | (12.6) | (43.1) | 131.9 | – |
| Total income | 498.0 | 13.9 | 41.0 | 16.3 | 569.2 |

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

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| | **£m** | £m | **£m** | £m |
| Cash in hand | **18.6** | 18.3 | **18.6** | 18.3 |
| Cash ratio deposit with the Bank of England | **50.3** | 44.7 | **50.3** | 44.7 |
| Other deposits with the Bank of England | **3,601.7** | 3,251.6 | **3,601.7** | 3,251.6 |
| | **3,670.6** | 3,314.6 | **3,670.6** | 3,314.6 |

Cash ratio deposits are mandatory requirements of the Bank of England. They are considered to be encumbered assets as 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 | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| | **£m** | £m | **£m** | £m |
| Loans and advances to banks | **599.3** | 482.0 | **262.5** | 120.8 |

Included within loans and advances to credit institutions are balances held in collateral accounts relating to swap agreements, and bank account balances held in the Group's Covered Bond and Securitisation programmes. Such items are considered to be encumbered assets as they are not available for use in the Group's day to day operations.

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

## 15. DEBT SECURITIES

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| | **£m** | £m | **£m** | £m |
| Debt securities issued by: | | | | |
| Public bodies | **390.2** | 313.4 | **390.2** | 313.4 |
| Other borrowers | **134.6** | 311.2 | **4,124.6** | 1,557.8 |
| | **524.8** | 624.6 | **4,514.8** | 1,871.2 |

All debt securities are listed in a recognised investment exchange.

Debt securities of £0.5bn (2013 – £0.6bn) are due in over one year.

## 15. DEBT SECURITIES (continued)

| 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 2014 | **7.4** | **(2.4)** | **531.9** | **87.7** | **624.6** |
| Transfers | **–** | **–** | **64.2** | **(64.2)** | **–** |
| Additions | **–** | **–** | **251.6** | **–** | **251.6** |
| Disposals and repayments | **–** | **–** | **(361.7)** | **(24.7)** | **(386.4)** |
| Exchange translation | **–** | **–** | **1.3** | **0.8** | **2.1** |
| Other changes in value | **1.8** | **(6.5)** | **37.2** | **0.4** | **32.9** |
| At 31 December 2014 | **9.2** | **(8.9)** | **524.5** | **–** | **524.8** |
| Movements in debt securities during the year were: | | | | | |
| At 1 January 2013 | 4.9 | (10.0) | 360.8 | 136.8 | 492.5 |
| Additions | – | – | 445.7 | – | 445.7 |
| Disposals and repayments | – | – | (249.7) | (49.6) | (299.3) |
| Exchange translation | – | – | 0.3 | (0.2) | 0.1 |
| Other changes in value | 2.5 | 7.6 | (25.2) | 0.7 | (14.4) |
| At 31 December 2013 | 7.4 | (2.4) | 531.9 | 87.7 | 624.6 |

The held to maturity portfolio of mainly Residential Mortgage Backed Securities has been transferred to the available for sale accounting classification to reflect our intention to dispose of this portfolio when market conditions allow.

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.

## 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 2014 | **7.4** | **(2.4)** | **531.9** | **1,334.3** | **1,871.2** |
| Transfers | **–** | **–** | **64.2** | **(64.2)** | **–** |
| Additions | **–** | **–** | **251.6** | **3,442.0** | **3,693.6** |
| Disposals and repayments | **–** | **–** | **(361.7)** | **(723.6)** | **(1,085.3)** |
| Exchange translation | **–** | **–** | **1.3** | **0.8** | **2.1** |
| Other changes in value | **1.8** | **(6.5)** | **37.2** | **0.7** | **33.2** |
| At 31 December 2014 | **9.2** | **(8.9)** | **524.5** | **3,990.0** | **4,514.8** |
| Movements in debt securities during the year were: | | | | | |
| At 1 January 2013 | 4.9 | (10.0) | 360.8 | 952.1 | 1,307.8 |
| Additions | – | – | 445.7 | 500.0 | 945.7 |
| Disposals and repayments | – | – | (249.7) | (119.2) | (368.9) |
| Exchange translation | – | – | 0.3 | (0.2) | 0.1 |
| Other changes in value | 2.5 | 7.6 | (25.2) | 1.6 | (13.5) |
| At 31 December 2013 | 7.4 | (2.4) | 531.9 | 1,334.3 | 1,871.2 |

## 16. LOANS AND ADVANCES TO CUSTOMERS

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Loans and advances to customers comprise: | | | | |
| Loans secured on residential property | | | | |
| Loans fully secured on residential property | **31,687.1** | 29,120.6 | **17,927.5** | 17,536.7 |
| Other loans secured on residential property | **57.5** | 31.2 | **13.0** | 10.9 |
| Unsecured loans | **2.0** | 7.9 | **2.0** | 7.9 |
| Loans secured on commercial property | **399.1** | 373.5 | **399.1** | 373.5 |
| Fair value hedging adjustments | **134.7** | 28.8 | **134.7** | 28.8 |
| Impairment provisions | **(46.3)** | (46.2) | **(7.0)** | (9.7) |
| | **32,234.1** | 29,515.8 | **18,469.3** | 17,948.1 |

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 £32.0bn (2013 – £28.4bn) are due in over one year.

Fair value hedging adjustments of £134.7m (2013 - £28.8m) 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

| | Construction in progress £m | Purchased software £m | Internally generated assets £m | Other £m | Total £m |
|---|---|---|---|---|---|
| **Group** | | | | | |
| Cost | | | | | |
| At 1 January 2014 | **6.6** | **24.9** | **18.0** | **18.5** | **68.0** |
| Additions | **9.3** | **4.1** | **0.2** | **–** | **13.6** |
| Disposals | **–** | **(3.9)** | **(5.6)** | **–** | **(9.5)** |
| Transfers | **(1.9)** | **1.7** | **0.2** | **–** | **–** |
| At 31 December 2014 | **14.0** | **26.8** | **12.8** | **18.5** | **72.1** |
| Amortisation | | | | | |
| At 1 January 2014 | **–** | **16.0** | **9.5** | **7.6** | **33.1** |
| Charged in year | **–** | **3.1** | **1.9** | **1.4** | **6.4** |
| Impairment | **–** | **0.4** | **4.7** | **–** | **5.1** |
| Disposals | **–** | **(3.1)** | **(5.6)** | **–** | **(8.7)** |
| Transfers | **–** | **–** | **–** | **–** | **–** |
| At 31 December 2014 | **–** | **16.4** | **10.5** | **9.0** | **35.9** |
| Net book value | | | | | |
| At 31 December 2014 | **14.0** | **10.4** | **2.3** | **9.5** | **36.2** |
| | | | | | |
| Cost | | | | | |
| At 1 January 2013 | – | 21.4 | 27.0 | 18.5 | 66.9 |
| Additions | 6.6 | 5.0 | 11.4 | – | 23.0 |
| Disposals | – | (1.5) | (19.8) | – | (21.3) |
| Transfers | – | – | (0.6) | – | (0.6) |
| At 31 December 2013 | 6.6 | 24.9 | 18.0 | 18.5 | 68.0 |
| Amortisation | | | | | |
| At 1 January 2013 | – | 15.4 | 11.1 | 6.1 | 32.6 |
| Charged in year | – | 2.1 | 5.3 | 1.5 | 8.9 |
| Impairment | – | – | 13.0 | – | 13.0 |
| Disposals | – | (1.5) | (19.8) | – | (21.3) |
| Transfers | – | – | (0.1) | – | (0.1) |
| At 31 December 2013 | – | 16.0 | 9.5 | 7.6 | 33.1 |
| Net book value | | | | | |
| At 31 December 2013 | 6.6 | 8.9 | 8.5 | 10.9 | 34.9 |

## 17. INTANGIBLE ASSETS (continued)

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.

Transfers relate to the reclassification of assets from construction in progress to purchased software and internally generated assets.

Any impairment in the value of intangible assets is dealt with through the Income Statement as it arises. During the period, £4.7m of internally developed software and £0.4m of purchased software were written off as the recoverable amount based on the value in use was deemed to be nil.

## 17. INTANGIBLE ASSETS (continued)

| | Construction in progress £m | Purchased software £m | Internally generated assets £m | Other £m | Total £m |
|---|---|---|---|---|---|
| **Society** | | | | | |
| Cost | | | | | |
| At 1 January 2014 | **6.6** | **23.9** | **18.0** | **18.5** | **67.0** |
| Additions | **9.3** | **4.1** | **0.2** | **–** | **13.6** |
| Disposals | **–** | **(3.9)** | **(5.6)** | **–** | **(9.5)** |
| Transfers | **(1.9)** | **1.7** | **0.2** | **–** | **–** |
| At 31 December 2014 | **14.0** | **25.8** | **12.8** | **18.5** | **71.1** |
| Amortisation | | | | | |
| At 1 January 2014 | **–** | **15.0** | **9.5** | **7.6** | **32.1** |
| Charged in year | **–** | **3.1** | **1.9** | **1.4** | **6.4** |
| Impairment | **–** | **0.4** | **4.7** | **–** | **5.1** |
| Disposals | **–** | **(3.1)** | **(5.6)** | **–** | **(8.7)** |
| Transfers | **–** | **–** | **–** | **–** | **–** |
| At 31 December 2014 | **–** | **15.4** | **10.5** | **9.0** | **34.9** |
| Net book value | | | | | |
| At 31 December 2014 | **14.0** | **10.4** | **2.3** | **9.5** | **36.2** |
| Cost | | | | | |
| At 1 January 2013 | – | 20.4 | 27.0 | 18.5 | 65.9 |
| Additions | 6.6 | 5.0 | 11.4 | – | 23.0 |
| Disposals | – | (1.5) | (19.8) | – | (21.3) |
| Transfers | – | – | (0.6) | – | (0.6) |
| At 31 December 2013 | 6.6 | 23.9 | 18.0 | 18.5 | 67.0 |
| Amortisation | | | | | |
| At 1 January 2013 | – | 14.5 | 11.1 | 6.1 | 31.7 |
| Charged in year | – | 2.0 | 5.3 | 1.5 | 8.8 |
| Impairment | – | – | 13.0 | – | 13.0 |
| Disposals | – | (1.5) | (19.8) | – | (21.3) |
| Transfers | – | – | (0.1) | – | (0.1) |
| At 31 December 2013 | – | 15.0 | 9.5 | 7.6 | 32.1 |
| Net book value | | | | | |
| At 31 December 2013 | 6.6 | 8.9 | 8.5 | 10.9 | 34.9 |

## 17. INTANGIBLE ASSETS (continued)

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.

Transfers relate to the reclassification of assets from construction in progress to purchased software and internally generated assets. Any impairment in the value of intangible assets is dealt with through the Income Statement as it arises. During the period, £4.7m of internally developed software and £0.4m of purchased software were written off as the recoverable amount based on the value in use was deemed to be nil.

## 18. INVESTMENT PROPERTIES

| | Group | | Society | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| | **£m** | £m | **£m** | £m |
| Cost | | | | |
| At 1 January | **20.4** | 20.3 | **20.2** | 20.1 |
| Additions | **0.3** | 0.1 | **0.3** | 0.1 |
| Disposals | **–** | – | **–** | – |
| Transfers | **0.8** | – | **0.8** | – |
| At 31 December | **21.5** | 20.4 | **21.3** | 20.2 |
| Depreciation | | | | |
| At 1 January | **3.9** | 3.0 | **3.9** | 3.0 |
| Charged in year | **0.3** | 0.6 | **0.3** | 0.6 |
| Impairment | **0.7** | 0.3 | **0.7** | 0.3 |
| Disposals | **–** | – | **–** | – |
| Transfers | **0.1** | – | **0.1** | – |
| At 31 December | **5.0** | 3.9 | **5.0** | 3.9 |
| Net book value | | | | |
| At 31 December | **16.5** | 16.5 | **16.3** | 16.3 |
| Fair value | | | | |
| At 31 December | **20.9** | 19.2 | **20.6** | 18.8 |

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 (2013 – £2.2m).

Transfers relate to the reclassification of assets between investment properties and property, plant and equipment usually due to changes in occupancy.

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. During the period, impairment of £0.7m was recognised on a group of properties with a recoverable amount of £1.4m based on the internal valuation performed by the Group's Estates Manager.

## 18. INVESTMENT PROPERTIES (continued)

The fair value of the Group's investment properties at 31 December 2014 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 of their fair value. 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 fair value measurements for investment properties have been classified as Level 2 as they have been calculated based on observable market prices (as defined in Note 40).

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 2014 was not materially different from their valuation incorporated in the financial statements.

## 19. PROPERTY, PLANT AND EQUIPMENT

| | Construction in progress £m | Land and buildings £m | Equipment fixtures, fittings and vehicles £m | Total £m |
|---|---|---|---|---|
| **Group** | | | | |
| Cost | | | | |
| At 1 January 2014 | **0.4** | **123.8** | **74.3** | **198.5** |
| Additions | **11.9** | **6.9** | **10.1** | **28.9** |
| Disposals | **–** | **(0.3)** | **(14.5)** | **(14.8)** |
| Transfers | **(8.0)** | **4.9** | **2.3** | **(0.8)** |
| At 31 December 2014 | **4.3** | **135.3** | **72.2** | **211.8** |
| Depreciation | | | | |
| At 1 January 2014 | **–** | **27.7** | **46.8** | **74.5** |
| Charged in year | **–** | **2.8** | **8.3** | **11.1** |
| Impairment | **–** | **3.9** | **–** | **3.9** |
| Disposals | **–** | **(0.2)** | **(14.1)** | **(14.3)** |
| Transfers | **–** | **(0.1)** | **–** | **(0.1)** |
| At 31 December 2014 | **–** | **34.1** | **41.0** | **75.1** |
| Net book value | | | | |
| At 31 December 2014 | **4.3** | **101.2** | **31.2** | **136.7** |
| Cost | | | | |
| At 1 January 2013 | – | 120.9 | 60.7 | 181.6 |
| Additions | 0.4 | 7.5 | 17.2 | 25.1 |
| Disposals | – | (4.6) | (4.2) | (8.8) |
| Transfers | – | – | 0.6 | 0.6 |
| At 31 December 2013 | 0.4 | 123.8 | 74.3 | 198.5 |
| Depreciation | | | | |
| At 1 January 2013 | – | 24.7 | 43.9 | 68.6 |
| Charged in year | – | 1.9 | 6.8 | 8.7 |
| Impairment | – | 5.5 | – | 5.5 |
| Disposals | – | (4.4) | (4.0) | (8.4) |
| Transfers | – | – | 0.1 | 0.1 |
| At 31 December 2013 | – | 27.7 | 46.8 | 74.5 |
| Net book value | | | | |
| At 31 December 2013 | 0.4 | 96.1 | 27.5 | 124.0 |

During the period, impairment of £3.9m was recognised on a group of properties with a recoverable amount of £6.5m based on the internal valuation performed by the Group's Estates Manager as described in Note 18.

## 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 2014 | **0.4** | **101.8** | **61.9** | **164.1** |
| Additions | **11.9** | **6.9** | **10.1** | **28.9** |
| Disposals | **–** | **(0.3)** | **(2.5)** | **(2.8)** |
| Transfers | **(8.0)** | **20.8** | **2.6** | **15.4** |
| At 31 December 2014 | **4.3** | **129.2** | **72.1** | **205.6** |
| Depreciation | | | | |
| At 1 January 2014 | **–** | **22.4** | **35.0** | **57.4** |
| Charged in year | **–** | **2.6** | **8.2** | **10.8** |
| Impairment | **–** | **3.9** | **–** | **3.9** |
| Disposals | **–** | **(0.2)** | **(2.5)** | **(2.7)** |
| Transfers | **–** | **(0.1)** | **–** | **(0.1)** |
| At 31 December 2014 | **–** | **28.6** | **40.7** | **69.3** |
| Net book value | | | | |
| At 31 December 2014 | **4.3** | **100.6** | **31.4** | **136.3** |
| Cost | | | | |
| At 1 January 2013 | – | 98.9 | 48.3 | 147.2 |
| Additions | 0.4 | 7.5 | 17.2 | 25.1 |
| Disposals | – | (4.6) | (4.2) | (8.8) |
| Transfers | – | – | 0.6 | 0.6 |
| At 31 December 2013 | 0.4 | 101.8 | 61.9 | 164.1 |
| Depreciation | | | | |
| At 1 January 2013 | – | 19.7 | 32.3 | 52.0 |
| Charged in year | – | 1.6 | 6.6 | 8.2 |
| Impairment | – | 5.5 | – | 5.5 |
| Disposals | – | (4.4) | (4.0) | (8.4) |
| Transfers | – | – | 0.1 | 0.1 |
| At 31 December 2013 | – | 22.4 | 35.0 | 57.4 |
| Net book value | | | | |
| At 31 December 2013 | 0.4 | 79.4 | 26.9 | 106.7 |

During the year, ownership of the Society's head office in Bradford was transferred from YBS Properties Ltd (a subsidiary company) to the Society. The net book value of £16.2m is included within the cost transfers.

## 20. DEFERRED TAX ASSETS AND LIABILITIES

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| The movement on the net deferred tax asset is as follows: | | | | |
| At 1 January | **42.4** | 93.4 | **42.1** | 75.6 |
| Income Statement credit/(charge) (Note 11) | **3.7** | (18.0) | **0.8** | (0.5) |
| Tax expense recognised directly in equity | **(18.6)** | (33.0) | **(18.6)** | (33.0) |
| At 31 December | **27.5** | 42.4 | **24.3** | 42.1 |
| Deferred tax assets and liabilities are attributable to the following items: | | | | |
| **Deferred tax assets** | | | | |
| Provision for loan impairment | **0.1** | 0.3 | **0.1** | 0.2 |
| Other provisions | **0.1** | 0.1 | **–** | 0.1 |
| Other temporary differences | **0.5** | 0.5 | **0.5** | 0.5 |
| Depreciation in excess of capital allowances | **2.6** | 2.9 | **2.5** | 2.8 |
| Transfer of engagements – tax value of losses carried forward | **7.2** | 9.8 | **7.2** | 9.8 |
| Pensions and other post retirement benefits | **1.8** | 1.9 | **1.8** | 1.9 |
| Implementation of IAS 39 – mortgages and hedging | **1.0** | 0.8 | **1.0** | 0.8 |
| Cash flow hedging | **9.2** | 1.2 | **9.2** | 1.2 |
| Transfer of engagements – fair value adjustments | **16.8** | 29.0 | **16.8** | 28.5 |
| Fair value volatility on financial instruments in securitisation entities | **3.5** | 0.7 | **–** | – |
| | **42.8** | 47.2 | **39.1** | 45.8 |
| **Deferred tax liabilities** | | | | |
| Pensions and other post retirement benefits | **12.9** | 0.8 | **12.9** | 0.8 |
| Accelerated tax depreciation | **–** | 0.2 | **–** | – |
| Implementation of IAS 39 – mortgages and hedging | **1.1** | 2.2 | **0.9** | 1.8 |
| Other temporary differences | **0.5** | 0.6 | **0.5** | 0.5 |
| Transfer of engagements – fair value adjustments | **0.5** | 0.6 | **0.5** | 0.6 |
| Fair value volatility on financial instruments in securitisation entities | **0.3** | 0.4 | **–** | – |
| | **15.3** | 4.8 | **14.8** | 3.7 |

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

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

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| Accelerated tax depreciation | **0.1** | 1.1 | **0.4** | 1.2 |
| Pensions and other post retirement benefits | **(0.3)** | – | **(0.3)** | – |
| Other provisions | **0.1** | 0.1 | **0.1** | 0.1 |
| Other temporary differences | **(1.3)** | (1.0) | **(1.1)** | (0.8) |
| Release of fair value adjustments on merger | **0.6** | 4.9 | **0.1** | – |
| Fair value volatility on financial instruments in securitisation entities | **(2.9)** | 12.9 | **–** | – |
| | **(3.7)** | 18.0 | **(0.8)** | 0.5 |

## 21. OTHER ASSETS

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| Prepayments and accrued income | **20.1** | 14.6 | **16.7** | 11.5 |
| Due from subsidiary undertakings | **–** | – | **16.6** | 19.6 |
| Other assets | **10.8** | 1.0 | **9.3** | (0.3) |
| | **30.9** | 15.6 | **42.6** | 30.8 |

## 22. SHARES

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| Shares comprising balances held by individuals | **27,347.0** | 26,415.3 | **27,347.0** | 26,415.3 |
| Fair value adjustments | **(105.6)** | (125.0) | **(105.6)** | (125.0) |
| | **27,241.4** | 26,290.3 | **27,241.4** | 26,290.3 |

## 23. AMOUNTS OWED TO CREDIT INSTITUTIONS

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| Amounts owed to: | | | | |
| Banks | **3,469.8** | 2,618.4 | **3,469.8** | 2,618.4 |
| Other credit institutions | **1.5** | 3.0 | **1.5** | 3.0 |
| | **3,471.3** | 2,621.4 | **3,471.3** | 2,621.4 |

Included within amounts owed to credit institutions are amounts deposited by counterparties under swap collateralisation agreements.

## 24. OTHER DEPOSITS

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| Amounts owed to: | | | | |
| Group companies | **–** | – | **5,562.9** | 1,693.5 |
| Other customers | **508.0** | 501.4 | **226.0** | 272.4 |
| | **508.0** | 501.4 | **5,788.9** | 1,965.9 |

Amounts due to Group companies comprise balances due to subsidiary undertakings.

## 25. DEBT SECURITIES IN ISSUE

| | Group 2014 £m | Group 2013 £m | Society 2014 £m | Society 2013 £m |
|---|---|---|---|---|
| Covered bonds | **2,231.8** | 1,847.9 | **2,231.8** | 1,847.9 |
| Medium term notes | **487.4** | – | **487.4** | – |
| Residential mortgage backed securities | **804.0** | 945.7 | **–** | – |
| | **3,523.2** | 2,793.6 | **2,719.2** | 1,847.9 |

Debt securities in issue include Group £3.0bn (2013 – £2.8bn) and Society £2.2bn (2013 – £1.8bn) secured on certain loans and advances to customers. Further information is given in Note 35.

## 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 operated 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 Norwich & Peterborough Scheme merged into the Scheme on 28 February 2014.

In addition, the Group operates unfunded defined benefit pension schemes for certain current and former members of staff. The present value at 31 December 2014 of the defined benefit obligation in relation to these schemes was £7.1m (2013 - £7.0m) 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 & Peterborough Building Society. The total expense recognised for these defined contribution benefits is £10.3m (2013 – £8.0m).

### 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, with the exception of N&P Section Members, since 1 April 2010 are based on career average revalued earnings. N&P Section members earn benefits based on their Final Pensionable Salary as at 31 March 2010. 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 defined benefit section of the Scheme has a weighted average maturity of around 20 years.

| **Summary of assumptions** | **31 Dec 2014 %** | 31 Dec 2013 % | 31 Dec 2012 % | 31 Dec 2011 % | 31 Dec 2010 % |
|---|---|---|---|---|---|
| Retail Prices index (RPI) Inflation | **3.3** | 3.7 | 3.2 | 3.3 | 3.8 |
| Consumer price index (CPI) inflation | **2.3** | 2.7 | 2.7 | 2.3 | 3.1 |
| Discount rate | **3.7** | 4.5 | 4.5 | 4.9 | 5.5 |
| Rate of increase in pay | **4.3** | 4.7 | 4.2 | 4.3 | 5.3 |
| Rate of increase of pensions in payment* | | | | | |
| subject to a min of 3% and a max of 5% | **3.8** | 3.9 | 3.8 | 3.7 | 4.0 |
| subject to a min of 0% and a max of 5% | **3.0** | 3.3 | 3.0 | 3.1 | 3.8 |
| subject to a min of 0% and a max of 3% | **2.3** | 2.4 | 2.2 | 2.4 | 2.9 |
| subject to a min of 0% and a max of 2.5% | **2.0** | 2.1 | 2.0 | 2.1 | 2.4 |
| Rate of increase for deferred pensions* | | | | | |
| subject to a min of 0% and a max of 5% | **2.3** | 2.7 | 2.7 | 2.3 | 3.1 |
| subject to a min of 0% and a max of 2.5% | **2.3** | 2.5 | 2.5 | 2.3 | 2.3 |

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

## 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:

| | **2014 Years** | 2013 Years |
|---|---|---|
| For a current 60 year old male | **28.3** | 28.6 |
| For a current 60 year old female | **28.9** | 28.3 |
| For a current 45 year old male | **30.2** | 30.5 |
| For a current 45 year old female | **30.8** | 29.5 |

| **Categories of assets** | **31 Dec 2014 %** | 31 Dec 2013 % | 31 Dec 2012 % | 31 Dec 2011 % | 31 Dec 2010 % |
|---|---|---|---|---|---|
| Equities | **28** | 32 | 28 | 26 | 32 |
| Bonds | **63** | 56 | 61 | 63 | 56 |
| Cash and other | **9** | 12 | 11 | 11 | 12 |
| | **100** | 100 | 100 | 100 | 100 |

| **Reconciliation of funded status** | **31 Dec 2014 £m** | 31 Dec 2013 £m | 31 Dec 2012 £m | 31 Dec 2011 £m | 31 Dec 2010 £m |
|---|---|---|---|---|---|
| Present value of defined benefit obligation | **(725.4)** | (626.5) | (589.3) | (532.9) | (456.7) |
| Assets at fair value | **789.8** | 626.9 | 607.8 | 564.6 | 442.5 |
| Funded status/defined benefit asset/(liability) | **64.4** | 0.4 | 18.5 | 31.7 | (14.2) |

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 2013, 2012 and 2011 balances include those of the Norwich & Peterborough scheme, as follows:

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| Present value of defined benefit obligation | (98.0) | (90.5) | (79.5) |
| Assets at fair value | 94.6 | 87.0 | 78.3 |
| Funded status/defined benefit liability | (3.4) | (3.5) | (1.2) |

| **Statement of Comprehensive Income (SCI)** | **2014 £m** | 2013 £m | 2012 £m | 2011 £m | 2010 £m |
|---|---|---|---|---|---|
| Actuarial gain/(loss) recognised in SCI | **50.3** | (20.4) | (22.5) | 18.7 | 4.8 |
| Cumulative actuarial (losses)/gains recognised at 1 January | **(22.1)** | (1.7) | 20.8 | 2.1 | (2.7) |
| Cumulative actuarial gains/(losses) recognised at 31 December | **28.2** | (22.1) | (1.7) | 20.8 | 2.1 |

## 26. RETIREMENT BENEFIT OBLIGATIONS (continued)

| Experience gain and losses | 2014 £m | 2013 £m | 2012 £m | 2011 £m | 2010 £m |
|---|---|---|---|---|---|
| Loss on change of assumptions | **(84.3)** | (24.6) | (44.9) | (19.4) | (5.9) |
| Gain on other experience | **1.4** | 2.7 | 3.0 | 30.8 | 0.5 |
| Experience gain on assets | **133.2** | 1.5 | 19.4 | 7.3 | 10.2 |
| Actuarial gain/(loss) recognised in SCI | **50.3** | (20.4) | (22.5) | 18.7 | 4.8 |

| Components of pension expense as shown in the Income Statement | 2014 £m | 2013 £m |
|---|---|---|
| Service cost | **6.3** | 6.2 |
| Interest income | **(0.2)** | (0.9) |
| Total pension expense | **6.1** | 5.3 |

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 | 2014 £m | 2013 £m |
|---|---|---|
| Present value of defined benefit obligation at 1 January | **626.5** | 589.3 |
| Defined benefit service cost | **6.3** | 6.2 |
| Interest cost | **27.5** | 26.2 |
| Actuarial loss | **82.9** | 21.9 |
| Defined benefit actual benefits paid | **(17.8)** | (17.1) |
| Present value of defined benefit obligation at 31 December | **725.4** | 626.5 |
| **Movement in defined benefit fair value of assets** | | |
| Fair value of assets at 1 January | **626.9** | 607.8 |
| Expected return on assets | **27.7** | 27.1 |
| Actuarial gain on assets | **133.2** | 1.5 |
| Defined benefit actual company contributions | **19.8** | 7.6 |
| Defined benefit actual benefits paid | **(17.8)** | (17.1) |
| Fair value of plan assets at 31 December | **789.8** | 626.9 |

None of the assets were invested in the Group's own financial instruments (2013 – £nil) or the Group's own property (2013 – £nil).

| Estimated contributions in 2015 | 2015 £m |
|---|---|
| Society contributions | **10.4** |
| Employee contributions | **–** |
| Total contributions | **10.4** |

Society contributions include £1.7m 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.

## 26. RETIREMENT BENEFIT OBLIGATIONS (continued)

### Scheme specific risks

The ultimate cost of the schemes to the Society will depend upon actual future events rather than the assumptions made. Many of the assumptions made are unlikely to be borne out in practice and, as such, the cost of the schemes may be higher or lower than disclosed. In general, the risk to the Society is that the assumptions underlying the disclosures, or the calculation of contribution requirements, are not borne out in practice and the cost to the Society is higher than expected. This could result in higher contributions being required from the Group and a higher deficit being disclosed. This may also impact the Society's ability to grant discretionary benefits or other enhancements to members.

The assumptions not being borne out in practice could include:

- The investment return on the Scheme's assets being lower than assumed, resulting in an unaffordable increase in the contributions required from the Society. The level of bond returns will be a key determinant of overall investment return; the investment portfolio is also subject to a range of other risks typical of the asset classes held, in particular equity returns, credit risk on bonds and exposure to the property market.
- Falls in asset values (particularly equities) not being matched by similar falls in the value of liabilities. This risk has been mitigated to some degree by the implementation of an asset liability matching investment strategy which is designed to match a proportion of the Scheme's interest rate exposure.
- Future levels of inflation being higher than assumed, resulting in higher than anticipated annual increases to benefits in payment, revaluations of benefits prior to retirement and salary increases. This risk has been mitigated to some degree by the implementation of an asset liability matching investment strategy which is designed to match a proportion of the Scheme's inflation exposure.
- Unanticipated improvements in the longevity of members leading to an increase in the Scheme's liabilities.

### Assets

The Scheme's investment strategy, with a significant proportion of the assets invested in an asset liability matching strategy (consisting of index-linked government and corporate bonds and swaps), is expected to reduce the volatility of the difference between the market value of the assets and the IAS 19 liabilities.

| Disaggregation of assets | 31 Dec 2014 % | 31 Dec 2013 % |
|---|---|---|
| Equities | **28** | 32 |
| Bonds – index–linked gilts | **48** | 33 |
| Bonds – corporate and other | **13** | 21 |
| Swaps | **2** | 2 |
| Cash and other | **9** | 12 |
| | **100** | 100 |

The majority of the Scheme's investments are in quoted assets, with the exception of the liability matching assets classified as 'Swaps' and reinsurance assets included in 'Cash and other', where a proportion of these will be invested in unquoted assets.

## 26. RETIREMENT BENEFIT OBLIGATIONS (continued)

### Sensitivities

The IAS19 liability measurement (DBO) and the Service Cost are sensitive to the assumptions made about future inflation and salary growth levels, as well as the assumptions made about life expectancy. They are also sensitive to the discount rate, which depends on market yields on Sterling-denominated high quality corporate bonds. A decrease in corporate bond yields will increase the liabilities although this will be partially offset by an increase in matching assets.

The table below shows the sensitivity of the defined benefit obligation and the assets to changes in these assumptions. The final assumptions are chosen by the Society.

**Principal Sensitivity Illustrations**

| | Defined benefit obligation £m | Assets £m | **Net effect £m** |
|---|---|---|---|
| Total as at 31 December 2014 | 725.4 | 789.8 | **64.4** |
| Change in defined benefit obligation / assets given the following change of assumption; | | | |
| Discount Rate[1]: 1.00% decrease | 167.7 | 153.6 | **(14.1)** |
| Salary Escalation: 0.75% increase | 8.8 | – | **(8.8)** |
| Inflation[2]: 0.50% increase | 27.4 | 38.6 | **11.2** |
| Life Expectancy: 1 year average increase | 25.4 | – | **(25.4)** |

[1] The change in the discount rate is assumed to be equivalent to a 1% decrease in Gilt, swap and credit based interest rates.

[2] The sensitivities to the inflation assumption change include corresponding changes to the future salary increases and future pension increases assumptions, where the pension increases are subject to the relevant maximum and minimum rates of increase that apply to each tranche of benefit.

The sensitivity illustrations above are calculated changing each assumption in isolation, keeping all other assumptions constant. In practice this is unrealistic as the financial assumptions are correlated.

The asset liability matching strategy implemented for the Scheme means that a change in discount rate or inflation assumption has a similar impact on the liabilities and the assets, reducing the volatility of the net impact.

## 27. OTHER LIABILITIES

| | **Group** | | **Society** | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Accruals and deferred income | **47.3** | 38.4 | **46.8** | 37.6 |
| Income tax deducted at source | **29.9** | 38.2 | **29.9** | 38.2 |
| Other | **6.3** | 9.0 | **6.3** | 72.2 |
| | **83.5** | 85.6 | **83.0** | 148.0 |

## 28. PROVISIONS

Movements in provisions during the year were as follows:

| | FSCS levy £m | Customer redress £m | Other £m | Total £m |
|---|---|---|---|---|
| **Group** | | | | |
| At 1 January 2014 | **25.9** | **54.8** | **3.3** | **84.0** |
| Amounts utilised during the year | **(22.1)** | **(51.6)** | **(0.1)** | **(73.8)** |
| Provision charge during the year | **12.4** | **11.0** | **2.6** | **26.0** |
| At 31 December 2014 | **16.2** | **14.2** | **5.8** | **36.2** |
| **2013** | | | | |
| At 1 January 2013 | 35.5 | 61.1 | 6.9 | 103.5 |
| Amounts utilised during the year | (21.4) | (19.0) | (0.4) | (40.8) |
| Provision charge/(release) during the year | 11.8 | 12.7 | (3.2) | 21.3 |
| At 31 December 2013 | 25.9 | 54.8 | 3.3 | 84.0 |
| **Society** | | | | |
| **2014** | | | | |
| At 1 January 2014 | **25.9** | **52.9** | **3.3** | **82.1** |
| Amounts utilised during the year | **(22.0)** | **(49.9)** | **(0.1)** | **(72.0)** |
| Provision charge during the year | **12.4** | **10.9** | **2.5** | **25.8** |
| At 31 December 2014 | **16.3** | **13.9** | **5.7** | **35.9** |
| **2013** | | | | |
| At 1 January 2013 | 35.5 | 61.1 | 6.9 | 103.5 |
| Amounts utilised during the year | (21.4) | (19.0) | (0.4) | (40.8) |
| Provision charge/(release) during the year | 11.8 | 10.8 | (3.2) | 19.4 |
| At 31 December 2013 | 25.9 | 52.9 | 3.3 | 82.1 |

### Financial Service Compensation Scheme (FSCS) levy

The FSCS has borrowings of £16bn 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 outstanding 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 and the Group estimates this will be in the range of £1bn. The FSCS is recovering the shortfall by levying member firms in instalments until March 2016. The Group's share of the shortfall is estimated to be £27.6m. As per IFRIC 21, the trigger point has not yet been met in terms of this expected shortfall, and accordingly the Group has not recognised a provision for such contingent liabilities. Fair value adjustments were made on merger with Chelsea and Norwich & Peterborough building societies to provide for future FSCS levies in respect of the acquired protected deposits, which reduces the charge for the year.

The Group has recognised in this year's results, a provision charge for a levy of £12.4m for the scheme year 2014/2015.

## 28. PROVISIONS (continued)

### Customer remediation and conduct issues

Provisions have been made in respect of various customer claims and represent management's best estimate of the likely costs. The largest provision (£5.3m) is for customer remediation in relation to products sold by Chelsea and Norwich & Peterborough building societies prior to their respective mergers with the Yorkshire Building Society in 2010 and 2011. The provision is calculated using management's estimate of complaint volumes, redress payments and complaint handling costs. The second largest provision (£4.6m) relates to the Group's approach to the promotional materials of some investments linked to stock market performance and administration fee charging in relation to mortgage collection and failed direct debits. These have been calculated using management's estimates of complaint volumes, redress payments and other costs. The costs are not expected to vary materially given that the remediation exercises are in their final stages. Of the remaining provision, £3.2m relates to sales of payment protection insurance (PPI) and is 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, and £1.1m is in relation to smaller remediation exercises to correct potential instances of customer detriment.

The Group also has a contingent liability of £3.7m, in relation to the promotional materials of some investments linked to stock market performance. This is due to the fact that the Group is jointly and severally liable for the reimbursement of customers, together with Credit Suisse, the party who designed the product. However, as the reimbursements are being made by Credit Suisse and the Group would only settle the full amount if Credit Suisse went into administration, a provision has not been recognised in respect of this contingent liability.

### Other

Other provisions include provisions for claims relating to negligent valuations undertaken prior to 2010 by a subsidiary of Norwich & Peterborough Building Society (£2.5m) and property related provisions in respect of onerous leases (£3.3m).

## 29. SUBORDINATED LIABILITIES

| Group and Society | 2014 £m | 2013 £m |
|---|---|---|
| 6.63% Subordinated Bonds 2015 | **10.2** | 10.2 |
| Floating Subordinated Bonds 2018 | **5.0** | 5.0 |
| 11⅜% Subordinated Bonds 2022 | **5.0** | 5.0 |
| 6⅜% Subordinated Bonds 2024 | **4.1** | 4.1 |
| 4⅛% Subordinated Bonds 2024 | **248.2** | – |
| 13½% Convertible Tier 2 Capital Notes 2025 | **25.8** | 25.7 |
| Fair value hedging adjustments | **1.2** | (1.3) |
| | **299.5** | 48.7 |

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 Prudential Regulation Authority under the following conditions:

- Redemption of all (but not some only) of the 11⅜% 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 11⅜% and an aggregate of 3.10% and the then current five year benchmark Gilt rate.
- Redemption of all (but not some only) of the 4⅛% Notes at par on 20 November 2019 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 20 November 2019 the fixed rate of interest will become the sum of the five year Gilt rate and 2.90%.

## 29. SUBORDINATED LIABILITIES (continued)

- 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 Common Equity 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 Subscribed 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 | 2014 £m | 2013 £m |
|---|---|---|
| 5.649% Permanent Interest Bearing Shares | **6.2** | 6.2 |
| Fair value hedging adjustments | **0.7** | 0.6 |
| | **6.9** | 6.8 |

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 Prudential Regulation 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

On 1 January 2014 the Basel III regulatory capital framework was written into European law in the form of a regulation and directive commonly known as CRD IV. This replaces the Basel II framework.

The ratios, deductions and definitions below are in accordance with CRD IV regulations.

| | 2014 £m | 2013 £m |
|---|---|---|
| **Tier 1** | | |
| **Common Equity Tier 1 (CET1)** | | |
| General reserve | **1,993.5** | 1,805.9 |
| Deferred tax assets that rely on future profitability | **(7.2)** | – |
| Pension fund adjustments[1] | **(51.5)** | (3.0) |
| Intangible fixed assets | **(35.7)** | (34.9) |
| Deductions from Tier 1 capital[2] | **(27.4)** | (11.4) |
| Total Common Equity Tier 1 capital | **1,871.7** | 1,756.6 |
| **Additional Tier 1 Capital** | | |
| Subscribed Capital[3] | **5.5** | 6.8 |
| | **1,877.2** | 1,763.4 |
| **Tier 2** | | |
| Subordinated liabilities[4] | **288.3** | 40.5 |
| Collective allowances for impairment | **23.4** | 12.7 |
| Deductions from Tier 2 capital[2] | – | (11.4) |
| | **311.7** | 41.8 |
| Other items excluded | – | (5.8) |
| **Total capital** | **2,188.9** | 1,799.4 |
| Risk weighted assets | **13,555.7** | 12,595.4 |
| Common Equity Tier 1 ratio | **13.8%** | 13.9% |
| Tier 1 ratio | **13.8%** | 14.0% |
| Total capital ratio | **16.1%** | 14.3% |
| Leverage ratio[5] | **4.8%** | 4.6% |

## 31. CAPITAL MANAGEMENT (continued)

[1] CRD IV allows a pension fund surplus, net of any associated deferred tax liabilities, to be deducted from Tier 1 capital. CRD IV does not permit a pension fund deficit to be added back to regulatory capital.

[2] Securitisation positions that are unrated or have low external ratings have been deducted from Tier 1 capital, with deductions applied to Tier 1. Under Basel II, this balance was split, after the deduction of tax, equally between Tier 1 and Tier 2 capital.

[3] Under CRD IV, subscribed capital is being phased out over a ten year period. Currently 80% of the subscribed capital balance sheet carrying value qualifies as Tier 1 capital.

[4] Subordinated liabilities are adjusted for amortisation in the regulatory capital value of instruments with less than five years to maturity. In November 2014 the Group raised £250m of Tier 2 subordinated debt with a ten year maturity but an option to call, or redeem the debt early, after five years.

[5] CRD IV regulatory capital rules have introduced a non-risk based leverage requirement that measures the relationship between capital resources and an adjusted measure of total on and off balance sheet assets. A minimum leverage ratio of 3% is in force until 2017 for the UK's eight largest financial institutions, when it will be reviewed, before becoming mandatory for all other institutions (including the Group) in 2018.

Throughout the year the Executive Risk Committee has reviewed the Group's capital position and regulatory developments under CRD IV. More detail of the Group's capital management strategies can be found in the Risk Management Report on page 50.

For a detailed analysis of the Group's capital position and disclosures please refer to the Pillar 3 Disclosure for 2014 which can be found on our website.

## 32. FINANCIAL COMMITMENTS

| | Group and Society | |
|---|---|---|
| | **2014 £m** | 2013 £m |
| Committed undrawn standby facilities | **161.3** | 169.8 |

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, 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 2014, but for which no provision has been made in the accounts, amounted to Group £2.3m and Society £2.3m (2013 – Group £11.0m and Society £11.0m).

Amounts payable under non-cancellable operating leases are as follows:

| | **2014** | | 2013 | |
|---|---|---|---|---|
| **Group** | **Land and buildings £m** | **Other £m** | Land and buildings £m | Other £m |
| Within one year | **7.6** | **0.8** | 8.7 | 1.3 |
| Between one and five years | **22.9** | **0.8** | 26.6 | 2.0 |
| Over five years | **15.8** | **–** | 22.2 | – |
| | **46.3** | **1.6** | 57.5 | 3.3 |

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<br>Fixed, variable and non-interest bearing rates | Amortised cost |
| Loans and advances to credit institutions | Short-term<br>Fixed and variable interest rates | Amortised cost |
| Debt securities | Short-term, medium-term and long-term<br>Fixed and variable interest rates | Generally held at fair value as available for sale assets.<br>Certain investments are held at fair value through the Income Statement or held to maturity at amortised cost.<br>Detail is given in Note 15 |
| Loans and advances to customers | Loan period is typically up to 25 years<br>Primarily mortgage products offering a variety of fixed and variable interest rates | Amortised cost* |
| Derivative financial instruments | Primarily medium-term<br>Value derived from underlying price, rate or index | Fair value through profit and loss |
| Intercompany deposit from Covered Bond Limited Liability Partnerships | Long-term<br>Fixed and variable interest rates | Fair value through profit and loss |
| Investments | Investment in subsidiary companies | Amortised cost/cost |
| Shares | Deposits made by individuals<br>Varying withdrawal notice periods<br>Fixed and variable interest rates | Amortised cost* |
| Amounts owed to credit institutions and other customers | Primarily short-term Time Deposits<br>Fixed and variable interest rates | Amortised cost* |
| Debt securities in issue | Medium-term<br>Fixed and variable interest rates | Amortised cost* |
| Subordinated liabilities | Long-term<br>Fixed and variable interest rates | Amortised cost* |
| Subscribed capital | Long-term<br>Fixed interest rates | Amortised cost* |

* Except where hedge accounting allows a fair value adjustment to be made for interest rate risk.

## 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 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, 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 amount £m | Fair values Assets £m | Fair values Liabilities £m |
|---|---|---|---|
| **At 31 December 2014** | | | |
| Interest rate swaps designated as fair value hedges | **18,784.7** | **169.3** | **277.8** |
| Equity linked interest rate swaps designated as fair value hedges | **239.7** | **22.4** | **–** |
| Interest rate swaps designated as cash flow hedges | **1,288.0** | **3.7** | **44.2** |
| Cross-currency interest rate swaps designated as fair value hedges | **1,323.9** | **–** | **43.9** |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | **5,121.9** | **18.8** | **47.0** |
| Equity linked interest rate swaps | **–** | **–** | **–** |
| Call options | **–** | **–** | **–** |
| Forward foreign exchange | **65.2** | **0.1** | **0.7** |
| Interest rate options | **–** | **–** | **–** |
| **Total derivatives held for hedging** | **26,823.4** | **214.3** | **413.6** |

| Society | Contract/ notional amount £m | Fair values Assets £m | Fair values Liabilities £m |
|---|---|---|---|
| **At 31 December 2014** | | | |
| Interest rate swaps designated as fair value hedges | **18,034.7** | **68.2** | **281.4** |
| Equity linked interest rate swaps designated as fair value hedges | **239.7** | **22.4** | **–** |
| Interest rate swaps designated as cash flow hedges | **1,288.0** | **3.7** | **44.2** |
| Cross-currency interest rate swaps designated as fair value hedges | **467.3** | **–** | **16.3** |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | **5,121.9** | **18.8** | **47.0** |
| Equity linked interest rate swaps | **–** | **–** | **–** |
| Call options | **–** | **–** | **–** |
| Forward foreign exchange | **65.2** | **0.1** | **0.7** |
| Interest rate options | **–** | **–** | **–** |
| **Total derivatives held for hedging** | **25,216.8** | **113.2** | **389.6** |

In line with industry best practice, expected future cash flows for derivative financial instruments have been discounted using the Overnight Indexed Swap (OIS) curve. The LIBOR curve was used for discounting in previous periods and the impact of the change in the valuation approach is not deemed to be material.

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.

## 34. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

| Group | Contract/ notional amount £m | Fair values Assets £m | Fair values Liabilities £m |
|---|---|---|---|
| **At 31 December 2013** | | | |
| Interest rate swaps designated as fair value hedges | 6,653.1 | 146.7 | 121.8 |
| Interest rate swaps designated as cash flow hedges | 2,349.9 | 27.1 | 19.7 |
| Cross-currency interest swaps designated as fair value hedges | 499.7 | 15.3 | – |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | 9,525.7 | 45.2 | 52.2 |
| Equity linked interest rate swaps | 537.5 | 38.3 | 0.9 |
| Call options | 2.7 | 0.2 | – |
| Forward foreign exchange | 69.1 | 0.2 | 0.2 |
| Interest rate options | 3.0 | – | – |
| **Total derivatives held for hedging** | 19,640.7 | 273.0 | 194.8 |

| Society | | | |
|---|---|---|---|
| **At 31 December 2013** | | | |
| Interest rate swaps designated as fair value hedges | 5,903.1 | 63.4 | 121.8 |
| Interest rate swaps designated as cash flow hedges | 2,349.9 | 27.1 | 19.7 |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | 9,525.7 | 45.0 | 54.5 |
| Equity linked interest rate swaps | 537.5 | 38.3 | 0.9 |
| Call options | 2.7 | 0.2 | – |
| Forward foreign exchange | 69.1 | 0.2 | 0.2 |
| Interest rate options | 3.0 | – | – |
| **Total derivatives held for hedging** | 18,391.0 | 174.2 | 197.1 |

## 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 the 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 Group's liquidity management comprises the following key areas:

- Limits are established by the Board that govern the quantity, quality and marketability of, and expected 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 Asset and Liability Committee (ALCO) 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 three months.
- The Society also manages liquidity in line with prevailing regulatory requirements. At present, this is issued by the PRA in the form of the Individual Liquidity Guidance (ILG) which is set by the PRA 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, 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. The prevailing regulatory requirement is expected to change during 2015, moving to the Liquidity Coverage Ratio (LCR), with the discontinuation of the ILG metric at the same time.
- The liquidity position of the Group is forecast across the planning period of five years, and measured against forecasts of the requirements on both a regulatory and internal basis. This is to ensure that the plans of the Group do not lead to liquidity limits being breached and the financial sustainability of the organisation being threatened. These forecasts are refreshed on a weekly basis, given the latest views of the various business areas within the Group which impact on the liquidity position, and are discussed at the weekly ALCO meetings.

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 to absorb the worst-case stress scenario over the ensuing 3 months.
- Liquidity stress tests – where 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.

## 35. LIQUIDITY RISK (continued)

### Pledged assets

The Group's asset backed funding programmes reported within debt securities in issue (see Note 25) are secured against certain loans and advances to customers.

In addition, as part of its liquidity management, the Group enters into sale and repurchase agreements, whereby the Group sells but agrees to repurchase assets at a future date, typically up to three months UK Government securities and listed transferable debt securities. Proceeds of these sale and repurchase agreements are included within amounts owed to credit institutions (see Note 23).

Assets pledged and the nominal values of the notes in issue are as follows:

| | **2014** | | 2013 | |
|---|---|---|---|---|
| | **Assets pledged £m** | **Secured funding £m** | Assets pledged £m | Secured funding £m |
| Covered bond programme | **3,396.8** | **2,106.7** | 2,801.3 | 1,749.8 |
| Securitisation programme | **1,549.4** | **897.2** | 1,214.5 | 1,070.6 |
| Whole mortgage loan pools | **3,857.6** | **2,587.1** | 3,466.2 | 1,696.0 |
| Available for sale – Debt Securities | **373.8** | **372.0** | 10.9 | 10.7 |
| | **9,177.6** | **5,963.0** | 7,492.9 | 4,527.1 |

All of the assets pledged as security are retained in the Statement of Financial Position as the Group has retained substantially all the risk and rewards of ownership.

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. During 2014 the Society issued a new seven year €500m fixed rate bond. As at 31 December 2014 the Society had in issue £1,250m and €1,100m of covered bonds.

The Group established its first securitisation programme in 2011. This year the latest securitisation structure, Brass No. 4 PLC was established with a £1,000m issue secured against certain loans of Accord Mortgages Ltd, of which £700m was retained by the Yorkshire Building Society for use as collateral to potentially access funding schemes launched by the Bank of England. In addition, Tombac No. 1 plc (Tombac) was incorporated in February 2014 and in April 2014 Tombac issued £2,742m of listed debt securities all of which were retained by the Group. As at 31 December 2014, the Group had in issue £4,790m of securitisation issues, of which £3,987m was retained.

The whole mortgage loan pools are pre-positioned at the Bank of England under the Funding for Lending Scheme (FLS). The whole loan pool is pledged and drawings are made directly against the eligible collateral, subject to a haircut. Consequently, values shown are the whole mortgage loan pool balances.

## 35. LIQUIDITY RISK (continued)

The tables below show contractual future cash flows for all financial liabilities including interest payments. Further details of liquidity management are contained within the Risk Management Report on pages 52 to 53.

| Group<br>As at 31 December 2014 | Repayable on demand and up to one year £m | In more than one year but not more than five years £m | Over five years £m | Total £m |
|---|---|---|---|---|
| Shares | **23,815.6** | **3,634.9** | **9.3** | **27,459.8** |
| Amounts owed to credit institutions | **3,118.6** | **322.3** | **–** | **3,440.9** |
| Other deposits | | | | |
| Society | **228.1** | **–** | **–** | **228.1** |
| Subsidiaries | **281.9** | **–** | **–** | **281.9** |
| | **510.0** | **–** | **–** | **510.0** |
| Debt securities in issue | **554.5** | **2,717.3** | **399.1** | **3,670.9** |
| Subordinated liabilities | **25.0** | **63.4** | **358.0** | **446.4** |
| Subscribed capital* | **0.3** | **1.4** | **1.7** | **3.4** |
| Operating lease payments | **8.4** | **23.7** | **15.8** | **47.9** |
| Derivative financial liabilities | **214.2** | **429.3** | **72.5** | **716.0** |
| **Total** | **28,246.6** | **7,192.3** | **856.4** | **36,295.3** |

| Group<br>As at 31 December 2013 | | | | |
|---|---|---|---|---|
| Shares | 23,098.4 | 3,437.5 | – | 26,535.9 |
| Amounts owed to credit institutions | 1,992.3 | 549.4 | 36.6 | 2,578.3 |
| Other deposits | | | | |
| Society | 270.6 | 3.5 | – | 274.1 |
| Subsidiaries | 229.0 | – | – | 229.0 |
| | 499.6 | 3.5 | – | 503.1 |
| Debt securities in issue | 76.2 | 2,907.0 | – | 2,983.2 |
| Subordinated liabilities | 5.0 | 32.9 | 60.7 | 98.6 |
| Subscribed capital* | 0.3 | 1.4 | 1.7 | 3.4 |
| Operating lease payments | 10.0 | 28.6 | 22.2 | 60.8 |
| Derivative financial liabilities | 111.8 | 251.6 | 430.3 | 793.7 |
| **Total** | 25,793.6 | 7,211.9 | 551.5 | 33,557.0 |

* The table includes interest payments on subscribed capital for ten years.

## 36. MARKET RISK

Market risk is the risk to earnings and capital arising from changes in interest rates, foreign currency exchange rates, structural mismatches within the Statement of Financial Position and the price of financial instruments.

### 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 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, SONIA and LIBOR. The effect of LIBOR and SONIA 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/SONIA 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, i.e. 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.

| **2014** | **Year end £000** | **Average £000** | **Maximum £000** | **Minimum £000** |
|---|---|---|---|---|
| VaR | **2,401** | **3,216** | **7,410** | **947** |
| Basis risk | **11** | **30** | **71** | **4** |
| BP sensitivity | **(148)** | **(158)** | **321** | **(337)** |

| | **Greater than one year £m** | **Greater than five years £m** | **Greater than 10 years £m** |
|---|---|---|---|
| Repricing gap | **785** | **11** | **(3)** |

| **2013** | Year end £000 | Average £000 | Maximum £000 | Minimum £000 |
|---|---|---|---|---|
| VaR | 5,426 | 3,968 | 7,026 | 1,272 |
| Basis risk | 34 | 108 | 205 | 12 |
| BP sensitivity | (256) | (51) | 321 | (336) |

| | Greater than one year £m | Greater than five years £m | Greater than 10 years £m |
|---|---|---|---|
| Repricing gap | 1,565 | 25 | 13 |

Detail of how the Group manages its interest rate risk is included in the Risk Management Report on pages 53 to 54.

## 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 54. Actual exposures were:

| | **2014 £m** | 2013 £m |
|---|---|---|
| Year end | **–** | 0.4 |
| Maximum | **0.7** | 0.6 |

## 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 regularly reviewed internally and against the external rating agencies, with revocation or suspension taking place where considered appropriate.

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.

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. Primary liquidity holdings, (which meet Individual Liquidity Guidance requirements) are buffer eligible and subject to internal credit risk approval. Secondary liquidity holdings are used to support the OLR (Overall Liquidity Requirements) if considered internally to be liquid.

The following table breaks down exposures using composite external ratings and includes RMBS and Structured Credit Investments.

| | **2014 %** | 2013 % |
|---|---|---|
| AAA | **1** | 4 |
| AA+ to AA- | **91** | 87 |
| A+ to A- | **7** | 8 |
| Other | **1** | 1 |
| | **100** | 100 |

The Group uses an internal credit ratings process to identify potential risks. Wholesale related credit risks are reported and discussed monthly at the Wholesale and Commercial Credit Committee. The Group's low risk appetite is reflected in the country exposures.

The Group's only Sovereign exposure is to the UK which has an average external rating of 'AA+'. At the year end, Sovereign exposure to the UK was £5,039m (2013 – £4,774m) to the Bank of England and £373m (2013 – £327m) in UK Government bonds.

The largest exposure to a single institution (other than the UK Government) was £195m (2013 – £314m) in both instances to a UK clearing bank.

## 38. WHOLESALE CREDIT RISK (continued)

| Country | Wholesale Exposures (including RMBS & Structured Credit Investments) at 31 December 2014 (£m) | Wholesale Exposures (including RMBS & Structured Credit Investments) at 31 December 2013 (£m) |
|---|---|---|
| United Kingdom | **5,910.9** | 5,749.7 |
| United States | **149.8** | 63.7 |
| Netherlands | **24.8** | 24.2 |
| Switzerland | **21.8** | 31.0 |
| Ireland | **20.8** | 20.8 |
| Cayman Islands | **17.5** | 15.7 |
| France | **17.3** | 2.5 |
| Denmark | **11.8** | 2.1 |
| Australia | **3.3** | 2.1 |
| Germany | **2.1** | 3.9 |
| Belgium | **<0.1** | <0.1 |
| Spain | **0** | 1.1 |
| Multilateral Development Banks | **0** | 152.5 |

The Society has maintained its low risk appetite for wholesale credit risk to financial institutions outside the UK.

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

The key trigger events used to evaluate impairments are set out in Note 1 on pages 81 to 87.

In addition to the above direct exposures the Group regularly monitors 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 regards to this information.

## 38. WHOLESALE CREDIT RISK (continued)

Wholesale credit risk is recorded in the following Statement of Financial Position captions:

| | 2014 £m | 2013 £m |
|---|---|---|
| Cash in hand and balances with the Bank of England | **3,670.6** | 3,314.6 |
| Loans and advances to credit institutions | **599.3** | 482.0 |
| Debt securities | **524.8** | 624.6 |
| Derivative financial instruments | **214.3** | 273.0 |
| Investments[1] | **1.4** | 1.4 |
| Total wholesale credit risk | **5,010.4** | 4,695.6 |

Debt securities, which are shown after fair value and impairment adjustments, can be further analysed as:

| | 2014 £m | 2013 £m |
|---|---|---|
| UK Government securities | **390.2** | 313.4 |
| Medium-term notes issued by financial institutions | **3.3** | 161.4 |
| Mortgage backed securities[2] | **60.4** | 84.5 |
| Combination note[3] | **9.2** | 7.4 |
| Synthetic credit investments[4] | **46.9** | 34.8 |
| Collateralised debt obligations[5] | **14.8** | 23.1 |
| | **524.8** | 624.6 |

[1] Principally an equity investment in VocaLink Holdings Limited which is associated with the Group's operation of cash machines.

[2] Mortgage backed securities are primarily backed by AAA rated UK prime residential mortgages.

[3] The combination note continues to pay contractual coupons with no evidence of impairment. Changes in fair value are taken directly to the Income Statement.

[4] There are four 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.

[5] There are investments in two 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 credit risk on loans and advances to customers can be broken down as follows:

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Retail mortgages | **31,661.3** | 29,178.4 | **17,866.9** | 17,590.1 |
| Commercial lending | **716.4** | 597.9 | **712.8** | 594.1 |
| Unsecured lending | **6.2** | 13.0 | **6.2** | 13.0 |
| Total gross exposure (contractual amounts) | **32,383.9** | 29,789.3 | **18,585.9** | 18,197.2 |
| Impairment, fair value, EIR and hedging adjustments | **(149.8)** | (273.5) | **(116.6)** | (249.1) |
| Total net exposure | **32,234.1** | 29,515.8 | **18,469.3** | 17,948.1 |

### Retail mortgages

The Group's exposure to mortgage related credit risk is monitored closely by the Credit Risk area within Group Risk. Reporting on risk exposures is provided monthly to the Retail Credit 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 affordability metrics). In addition, Group Risk undertakes a number of stress tests periodically 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** | **2014 %** | 2013 % |
|---|---|---|
| Scotland | **6.7** | 7.1 |
| North East | **3.5** | 3.7 |
| Yorkshire & Humberside | **9.5** | 10.1 |
| North West | **9.4** | 9.9 |
| Midlands | **12.1** | 12.3 |
| East of England | **4.6** | 4.7 |
| South West | **6.1** | 6.2 |
| Greater London | **23.2** | 21.6 |
| South East | **20.9** | 20.2 |
| Wales & Northern Ireland | **3.8** | 4.0 |
| Non-UK | **0.2** | 0.2 |
| | **100.0** | 100.0 |

## 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 credit risk area maintains oversight of the suitability of the indexation approach, process and its application on a regular basis.

| **Loan-to-value distribution of retail mortgage balances** | **Book** | | **New Lending** | |
|---|---|---|---|---|
| | **2014 %** | 2013 % | **2014 %** | 2013 % |
| Greater than 100% | **1.1** | 3.4 | **–** | – |
| 90% to 100% | **3.1** | 5.7 | **2.9** | – |
| 75% to 90% | **18.7** | 26.9 | **42.1** | 41.9 |
| 50% to 75% | **51.5** | 42.0 | **46.2** | 48.0 |
| Less than 50% | **25.6** | 22.0 | **8.8** | 10.1 |
| | **100.0** | 100.0 | **100.0** | 100.0 |

The average indexed loan-to-value, based on a simple average of each loan's indexed loan-to-value, is 50.9% (2013 – 54.1%).

| **Loan-to-value distribution of retail mortgage balances** | **2014** | | 2013 | |
|---|---|---|---|---|
| | **Not individually impaired %** | **Individually impaired %** | Not individually impaired % | Individually impaired % |
| Greater than 100% | **0.9** | **0.2** | 2.8 | 0.6 |
| 90% to 100% | **2.8** | **0.3** | 5.3 | 0.4 |
| 75% to 90% | **18.2** | **0.5** | 26.3 | 0.6 |
| 50% to 75% | **50.9** | **0.6** | 41.5 | 0.5 |
| Less than 50% | **25.4** | **0.2** | 21.8 | 0.2 |
| | **98.2** | **1.8** | 97.7 | 2.3 |

| **Retail mortgage customer type** | **Book** | | **New Lending** | |
|---|---|---|---|---|
| | **2014 %** | 2013 % | **2014 %** | 2013 % |
| First time buyer | **19.5** | 18.6 | **23.5** | 21.5 |
| Other buyers i.e. movers | **42.4** | 42.0 | **43.9** | 43.8 |
| Remortgage | **32.0** | 33.9 | **25.5** | 29.3 |
| Buy to let | **6.1** | 5.5 | **7.1** | 5.4 |
| | **100.0** | 100.0 | **100.0** | 100.0 |

## 39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

| Retail mortgage arrears | Group | | Society | |
|---|---|---|---|---|
| | **2014** | 2013 | **2014** | 2013 |
| Arrears outstanding as a percentage of debt | **%** | % | **%** | % |
| No arrears | **95.4** | 93.8 | **95.6** | 94.3 |
| Less than three months | **3.4** | 4.6 | **3.4** | 4.4 |
| Three months or more | **1.1** | 1.4 | **0.9** | 1.2 |
| Property in possession | **0.1** | 0.2 | **0.1** | 0.1 |
| | **100.0** | 100.0 | **100.0** | 100.0 |
| Number of properties in possession at the year end | **236** | 318 | **110** | 186 |

The percentage of retail mortgages with arrears of three months or more (as a % of outstanding balances, including possessions) has fallen during 2014 from 1.57% to 1.17%. The Council of Mortgage Lending (CML) industry average ratio for mortgage arrears is measured using the number of accounts (including possessions). The Group's retail mortgage arrears ratio (1.21%, 2013 – 1.45%) is below the comparable CML ratio (1.39%, 2013 – 1.76%). 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 Wholesale and Commercial Credit Committee. Reporting includes analysis of book growth, sector analysis of book, geographic distribution, loan-to-value analysis and the movement of loans into arrears and between arrears bands. Loans against specialist properties are strictly limited and we do not lend 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 and 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 2014 the Group has a commercial lending book (including lending to housing associations) of £716.4m. The Group originates commercial lending via its N&P brand, providing loans to commercial owner occupiers, commercial and residential property landlords (where the borrower is a corporate entity) and a small number of housing associations. The N&P commercial loan portfolio, which comprises 68.4% (2013 – 72.1%) of the total commercial lending book, 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. The majority of loans are advanced against commercial properties using a vacant possession valuation to mitigate against future losses.

This proactive approach to account management has resulted in 0.44% of N&P commercial accounts being more than three months in arrears (as a % of outstanding balances, including repossessions) as at the year end (2013 – 0.53%). While arrears and losses to date have been low, as part of the merger, all acquired N&P commercial loans were subject to a fair value adjustment to reflect likely future losses on the portfolio.

We have a small closed commercial loan book which arose from the merger with Chelsea Building Society. The book is in run off and we do not write any new commercial business under the Chelsea brand. At 31 December 2014 there were 6 loans remaining with outstanding balances totalling £29.1m (2013 – £42.8m). All loans are performing and are covenant compliant. During 2014 a loan secured on a retail park in Scotland (in administration) was disposed of by the sale of the security. Negative equity and arrears resulted in a loss on sale, which had been previously provided for in full.

In addition to the N&P commercial lending book, we have an active business lending to housing associations, in England and Wales, via the Yorkshire Building Society brand, properly known as 'Registered Providers'. This sector has particularly robust credit characteristics and the lending is low risk albeit at low margins. We have an opportunistic approach to attracting new business, within the constraints of a Board approved risk appetite, and do so when returns and capital efficiency contribute to financial sustainability. At 31 December 2014 the loan book was £197.1m (2013 – £124.1m). We have written further term loan facilities in the region of £184.5m (2013 – £230.0m) and these will draw down over the next 2 to 3 years.

## 39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

The Group commercial loan portfolio (including lending to housing associations) is spread throughout the UK as follows:

| Geographic distribution of commercial mortgage balances | 2014 % | 2013 % |
|---|---|---|
| Scotland | **0.1** | 2.3 |
| North East | **1.2** | 1.3 |
| Yorkshire & Humberside | **3.4** | 3.8 |
| North West | **10.1** | 11.9 |
| Midlands | **7.8** | 8.4 |
| East of England | **4.9** | 5.9 |
| South West | **4.5** | 5.3 |
| Greater London | **25.3** | 25.7 |
| South East | **34.1** | 28.8 |
| Wales | **8.6** | 6.6 |
| | **100.0** | 100.0 |

| N&P commercial mortgages by customer type | 2014 % | 2013 % |
|---|---|---|
| Housing associations | **3.9** | 4.8 |
| Buy to let | **19.5** | 16.0 |
| Commercial mortgages | **76.6** | 79.2 |
| | **100.0** | 100.0 |

| N&P commercial mortgages by property type | 2014 % | 2013 % |
|---|---|---|
| Office | **36.4** | 31.9 |
| Industrial | **8.4** | 9.1 |
| Retail and leisure | **27.6** | 26.3 |
| Housing Associations | **3.9** | 4.8 |
| Other, including mixed use | **23.7** | 27.9 |
| | **100.0** | 100.0 |

The average loan-to-value of the N&P commercial loan portfolio is 55.4% (2013 – 62.0%). The loan-to-value calculation has been undertaken using a combination of external professional valuations and indexation of the original valuation using data from the Investment Property Databank (IPD). IPD provides performance measurement services in the UK and Ireland on over 360 investment portfolios. Residential valuations are indexed using an average of Nationwide and Halifax house price indices.

The total value of the security held against N&P commercial loans is estimated to be £1,061m (2013 – £797m). £21.7m of the N&P exposures have an estimated LTV of greater than 100% (2013 – £49.4m). Of these, loans totalling £0.6m are in arrears. The largest N&P exposure to a single counterparty at 31 December 2014 is £8.8m (2013 – £8.5m).

Loans monitored on the "watch list" include those where there are circumstances which could impact on the quality and safety of the loan. Examples include borrowers requesting forbearance (such as changing loan repayments to interest only for a period), or reporting trading losses. Loans on the watch list total £8.4m (2013 – £9.2m). Our appetite and approach to the provision of commercial lending is to provide amortising term loans, typically over 10 – 25 years. We do not provide short-term, interest only facilities which require repayment on expiry through refinance. Where a period of interest only is agreed, it will be for a short period following which the loan will be structured to amortise over the remaining term. Buy to let loans are mainly interest only (£96.5m, 2013 – £70.4m). These loans are continuously monitored to ensure that full repayment is made on the expiry of the loan term.

## 39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

**N&P commercial mortgage arrears**

| Arrears outstanding as a percentage of debt | 2014 % | 2013 % |
|---|---|---|
| No arrears | **99.1** | 98.1 |
| Less than three months | **0.6** | 1.4 |
| Three months or more | **0.2** | 0.2 |
| Property in possession | **0.1** | 0.3 |
| | **100.0** | 100.0 |

## 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 2014 unsecured lending balances stood at £6.2m (current account overdrafts of £2.5m, personal loans of £3.7m) .Within the Group, unsecured lending is managed by the 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 2014, accounts that have been in excess of their agreed overdraft for three or more consecutive months stood at 1.4% of the portfolio by volume (2013 – 1.9%).

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 2014, accounts three or more months in arrears stood at 9.3% of the portfolio by volume (2013 – 14.7%).

At the point of merger, as with all N&P loan books, a fair value adjustment was applied against all unsecured lending.

## 39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

### Impairment

All loans (retail mortgage, commercial and unsecured) are reviewed at each reporting date for indications of impairment.

The following table shows as at the year end, impairment on the overall loan balances as well as 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.

| | Loans and advances | | Collateral | |
|---|---|---|---|---|
| **Group** | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| Not individually impaired: | | | | |
| Neither past due nor individually impaired | **30,905.1** | 27,968.2 | **30,891.1** | 27,803.6 |
| Past due but not individually impaired | **906.2** | 1,127.5 | **904.3** | 1,116.1 |
| Individually impaired | **572.6** | 693.6 | **544.3** | 653.8 |
| Total loans and advances | **32,383.9** | 29,789.3 | **32,339.7** | 29,573.5 |
| **Society** | | | | |
| Not individually impaired: | | | | |
| Neither past due nor individually impaired | **17,762.5** | 17,169.6 | **17,757.1** | 17,050.1 |
| Past due but not individually impaired | **529.1** | 670.1 | **528.9** | 663.7 |
| Individually impaired | **294.3** | 357.5 | **284.1** | 334.7 |
| Total loans and advances | **18,585.9** | 18,197.2 | **18,570.1** | 18,048.5 |

The loans and advances shown above exclude effective interest rate adjustments and credit loss fair values and therefore do not tie through directly to Note 16.

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. Commercial loans less than two months in arrears are also individually impaired where other qualitative factors suggest a measurable decrease in the present value of their future cash flows, i.e. where they are included on the watch list noted previously. All such mortgages that are past due but not individually 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.

Loans acquired on the merger with Norwich & Peterborough in 2011, and Chelsea in 2010, have been fair valued on a basis which makes allowances for anticipated losses over the remaining life of the loans. Past due loans totalling £585.0m in the above analysis for 31 December 2014 have thus been fair valued and are, therefore, unlikely to contribute any significant further losses to the Group.

## 39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

Note 1 on pages 81 to 87 describes the Group's approach to impairment provisioning and the key factors used in the calculation. The key model assumptions underpinning the current mortgage impairment provisions (shown in Note 9) are as follows:

| Factor | Value or range | | Derivation |
|---|---|---|---|
| Forecast house price inflation/(deflation) | 2015 | (5.0%) | Judgemental |
| | 2016 | 0.0% | |
| | 2017 | 0.0% | |
| | 2018 | 0.0% | |
| | 2019 | 0.0% | |
| Probability of possession | 10% to 70% for impaired accounts depending on the degree of impairment | | Judgemental and experience |
| Emergence period | 3 to 6 months | | Experience |
| Loss given possession | 2.5% to 45% for impaired accounts | | Current experience |
| Forced sale discount | 25% | | Current experience |
| Unemployment rate | 4.8% | | Judgemental and experience |

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, interest only concessions, arrears arrangements, direct debit suspension, payment holidays and term extensions. The use of account management tools are either fully recognised within provisioning or are low in materiality.

The analysis below sets out a total of £467.1m of mortgage balances which were subject to some form of forbearance during the past 12 months. Balances totalling £270.2m are more than two months in arrears and therefore fall within the Group's individual provision calculation. The remaining £196.9m 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 £46.3m to £46.5m.

No payment holiday forbearance has been granted.

## 39. CREDIT RISK ON LOANS AND ADVANCES TO CUSTOMERS (continued)

| | Positive arrears arrange-ments* £m | Negative arrears arrange-ments** £m | Capitali-sation £m | Permanent interest only £m | Temporary interest only £m | Term extension £m | Direct debit suspension £m | Total £m |
|---|---|---|---|---|---|---|---|---|
| Not in arrears | 15.2 | 0.7 | 0.2 | 4.3 | 3.3 | 12.3 | 14.4 | **50.4** |
| Less than one month | 66.0 | 4.1 | – | – | 1.0 | 0.8 | 1.1 | **73.0** |
| One to two months | 63.4 | 6.5 | – | – | 1.3 | 0.1 | 2.2 | **73.5** |
| Two to three months | 66.1 | 6.9 | – | 0.2 | 0.2 | – | 0.2 | **73.6** |
| Three to six months | 106.9 | 7.8 | – | – | 0.7 | – | 0.5 | **115.9** |
| Six to 12 months | 55.8 | 2.3 | – | – | 0.6 | – | 0.5 | **59.2** |
| 12 months or over | 14.9 | 0.1 | – | – | 0.3 | – | – | **15.3** |
| Property in possession | 6.1 | – | – | – | – | 0.1 | – | **6.2** |
| | **394** | **28.4** | **0.2** | **4.5** | **7.4** | **13.3** | **18.9** | **467.1** |

* 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 interest will continue to accrue on the unpaid amounts.

All requests for forbearance on commercial loans are subject to full credit risk appraisal and are predominately for a period of interest only which allows the borrower to improve income from trading or rent receipts, or pending the sale of the property. The appraisal process considers the likelihood of a loss being sustained from any borrower granted a concession and ensures that the concession is in the interests of both the borrower and the Group. In 2014 there are 39 accounts in the N&P commercial loans portfolio totalling £6.5m with an interest only concession (2013 – 35 accounts totalling £7.2m).

## 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.

| | **2014** | | 2013 | |
|---|---|---|---|---|
| **Group** | **Book Value £m** | **Fair Value £m** | Book Value £m | Fair Value £m |
| Assets | | | | |
| Cash in hand and balances with the Bank of England | **3,670.6** | **3,670.6** | 3,314.6 | 3,314.6 |
| Loans and advances to credit institutions | **599.3** | **599.3** | 482.0 | 482.0 |
| Debt securities – fair value | **9.2** | **9.2** | 7.4 | 7.4 |
| Debt securities – embedded derivative | **(8.9)** | **(8.9)** | (2.4) | (2.4) |
| Debt securities – available for sale | **524.5** | **524.5** | 531.9 | 531.9 |
| Debt securities – held to maturity | **–** | **–** | 87.7 | 86.9 |
| Loans and advances to customers | **32,234.1** | **32,737.2** | 29,515.8 | 29,804.6 |
| Investments | **1.4** | **1.4** | 1.4 | 1.4 |
| Liabilities | | | | |
| Shares | **27,241.4** | **27,197.0** | 26,290.3 | 26,177.8 |
| Amounts due to credit institutions | **3,471.3** | **3,471.3** | 2,621.4 | 2,621.4 |
| Other deposits | **508.0** | **508.0** | 501.4 | 501.4 |
| Debt securities in issue | **3,523.2** | **3,561.2** | 2,793.6 | 2,827.5 |
| Subordinated liabilities | **299.5** | **314.3** | 48.7 | 63.1 |
| Subscribed capital | **6.9** | **5.6** | 6.8 | 5.5 |
| **Society** | | | | |
| Assets | | | | |
| Cash in hand and balances with the Bank of England | **3,670.6** | **3,670.6** | 3,314.6 | 3,314.6 |
| Loans and advances to credit institutions | **262.5** | **262.5** | 120.8 | 120.8 |
| Debt securities – fair value | **9.2** | **9.2** | 7.4 | 7.4 |
| Debt securities – embedded derivative | **(8.9)** | **(8.9)** | (2.4) | (2.4) |
| Debt securities – available for sale | **524.5** | **524.5** | 531.9 | 531.9 |
| Debt securities – held to maturity | **3,990.0** | **3,990.4** | 1,334.3 | 1,331.7 |
| Loans and advances to customers | **18,469.3** | **18,588.1** | 17,948.1 | 18,070.0 |
| Investments | **14,406.8** | **14,406.8** | 11,186.1 | 11,186.1 |
| Liabilities | | | | |
| Shares | **27,241.4** | **27,197.0** | 26,290.3 | 26,177.8 |
| Amounts due to credit institutions | **3,471.3** | **3,471.3** | 2,621.4 | 2,621.4 |
| Other deposits | **5,788.9** | **5,788.9** | 1,965.9 | 1,965.9 |
| Debt securities in issue | **2,719.2** | **2,755.1** | 1,847.9 | 1,875.9 |
| Subordinated liabilities | **299.5** | **314.3** | 48.7 | 63.1 |
| Subscribed capital | **6.9** | **5.6** | 6.8 | 5.5 |

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.

## 40. FAIR VALUES (continued)

The fair values of debt securities are calculated using a Level 2 method, as described below, and 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.

The fair value of loans and advances to customers uses a Level 2 method and is assessed as the value of the expected future cash flows. Future cash flows are projected using contractual interest payments, contractual repayments and the expected prepayment behaviour of borrowers. Prudent assumptions are applied regarding expected levels of customer prepayments and the risk of defaults. The resulting expected future cash flows are discounted at current market rates to determine fair value. Overall the fair value is higher than the carrying value by £503m which arises primarily due to the product rates being above prevailing market rates.

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'. In 2014, the estimated fair value of share balances, using a Level 2 method is now lower than the carrying value by £44m 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 a Level 2 method based on observable market prices. The fair value of subordinated liabilities is higher than carrying value by £15m 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).

## 40. FAIR VALUES (continued)

| **Group** | **Level 1 £m** | **Level 2 £m** | **Level 3 £m** | **Total £m** |
|---|---|---|---|---|
| As at 31 December 2014 | | | | |
| Debt securities – fair value | **–** | **9.2** | **–** | **9.2** |
| Embedded derivatives | **–** | **(8.9)** | **–** | **(8.9)** |
| Debt securities – available for sale | **450.6** | **73.9** | **–** | **524.5** |
| Investments | **–** | **–** | **1.4** | **1.4** |
| Derivative assets | **–** | **214.3** | **–** | **214.3** |
| Derivative liabilities | **–** | **(413.6)** | **–** | **(413.6)** |
| | **450.6** | **(125.1)** | **1.4** | **326.9** |

| **Group** | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| As at 31 December 2013 | | | | |
| Debt securities – fair value | – | 7.4 | – | 7.4 |
| Embedded derivatives | – | (2.4) | – | (2.4) |
| Debt securities – available for sale | 471.5 | 60.4 | – | 531.9 |
| Investments | – | – | 1.4 | 1.4 |
| Derivative assets | – | 273.0 | – | 273.0 |
| Derivative liabilities | – | (194.8) | – | (194.8) |
| | 471.5 | 143.6 | 1.4 | 616.5 |

## 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 £30.1m to the pension scheme (2013 – £15.6m).

### Key management compensation

The key management personnel compensations are as follows:

| | **No. of key management personnel** | **2014 £000** | No. of key management personnel | 2013 £000 |
|---|---|---|---|---|
| Short-term employee benefits | | **3,275** | | 2,832 |
| Post employment benefits | | **64** | | 79 |
| Total key management personnel compensation | **14** | **3,339** | 13 | 2,911 |

### 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 2014** | **Amounts in respect of key management personnel and their close family members 2014 £000** | No. of key management personnel 2013 | Amounts in respect of key management personnel and their close family members 2013 £000 |
|---|---|---|---|---|
| Mortgage loans | | | | |
| At 1 January | | **388** | | 433 |
| Net movements in the year | | **(33)** | | (45) |
| At 31 December | **2** | **355** | 2 | 388 |
| Deposit accounts and investments | | | | |
| At 1 January | | **1,052** | | 1,082 |
| Net movements in the year | | **(385)** | | (30) |
| At 31 December | **14** | **667** | 12 | 1,052 |

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 £388,307 (2013 – £433,122).

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 £1,952 (2013 – £2,775), received interest totalling £12,042 (2013 – £13,637), 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.

## 41. RELATED PARTIES (continued)

### 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:

| | 2014 £m | 2013 £m |
|---|---|---|
| Shares in subsidiaries | | |
| At 1 January | **105.8** | 113.8 |
| Net movements | **–** | (8.0) |
| At 31 December | **105.8** | 105.8 |
| Loans to subsidiaries | | |
| At 1 January | **11,078.6** | 9,686.1 |
| Net movements | **3,220.7** | 1,392.5 |
| At 31 December | **14,299.3** | 11,078.6 |
| Deposits from subsidiaries | | |
| At 1 January | **1,693.5** | 1,695.8 |
| Net movements | **3,869.4** | (2.3) |
| At 31 December | **5,562.9** | 1,693.5 |
| Interest receivable on loans | **414.4** | 373.1 |
| Interest payable on deposits | **(64.1)** | (37.1) |
| Fees and expenses receivable | **33.6** | 29.8 |
| Fees and expenses payable | **(1.4)** | (2.7) |

### Transactions with joint venture

The outstanding investment in MutualPlus Ltd at 31 December 2014 and 31 December 2013 was £0.3m.

### Other

The Society has an investment in Arkose Funding Limited. During the year, a loan to Arkose Funding Limited was fully impaired (£4.0m).

## 42. CASH FLOWS FROM OTHER OPERATING ACTIVITIES

| | Group | | Society | |
|---|---|---|---|---|
| | **2014 £m** | 2013 £m | **2014 £m** | 2013 £m |
| **Working capital adjustments:** | | | | |
| Depreciation and amortisation | **27.6** | 37.0 | **27.3** | 36.4 |
| Profit/(loss) on sale of assets | **1.2** | (0.5) | **0.8** | (0.5) |
| Interest on subordinated liabilities and subscribed capital | **7.4** | 16.1 | **7.4** | 16.1 |
| Provisions | **45.9** | 44.1 | **29.1** | 27.8 |
| Fair value of subordinated liabilities and subscribed capital | **0.9** | (0.1) | **0.9** | (0.1) |
| (Profit)/loss on realisation of debt securities | **(1.3)** | 41.7 | **(1.3)** | 29.1 |
| Increase in other assets | **(31.2)** | (18.3) | **(27.7)** | (17.8) |
| (Decrease)/increase in other liabilities | **(79.3)** | (34.2) | **(140.4)** | 1.8 |
| **Working capital adjustments** | **(28.8)** | 85.8 | **(103.9)** | 92.8 |
| **(Increase)/decrease in operating assets:** | | | | |
| Loans and advances to customers | **(2,738.2)** | (1,966.2) | **(523.2)** | (122.6) |
| Investments | **–** | – | **(3,222.0)** | (1,388.7) |
| Derivative financial instruments | **201.1** | (197.0) | **178.2** | (178.3) |
| **Net (increase)/decrease in operating assets** | **(2,537.1)** | (2,163.2) | **(3,567.0)** | (1,689.6) |
| **Increase/(decrease) in operating liabilities:** | | | | |
| Shares | **951.1** | (527.2) | **951.1** | (527.2) |
| Amounts owed to credit institutions | **849.9** | 1,710.3 | **849.9** | 1,710.3 |
| Other deposits | **6.6** | 25.7 | **3,823.0** | (29.3) |
| **Net increase/(decrease) in operating liabilities** | **1,807.6** | 1,208.8 | **5,624.0** | 1,153.8 |

## 1. STATUTORY PERCENTAGES

| | 2014 % | Statutory Limit % |
|---|---|---|
| Lending limit | **2.4** | 25.0 |
| Funding limit | **21.6** | 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 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

| | 2014 % | 2013 % |
|---|---|---|
| As a percentage of shares and borrowings: | | |
| Gross capital | **6.52** | 5.79 |
| Free capital | **6.05** | 5.27 |
| Liquid assets | **13.80** | 13.73 |
| Profit after taxation for the financial year as a percentage of mean total assets | **0.41** | 0.44 |
| Management expenses as a percentage of mean total assets | **0.92** | 0.88 |

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.

## 3. INFORMATION RELATING TO THE DIRECTORS AT 31 DECEMBER 2014

| Director Name and Date of Birth | Business Occupation | Date of Appointment | Other Directorships |
|---|---|---|---|
| E. J. S. Anderson, BSc, CPFA<br>22 December 1950 | Company Director | 19 May 2003 | Airport Operators Association Ltd<br>Opera North Ltd<br>University of Leeds |
| K. M. Barker, DBE, CBE<br>29 November 1957 | Economist | 5 November 2010 | Coal Pension Trustee Services Ltd<br>Coal Staff Superannuation Scheme Trustees Ltd<br>Electra Private Equity Plc<br>Essex Community Foundation<br>Kate Barker Ltd<br>Society of Business Economists<br>Taylor Wimpey Plc |
| I. J. Bullock, BSc, FIA<br>7 November 1960 | Chief Customer Officer and Executive Director | 12 April 2007 | Accord Mortgages Ltd<br>BCS Loans and Mortgages Ltd<br>MutualPlus Ltd |
| A. M. Caton, BA<br>27 July 1963 | Chief Treasury and Corporate Affairs Officer and Executive Director | 1 July 2004 | Arkose Funding Ltd<br>Bradford Enterprise Agency Ltd<br>Chelsea Building Society Charitable Foundation<br>Chelsea Mortgage Services Ltd<br>Norwich and Peterborough (LBS) Ltd<br>West and North Yorkshire Chamber of Commerce and Industry<br>YBS Investments (No. 1) Ltd<br>YBS Investments (No. 2) Ltd<br>Yorkshire Building Society Charitable Foundation<br>Yorkshire Guernsey Ltd |
| L. F. Charlesworth, BA, MBA<br>24 August 1956 | Company Director | 31 December 2006 | St. James Investments Ltd<br>St. James Investment Company UK No. 3 Ltd |
| R. J. Churchouse, MA, ACA<br>16 January 1966 | Chief Operating Officer and Finance Director | 1 June 2010 | BCS Loans and Mortgages Ltd<br>Chelsea Mortgage Services Ltd<br>Norwich and Peterborough General Insurance Services Ltd<br>Norwich and Peterborough Insurance Brokers Ltd<br>Norwich and Peterborough Insurance Services Ltd<br>Norwich and Peterborough Sharedealing Services Ltd<br>YBS Investments (No.1) Ltd<br>YBS Investments (No.2) Ltd<br>Yorkshire Building Society Estate Agents Ltd<br>Yorkshire Key Services Ltd<br>Yorkshire Key Services (No. 2) Ltd |
| J. R. Heaps, LLB<br>8 July 1958 | Solicitor | 20 November 2014 | Eversheds Legal Services Ltd<br>Garden Bridge Trust |

## 3. INFORMATION RELATING TO THE DIRECTORS AT 31 DECEMBER 2014 (continued)

| Director Name and Date of Birth | Business Occupation | Date of Appointment | Other Directorships |
|---|---|---|---|
| P. R. Johnson, FCA<br>12 October 1946 | Chartered Accountant | 1 June 2007 | Cheadle Hulme School<br>Cheadle Hulme School Enterprise Ltd<br>Lakeland Ltd<br>Rugby Football Foundation |
| D. V. Paige, BSc, FCA<br>3 July 1951 | Company Director | 31 December 2006 | IFG Group PLC<br>Willis Ltd |
| M. A. Pain, BSc, FCA<br>15 June 1961 | Company Director | 1 August 2013 | Aviva Insurance Ltd<br>Johnston Press Plc<br>London Square (Caledonian Road) Ltd<br>London Square (Chigwell) Ltd<br>London Square (Crimscott Street) Ltd<br>London Square Developments (Holdings) Ltd<br>London Square (Holdings) Ltd<br>London Square (Leonard St.) Ltd<br>LSQ Management Ltd<br>Somerset House Enterprises Ltd<br>Somerset House Trust<br>Spirit Pub Company Plc |
| G. P. C. Parsons, BA<br>31 July 1965 | Company Director | 1 May 2013 | Commercial Services Kent Ltd<br>Commercial Services Trading Ltd<br>Kent County Trading Ltd<br>Nescot Business Services Ltd<br>Nescot Consortium Services LLC<br>Warmup Plc |
| C. J. Pilling, MA<br>30 March 1965 | Chief Executive Officer | 31 December 2011 | Department of Health |
| M. C. Regnier, MEng, MBA<br>30 September 1971 | Chief Commercial Officer and Executive Director | 3 June 2014 | None |

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, Mr C. J. Pilling entered into a contract on 31 December 2011 and Mr M. C. Regnier entered into a contract on 3 June 2014 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.

# Glossary

The following glossary defines terminology used within the Annual Report and Accounts:

| | |
|---|---|
| Additional Tier 1 (AT1) capital | Any remaining eligible Permanent Interest Bearing shares. |
| 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. |
| Basel | 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. Enacted in the European Union via capital requirements directives. |
| 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. |
| Buy to let (BTL) | Lending on property that is to be let to individuals. |
| Capital Requirements Directive (CRD) | European legislation giving force to the Basel regulatory capital framework in the UK. The latest legislation – the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) (together commonly referred to as CRD IV) came in to effect from 1 January 2014. |
| Collateralised debt obligations | Structured financial products issued by a third party which reference asset backed securities and/or certain other related assets purchased by the issuer. |
| Collateral (for loans and advances to customers) | Security (property) pledged for the repayment of a loan. Collateral is valued as the lower of the value of the property or the outstanding loan amount. |
| Commercial lending | Secured loans to a commercial borrower. |
| Common Equity Tier 1 (CET1) capital | The highest quality regulatory capital resources, comprising of retained earnings less regulatory adjustments, as defined under CRD IV. Equivalent to Core Tier 1 defined under previous CRD legislation. |
| Common Equity Tier 1 capital ratio | The ratio of Common Equity Tier 1 Capital to Risk Weighted Assets. |
| Contractual maturity | The final payment date of a loan or financial instrument, at which all the outstanding loan and interest is repayable. |
| 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 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 indebtness including certificates of deposits, and fixed and floating rate notes. |

| | |
|---|---|
| Derivative financial instruments | Contracts or agreements whose value is derived from one or more underlying prices, rates or indices 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. |
| Effective interest rate (EIR) | 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 or counterparty fails to meet its obligations to the Group. |
| Fair value | The value of the assets based on either the external market price or internal pricing models (using external data). |
| Financial Advice Service (FAS) | A financial advice service offered by Norwich & Peterborough prior to the merger in 2011. |
| Financial Conduct Authority (FCA) | The UK conduct regulator which is responsible for regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets. The FCA's objective is 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 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. |
| Forbearance | The Group grants concessions to assist borrowers who experience difficulties in meeting their obligations to pay their mortgage. Examples of forbearance tools are described in Note 39. |
| 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. |
| Impaired loans | Loans which have been assessed and there is evidence to suggest a measurable decrease in the present value of cash flows expected from the loans that have occurred after initial recognition of the asset, but before the statement of financial position date. |
| 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 impaired loans | Where retail or commercial mortgages are in arrears by two months or more, they are individually assessed for impairment. Commercial loans less than two months in arrears are also individually impaired where other factors suggest a measurable decrease in the present value of their future cash flows. |

| | |
|---|---|
| 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 Financial Reporting Standards issued by the International Accounting Standards Board (IASB). |
| Liquidity Coverage Ratio (LCR) | A liquidity metric which aims to ensure that a firm maintains an adequate level of liquidity to meet its needs for a 30 calendar day time horizon under a severe stress scenario. |
| LIBOR (London Interbank Offered Rate) | A benchmark interest rate which banks can borrow funds from other banks in the London interbank market. |
| 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 loss provisions | A provision which is held against loans and advances to customers, which represent management's best estimate of losses incurred in the loan portfolio at the reporting date. |
| Loan-to-value ratio (LTV) | A ratio showing outstanding loan balance as a percentage of the value of the security. |
| Loss given possession | The loss that is expected to crystallise when a repossessed property is sold. |
| 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 loan with the Society. |
| 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 total assets. |
| Net Stable Funding Ratio (NSFR) | A liquidity ratio, under Basel III, to calculate the proportion of long-term assets that are funded by stable, long-term sources (customers deposits and long-term wholesale funding). |
| 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, Sterling denominated Tier 1 capital instruments repayable at the option of the Society. |
| PRA Remuneration Code | Guidance provided by the PRA on directors' remuneration. |

| | |
|---|---|
| Prime lending | The Group's core business of providing residential mortgages to customers with no known default history. |
| Probability of possession | The likelihood of an account moving into possession. This is used when calculating loan loss provisions. |
| Prudential Regulation Authority (PRA) | The UK prudential regulator, which is a part of the Bank of England and alongside the FCA has responsibility for the oversight of building societies, banks and insurers. The PRA's objective is to promote the safety and soundness of regulated firms. |
| Mortgage Backed Security/ 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. |
| Repossessions | Property taken into ownership by the Society as a result of the borrower's failure to make contractual loan repayments. |
| Risk appetite | The level of risk that the Group is willing to take (or not take) in order to safeguard the interests of members whilst achieving business objectives. |
| Risk weighted assets | 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. |
| Small Change Big Difference® | Our unique scheme which allows each member to donate the pence of their interest to the Yorkshire Building Society Charitable Foundation. |
| SONIA (Sterling Overnight Indexed Average) | An index that tracks actual market overnight funding rates calculated as a weighted average overnight deposit rate for each business day. |
| Standardised approach | A method of calculating capital requirements under CRD IV. |
| 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 (T1) capital | The sum total of Common Equity Tier 1 and Additional Tier 1 capital. |
| Tier 1 capital ratio | The ratio of Tier 1 capital to risk weighted assets. |
| Tier 2 (T2) capital | A measure of regulatory capital that includes subordinated liabilities and provisions for collective impairment, less regulatory adjustments. |
| Total capital | The total capital resources, including retained earnings, PIBS, provisions for collective impairment and subordinated liabilities, less regulatory adjustments. |
| Total capital ratio | The ratio of total capital to risk weighted assets. |
| UK Corporate Governance Code | The UK code on corporate governance, published by the Financial Reporting Council in October 2012, which sets out standards of good practice in relation to Board leadership and effectiveness, accountability and remuneration. |

| | |
|---|---|
| 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. |
| Watch list | The watch list is used by the N&P commercial lending team to flag those loans where there are circumstances which could impact on the quality and safety of the loan. |
| Weighted average maturity | Provides a measure of the weighted average remaining term of outstanding wholesale funding. |
| Wholesale funding | The funding that is available between banks and other financial or commercial institutions. Examples of wholesale funding include covered bonds, deposits and government guarantees. |

**Principal Office:**
Yorkshire House, Yorkshire Drive, Bradford BD5 8LJ. ybs.co.uk

**Auditors:**
Deloitte LLP, 1 City Square, Leeds LS1 2AL.



YBS GROUP

recycle

This document is fully recyclable. When you have finished with it, please recycle it!

YBM 0019 03 03 15