OUR SOCIETY

YORKSHIRE BUILDING SOCIETY

YORKSHIRE BUILDING SOCIETY
Annual Review 2018

Being with a building society means you call the shots in how we do things.

And your money works hard not just for you – but for people up and down the country.

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Society Highlights

Significant strategic progress throughout 2018 and a robust financial performance.

All non statutory measures below are defined in the Glossary on pages 187 to 190 under the heading Alternative Performance Measures.

Providing real help for real life

Savings accounts opened
197,000
193,000 in 2017
Helping thousands of our members save for their future.

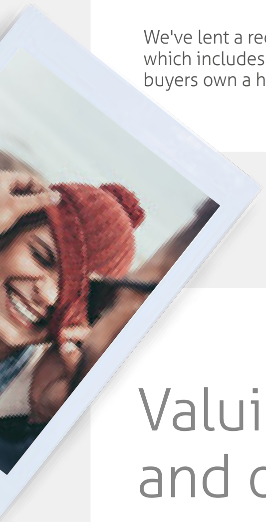
Retail savings balances
£29.6bn
£28.9bn in 2017
We use some of this money to help people get on to the property ladder.

Average savings rate paid
0.37%
above the market average of 0.72%[1]
This equates to more than £100m of benefit given back to our members.

Gross lending
£8.9bn
£8.1bn in 2017
We've lent a record amount in 2018 which includes helping 6,960 first-time buyers own a home of their own.

Gross mortgage market
3.3%[2]
3.1% in 2017
This reflects our share of all mortgage lending in the UK housing market.

Mortgage balances grew by
4.7%
2.8% in 2017
We use the interest from our mortgages to give back to our savers and invest back in to the business.



Valuing our members and our people

34th
Inclusive Companies – Inclusive Top 50 UK Employers (2018).

+41[3]
We maintained our Net Promoter Score at +41

[1] YBS Group average savings rate compared to rest of market average rates based on savings stock from CACI's Current Account and Savings Database (CSDB), covering 87% of the retail savings market (based on stock value). Data period January - November 2018.

Financially sustainable

Statutory Profit ↑
£193m

£166m in 2017

This figure shows profit earned from our ongoing business operations, excluding taxes.

Core Operating Profit ↑
£181m

£160m in 2017

This figure shows our profit position which may exclude one-time charges or infrequent events.

Cost:income ratio ↓
61%

63% in 2017

The lower the ratio, the less we're spending to generate every pound of income.

Common Equity Tier 1 (CET1) ↑
16.3%

15.8% in 2017

We maintain a Tier 1 capital ratio above a certain minimum so that we're protected against unexpected losses.

Liquidity ratio ↓
13.9%

15.7% in 2017

This ratio measures our ability to lend to borrowers, give money back to savers when they want it and pay our bills.

Leverage ratio ↑
5.8%

5.7% in 2017

This ratio looks at the capital we hold compared to our assets and demonstrates the Society's ability to withstand unexpected events.

Best overall Mortgage Provider

Moneynet Personal Finance awards.

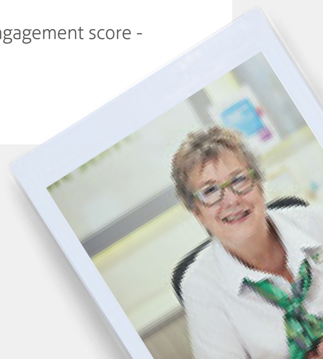
Top 30 Employer for Working Families 2018

100,000 hours volunteering

Colleagues gave back to causes close to their hearts and benefiting their local communities.

66%

Colleague engagement score - 68% 2017.



[2] Bank of England total industry gross lending in 2018.

[3] KPMG Nunwood Customer Voice Programme, January-December 2018. Based on 14,556 completed interviews with customers. Net Promoter score and NPS are trademarks of Satmetrix Systems, Inc. Bains & Company, Inc., and Fred Reichheld.

John Heaps - Chairman's welcome

Real help with real life

I am pleased to report that Yorkshire Building Society has had another good year. Despite difficult trading conditions and increased competition, we have been able to deliver a strong set of financial results and, at the same time, we have made considerable progress with key elements of our strategic plan.

The various steps we have taken are all designed to meet our fundamental objective to provide real help with real life. We do this through offering our customers the highest levels of service, a safe place for savings and the best possible interest rates for savers and borrowers alike. In short, to meet our plans, we must be simply brilliant at our two fundamental purposes of helping people to save to meet life's challenges and opportunities and helping people into a place to call home.

These goals are only achievable if we maintain a strong financial base. I am pleased to report that the Society has met all its financial objectives, delivering increased profits before tax of £193m, an improved capital position and liquidity well ahead of regulatory requirements. These financial objectives have been achieved, whilst at the same time, maintaining an average savings rate that is 0.37%[1] higher than the market average and delivering improvements to our infrastructure and core product range.

Customers at our heart

In 2018, we continued our work to close uneconomic lines of business to refocus the Society's activities on our core business of mortgages and savings. The financial services market continues to evolve at pace as we see increased regulation, competition, changing customer behaviours and a growing demand for digital services. Our mutual business model enables us to recognise and respond to the changing environment, whilst remaining focused on keeping our members' interests at the heart of all that we do. We regularly communicate with members and encourage their feedback to help us better understand what matters to them.

The pledges we made to our savers, originally in 2015, as described in the Strategic Report on page 22, have been maintained and we have continued to offer average savings rates which are above the average for the rest of the market. Whilst we know that the current economic environment remains challenging for savers, we will continue to support them as far as possible. Although we aim to protect savers from the impact of low rates, we can only do this within the context of maintaining our financial security and ensuring that we do not attract more liquidity than we can safely and sensibly lend.

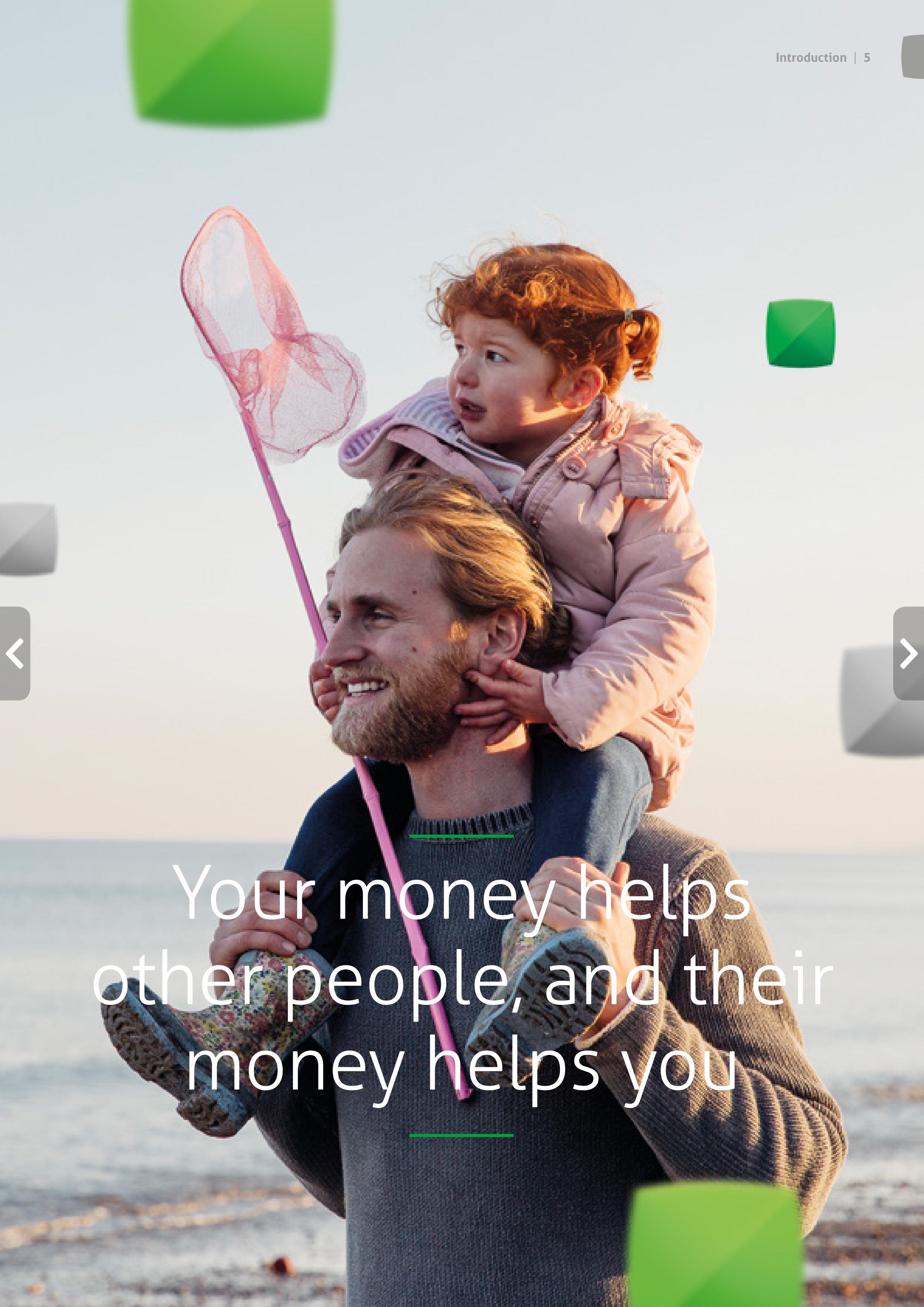
Through 2018, we have continued to maintain our focus on helping customers overcome the obstacles they encounter when trying to buy their home. In addition, we are helping people that would like to support their family members in the home buying process. Our Offset Plus product allows family and friends to use their savings to offset the cost of a mortgage. Understanding needs is critical for us to provide real help to customers and, whilst we have delivered a number of improvements in 2018, there is still more we intend to do in 2019.

These initiatives are outlined in more detail in the Strategic Report that starts on page 12.

We have now completed the brand and distribution changes we outlined in 2017, including the retirement of our Chelsea and Norwich & Peterborough (N&P) brands from the high street, closure of our current account offering and of a number of branches linked to these changes. The impact of any changes on our customers and colleagues is always at the forefront of our thinking when we are setting our strategy. We recognise that some changes can create uncertainty, and in some cases, difficulties for our customers and we try hard to minimise these impacts. We believe these changes were necessary to position the Society well for the challenges of the future, as described in the Strategic Report. Our period of change will continue through 2019 and into 2020 as we review our costs and operating model of the Society and react to changing market demands.

Our people continue to be the foundation of our business and we recognise that they play a key role in the delivery of the products and services our customers need. We have continued to make improvements in recognising their contribution, enhancing the way we support and develop all colleagues.

[1] YBS Group average savings rate compared to rest of market average rates based on savings stock from CACI's Current Account and Savings Database (CSDB), covering 87% of the retail savings market (based on stock value). Data period January - November 2018.



Your money helps other people, and their money helps you

External factors

The UK's withdrawal from the European Union (EU) is dominating the economic and political agenda. This has created significant uncertainty in the wider environment. Therefore, we anticipate volatility in financial markets to continue, as a result of which, economic confidence is expected to remain low, subduing corporate investment as capital spending decisions are delayed until there is more clarity around our trading relationship with the EU.

The combination of economic uncertainty and slow economic growth has only supported an increase of the Bank Rate from 0.50% to 0.75% in 2018. This position is not expected to change significantly in the immediate future, subject to how the UK leaves the EU, which could result in a number of different economic outcomes.

Regulatory factors

A number of regulatory changes have impacted the Society this year, the most significant of which include:

- The Second Payment Services Directive (PSD2) and Open Banking, which requires financial institutions to open their data to third parties in a standardised format. This will bring new entrants and more competition into the sector, as well as encouraging new business models and innovation. Further changes will be implemented in 2019.
- The General Data Protection Regulation (GDPR), which came into effect in May 2018. A programme of work was conducted to bring our business practices in line with the new law.

Data privacy has always been a priority for us. Given that demand for digital services is increasing and volumes of data we manage is growing, the protection of our customers' personal data continues to be of the highest importance.

The next major regulation impacting the Society will be Minimum Requirement for Own Funds and Eligible Liabilities (MREL), which will come into effect in 2020, and this will impact the amount of capital we hold. We are well positioned in this regard and will ensure we meet these requirements ahead of the deadline.

We have also closely followed the Financial Conduct Authority (FCA) strategic review of retail banking business models. The review looks at the funding of margin differences between retail banking models and examines the relative advantages of each and the potential impact of regulatory and technological changes on these business models.

At a headline level, the FCA's review findings show that building societies operate at the lowest margins due to their focus on low risk mortgages and paying high rates to savers. We also hold proportionately higher capital than the large retail banks. The findings from the review re-emphasise the considerable value that the mutual model adds to the financial services sector. As one of the leading building societies, we are proud of the significant part we play in the sector.

Corporate governance

The Financial Reporting Council (FRC) published the revised UK Corporate Governance Code (the Code) in July 2018. This is in addition to the Companies (Miscellaneous Reporting) Regulations 2018, which updates the Companies Act 2006 and applies to our intermediary lending subsidiary Accord Mortgages Limited. Together they provide the Government's suite of governance reforms, which aim to improve public trust in business. The Code came into effect for reporting periods from 1 January 2019.

Changes to your Board

I would like to extend a warm welcome to our new Non-executive Director Guy Bainbridge who was appointed to the Board with effect from 1 January 2019, and has also become a member of the Society's Audit Committee. Guy has extensive experience of retail banking at Board level and is a skilled and knowledgeable audit and accountancy specialist.

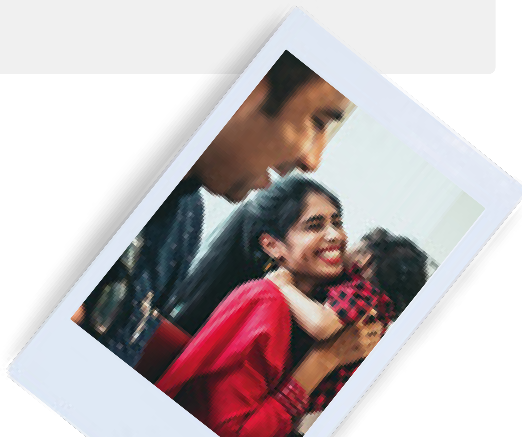
More information on our corporate governance approach and activity, as well as further details on the composition of the Board are included in the Corporate Governance Report which begins on page 43.

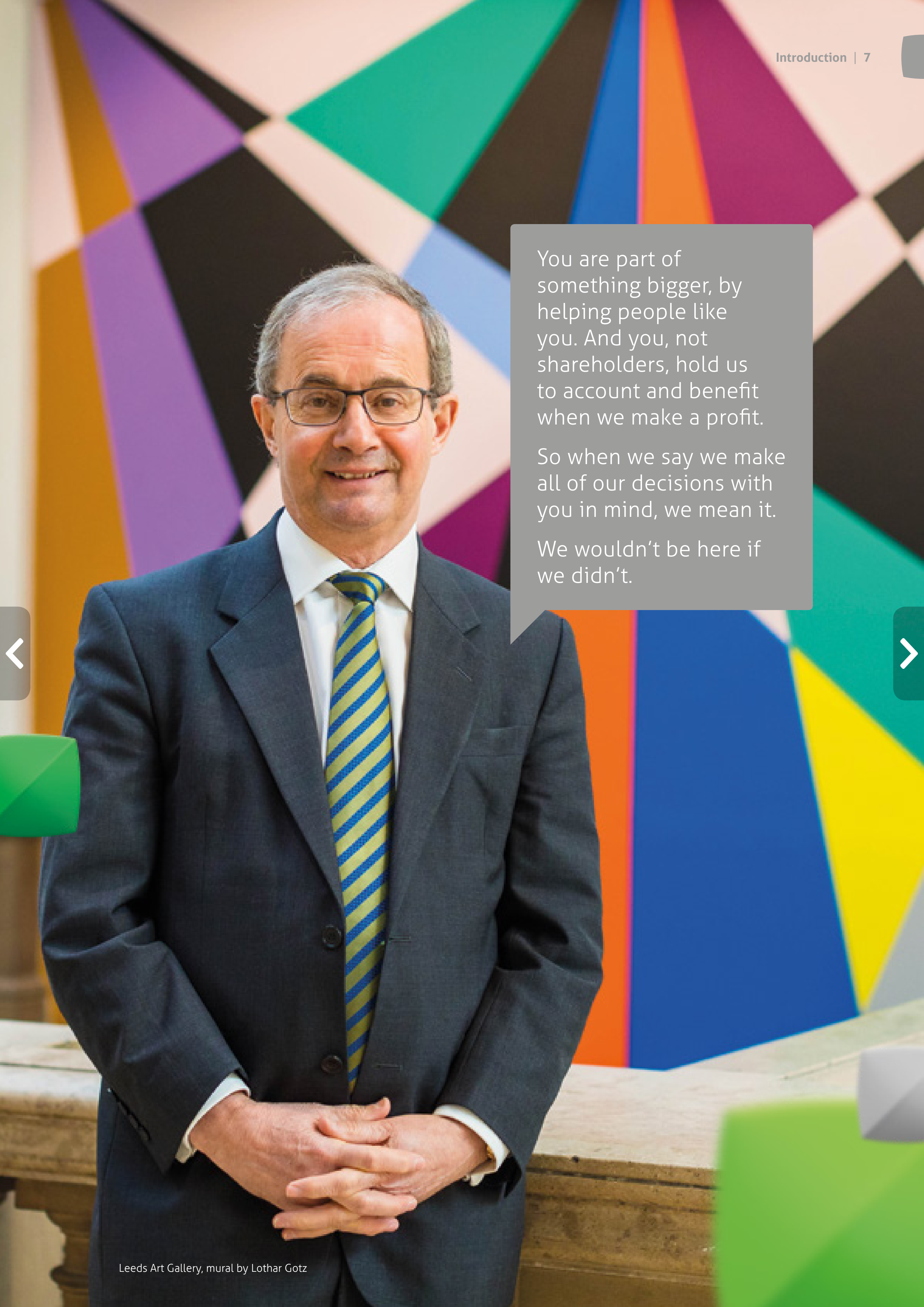
The future

Whilst the current economic outlook is uncertain and customer needs continue to evolve at an ever increasing pace, I do believe the Society is well positioned for the future. We will continue to invest in delivering improvements to our infrastructure and to our processes, at the same time developing new products and services. I expect competition in our market will continue to be intense. Our financial strength and mutual structure allows us to place our customers at the heart of every decision we make and enables us to provide real help with real life, as we have been doing for over 150 years.

John Heaps
Chairman

27 February 2019





You are part of something bigger, by helping people like you. And you, not shareholders, hold us to account and benefit when we make a profit.

So when we say we make all of our decisions with you in mind, we mean it.

We wouldn't be here if we didn't.

Leeds Art Gallery, mural by Lothar Gotz

A mutually rewarding relationship

Mike Regnier - Chief Executive's introduction

Customers at our heart

I'm happy to present a strong set of results for the Society. As Yorkshire Building Society is predominantly UK based, we have remained focused on providing real help with real life without becoming distracted by the broader EU exit conversations.

During 2018, we have reaffirmed our direction and strategy, which is focused on helping customers with the financial moments that really matter – whether that is helping people to have a place to call home or to save to meet life's challenges and opportunities. As a mutual organisation, this has been our story for over 150 years and remains our absolute focus today.

Our environment is changing rapidly in a number of different ways. Changes to regulation, new technology, greater competition and increasingly complex personal financial circumstances are all impacting the financial services market and all organisations are evolving to compete. We have now successfully completed much of the simplification our organisation needed. Revisions to our distribution network and branding, following merger activity in the financial crisis, are also largely complete. We are now in a position where our focus is to maintain the Society as a simple organisation, whilst managing our costs and developing our digital ambitions to improve service efficiency.

Our aim is to become simply brilliant in both of our key business lines. For mortgage customers, this means a focus on straightforward processes aligned to products that are flexible with fair pricing and, for savings customers, we will continue to provide great long-term value and service, alongside help and support with key life moments. We aim to be easy to do business with, whether that is face-to-face in branch, a telephone conversation or self-service through digital channels.

As noted, in 2018 we completed the closure of our N&P current account, as well as the removal of the N&P brand from the high street, combined with the closure of 13 branches. These changes have delivered the efficiency benefits we intended and we are now starting to see reductions in our overall cost base, as well as having a greater ability to make the investments we need to grow and improve our customer service. Whilst this has been a difficult time for customers and colleagues, I would like to thank those colleagues impacted for their professionalism and dedication through this period.

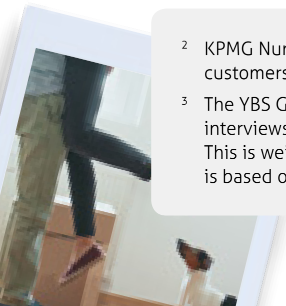
Here for our customers

One of the major benefits of being a mutual is that we really are able to put customers at our heart. In 2018, we have made further improvements to our mortgage processing and savings customer service. This is reflected in our combined Net Promoter Score (NPS), a measure of how willing our customers and broker partners are to recommend the Society's products and services to others. This has remained stable at +41[2], and although our score is not directly comparable to the financial services banking average of +5[3] it provides a good indication of how we compare to the industry. The stability of our score shows that most customers understand and support the changes we made in 2018.

Our transformation programme to replace existing mortgage processing systems with market leading technology is in progress and this will also allow us to improve automation and decision making in our lending processes and speed up our service. We have been recognised for our service through a number of awards, including Best Overall Mortgage Provider at the Moneynet Personal Finance Awards and retention of our 5 Star Rating for Service at the Finance Service Awards. We are also pushing forwards on other improvements to our savings processes.

In 2018, we have continued to find new ways to support borrowers who may struggle to access the mortgage market. We have launched products aligned to the Government's Help to Buy initiative during the year, as well as a range of improvements to meet the specific needs of customers who wish to buy a new build property. In addition, we have extended the reach of our intermediary business in the year through expanding the range of brokers we work with, as well as supporting them to grow their businesses via a series of new tools and initiatives. We have also improved our processes and proposition for existing customers looking to transfer onto a new fixed term product.

We are proud to have won a range of awards for our products in 2018, particularly for Best Offset Mortgage Provider and Best First Time Buyer Mortgage Provider. We also won Best Lender for Discount Mortgages.



2 KPMG Nunwood Customer Voice Programme, January- December 2018. Based on 14,556 completed interviews with customers. Net Promoter score and NPS are trademarks of Satmetrix Systems, Inc. Bains & Company, Inc., and Fred Reichheld.

3 The YBS Group Net Promoter Score uses weightings of scores from KPMG Nunwood Customer Voice Programme's interviews with YBS customers (see page 73 of the Directors' Remuneration Report for details on NPS weighting composition). This is weighted differently to the financial services banking average NPS in the 2018 KPMG Nunwood CEE report, which is based on an independent survey containing both YBS and non-YBS customers.

Financial performance

We have responded well to the current set of market challenges we face with a strong overall performance.

We have increased our statutory profit before tax to £193m (2017: £166m), which has further strengthened our capital position. In addition, core operating profit (defined in the glossary on page 187) has increased to £181m (2017: £160m), reflecting the underlying profitability of the Society. This result reflects a combination of the following:

- Continued focus on our savings customers – we opened 197,000 new savings accounts, have grown our retail savings balance by £0.7bn and paid our savers interest rates an average of 0.37% higher than the market, which is above our target range of 0.15%-0.25%, throughout the year.
- Continued pressure on mortgage margins driven by: ongoing market competitiveness, increased remortgage activity and run-off of historic business written on higher than average margins.
- Reduced operating costs by c.£29m through our efficiency programme and a focus on value for money.
- Continued investment in transforming our business. This is focused on a combination of business efficiency, investment in customer experience, maintaining regulatory compliance and delivering new digital technologies.
- Focused management of funding flows to manage our liquidity position - this is discussed further in the Strategic Report on page 31.
- Continued use of the low cost government funding through the Term Funding Scheme (TFS), which is available until 2021, whilst starting to repay our Funding for Lending Scheme (FLS) borrowings earlier than the contractual due date of 2020. As well as funding through the wholesale markets with several issuances made in the year.
- Lower charges due to reduced Payment Protection Insurance (PPI) and restructuring provisions in 2018. Increase to impairment losses on our loan book due to a change in measurement to IFRS 9 has been offset by an increase in House Price Index (HPI).

We have increased our statutory profit before tax to £193m (2017: £166m), which has further strengthened our capital position.

Further detail can be found in the financial performance section of the Strategic Report on pages 27 to 32.

Successfully reducing our operating costs has allowed us to improve our cost:income ratio to 61% (2017: 63%) despite the planned reduction in our income in the year. Our medium-term goal remains to achieve a ratio of less than 55%. Our management expense ratio, which measures management expenses as a percentage of mean total assets, has also fallen to 0.73% (2017: 0.83%).

Both cost:income ratio and management expense ratio are defined in our glossary on page 187.

Overall, this is a strong performance that delivers profit consistent with the level needed to sustain the business, whilst ensuring we provide long-term value to our members through our products and services.

Looking ahead

Arguably, the degree of uncertainty and potential for change in the economy, and in the financial services market in particular, is the greatest it has ever been. We do not expect the pace to slow in the coming years. There is increasing demand from consumers for greater levels of digital interaction, which is why our transformation programme includes investment in enhancing our digital capability. We do, however, still see strong demand for face-to-face service which many of our customer's value.

We have also seen the level of competition in the market for mortgages and savings increase throughout 2018. In part, we believe this is driven by changes to regulation, such as Open Banking and the ring-fencing of retail banks. Whilst these have the potential to be good for the consumer, it provides challenges for those organisations with a simple business model. In particular when, as noted in the FCA's recent review of retail banking models, some organisations are able to hold a lower level of capital or have other sources of competitive advantage that a building society does not have. As a mutual organisation, it is important for us to maintain our focus on the sustainability of our business and our business model, which we believe provides real benefit to members, as well as a positive impact on society as a whole. As a result, we continue to focus our activities on underserved segments of the market where people are not receiving adequate help to own their own homes and whose needs are not being fulfilled by the broader market. We believe these segments will allow us to maintain both our relevance and sustainability in the long-term.

Our strategy reflects our focus on delivering value to our members by providing simply brilliant services and products. Our colleagues play a vital role in delivering that service and we will continue to invest in creating an inclusive environment where colleagues have the opportunity to reach their full potential. As a part of our commitment to diversity, we signed the Women in Finance Charter during 2018.

Mike Regnier
Chief Executive

27 February 2019

We are proud to have won the following industry awards in 2018:

Customer

Moneynet Personal Finance Awards 2018
Best Overall Mortgage Provider

Moneynet Personal Finance Awards 2018
Best Offset Mortgage Provider

Moneynet Personal Finance Awards 2018
Best First Time Buyer Mortgage Provider

Moneywise Mortgage Awards 2018
Best Lender for Discount Mortgages

Moneyfacts Consumer Awards 2018
First-Time Mortgage Buyers' Choice

2018 Moneyfacts Awards
Best Building Society Mortgage Provider

Moneyfacts Business Awards
Best Service from a Commercial Mortgage Provider

Annual LSL Group Awards
Most Improved Lender

TMA Supernovas 2018
Best Mainstream Lender

TMA Supernovas 2018
Best Customer Service

TMA Supernovas 2018
Best Business Development Management Team

People

National Centre for Diversity Grand Awards
UK Financial Services Company of the Year

National Centre for Diversity Grand Awards
UK's Most Improved Organisation of the Year

Inclusive Companies
34th in the Inclusive Top 50 UK Employers List

Not a Red Card Awards
Best Mental Health Initiative – Large Company

Working Families
Top 30 Employers for Working Families

PEX Network Awards 2018
Most Innovative Approach to Driving Culture Change

Lotus Awards
Workplace Culture

Institute of Internal Communications North Awards 2018
Most Effective Culture Change Programme

Institute of Internal Communications North Awards 2018
Best Evaluation and Measurement

CIPD People Management Awards
Best Change Management Initiative

Community

Third Sector Business Charity Awards
CSR Team of the Year

We are pleased to have won a range of awards for our products in 2018, particularly for Best Overall Mortgage Provider and Best First Time Buyer Mortgage Provider. We also won UK Financial Services Company of the Year at the National Centre for Diversity Grand Awards.

Strategic Report

In this strategic review, we set out our assessment of the environment in which we operate, our progress against a range of strategic aims and the key risks that the Group faces.

Market review

Economic and political overview

The underlying economic performance in the UK through 2018 has been stable, but there are increasing levels of concern over the UK leaving the EU and the nature of a withdrawal agreement, if any. A failure to ratify the EU withdrawal agreement before the UK departs in March 2019 is the key downside risk to the UK economy. As the Society operates almost entirely within the UK, we anticipate that the direct impact of the exit will be low. The potential threat to the Society will be as a result of the more general economic impact from adverse movements in inflation, growth, interest rates and house prices.

Low unemployment rates combined with slowing inflation has led to a revival in real wage growth in recent months, to its fastest rate of increase since the start of the last financial crisis. Looking ahead, wages should continue to be supported by recruitment difficulties; the high vacancy rate and more generous public sector pay agreements. Consumer spending through 2018 has remained high, though there is a continued move away from the high street, reflecting an increase in online activity. In August 2018, the Monetary Policy Committee unanimously voted to raise interest rates based partly on concerns around inflation pressures. The future path of Bank Rate rises not only rests on the negotiations to leave the EU, but also the extent to which wage growth continues its recent trend.

The Society remains alert to these wider macroeconomic risks through its risk management framework and these are reflected in our emerging risks as set out on page 33. Any significant impact on the Society's Key Performance Indicators (KPIs) could lead to us changing our planned activities.

UK mortgage and savings market

Mortgages for house purchases have remained stable, with the first-time buyer market continuing to provide most of the activity. Government initiatives such as Stamp Duty relief, Help to Buy equity loans and Help to Buy ISAs have contributed to this trend. Over the past three to four years, we have also seen more mortgage lenders offering 95% loan-to-value mortgages, as well as strong competition driving mortgage rates down. The buy-to-let sector remains weak across the country, though the deterioration is most marked in London and the South East following the much publicised tax and regulatory changes.

The remortgage market has reached its highest level in almost a decade, as homeowners take advantage of a competitive market and lock into attractive deals with longer terms. This also reflects the large number of mortgages coming to the end of their fixed rate terms, and this is expected to continue into 2019.

Ring-fencing of the large UK banks came into effect in 2019, meaning that any excess liquidity that they hold will most likely be lent to retail consumers. Throughout 2018 the large banks have started to utilise this liquidity, leading to a suppression of customer rates. In addition, there has been continued growth from challenger banks. Funding costs have remained low as a result of existing drawings from the government's Funding for Lending Scheme (FLS) and Term Funding Scheme (TFS). These factors have combined to result in a highly competitive mortgage market characterised by ever lower margins.

Annual house price growth is stable and only increased by 0.5% in 2018. Small price reductions in London and the South East are having an impact on the national market, with prices rising in the rest of the UK. House prices are forecast to increase in the range of 2% to 4%[4] in 2019, although there is considerable uncertainty around this due to the wider economic consequences of the UK leaving the EU.

The Society's trading performance against this market backdrop, including the impact on its KPIs, is covered in the financial performance section of this Strategic Report.

[4] Halifax December 2018 House Price Index.

Competitive landscape

Advances in technology and data are transforming the way in which our customers want to interact with us, and the pace of this change is increasing. Customers are increasingly demanding online interaction and transactions, often via mobile devices, rather than in branches.

New regulation, including the introduction of Open Banking, is designed to give more control and choice to customers about how they can view and manage their money. This will allow business models to emerge that can freely tap into banking infrastructure and data to create new value-added services for customers. Open Banking and simpler authorisation processes lower barriers to entry to the market, increasing the potential for new competition. This is expected to accelerate consumer migration away from traditional banking services, through increased choice of provider and proposition.

We are responding to these changes in the competitive landscape primarily through our digital programme described further on page 14, and by our brand and distribution changes detailed on page 20.

Regulatory overview

A significant amount of new regulation is expected to impact the financial services industry over the next few years.

Key changes include:

Open Banking

Open Banking, and the sharing of consumers' banking transaction data securely with trusted third party providers (TPPs) of banking services, will continue to evolve and shape the retail banking market in 2019. The first stage of this regulation came into effect in January 2018 and there are further changes due in September 2019. These are intended to provide a safe and secure framework for these providers to access data and provide consumer services. We are in the process of delivering the necessary systems developments to meet these requirements. The regulations will initially impact certain payment accounts, but may be extended to cover other savings accounts.

Payment Strategy Forum (PSF) Blueprint for the Future of UK payments

The PSF has published its final draft Blueprint for the delivery of the UK's new payment system. The new payment systems operator, Pay-UK, will develop a New Payments Architecture. One element of this is to develop a mechanism whereby a confirmation of the payee is provided to the payer, by verifying the name on the receiving account. This is a mechanism to address the risk of authorised push payment scams. The Society is working with its partner banks to ensure compliance.

Dormant Accounts Scheme

HM Treasury has announced details of four named industry 'champions' who will work with the banking, securities, pensions, insurance, wealth management and investment sectors to increase the amount of dormant funds that can be released for good causes. Under the current Dormant Accounts Scheme, bank or building society accounts that have been left completely untouched for more than 15 years could be released for good causes.

The finalisation of the Basel III reforms (often called Basel IV)

This relates to capital management and is likely to increase the level of capital requirements for many firms, including implementing floors on the amount of capital that must be held by firms using the internal ratings based (IRB) approach to credit risk.

Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

This will have an impact in the medium-term on capital and wholesale funding requirements across the industry. This significantly increases the level of capital or 'bail in' debt that institutions must hold and is implemented on a transitional basis in 2020 and under final rules from 2022.

General Data Protection Regulation (GDPR)

This regulation, which covers data protection and privacy for all individuals in the EU, came into effect in May 2018. We continue to monitor new guidance produced from the Information Commissioner's Office and accordingly will adapt our business practices in line with this.

Our strategy

Our purpose and mission

Real help 150 years ago was making a house purchase a reality for people who could not otherwise afford one. Real help today means continuing to help customers take their first step on the property ladder, but supporting them with flexibility such as payment holidays if they are needed. Real help also helps build financial resilience by supporting people to get into a savings habit or to enable our savings customers to make the most of their assets and create their financial legacy for the next generation.

Helping our local communities to thrive is another way in which we provide real help, such as delivering financial education lessons in local schools, using our colleagues' skills and expertise to support communities and providing adapted support to customers in vulnerable situations.

It's because of this focus on providing real help with the challenges and opportunities today's world presents that over 3 million customers choose to do business with us.

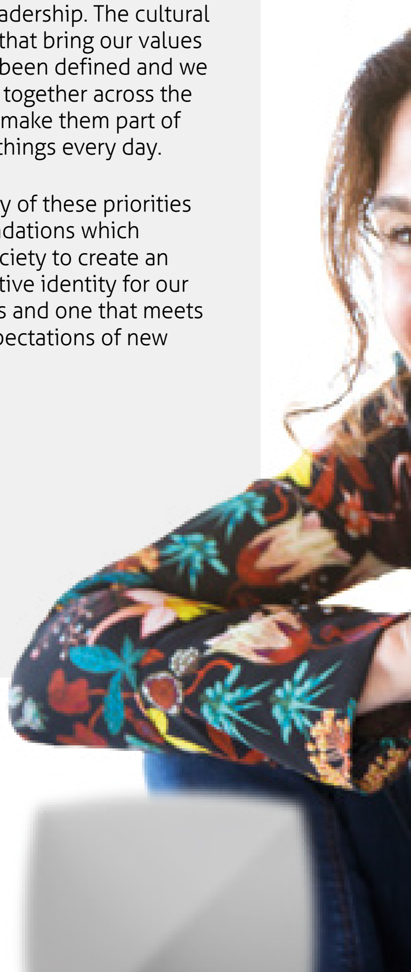
> For over 150 years we have been delivering real help with real life for our customers. By being simply brilliant in our core markets of mortgages and savings we aim to do this even better.

Our priorities

The Society has been focusing on five key areas:

1. **Trading competitively** – providing our members with real value through our mortgage and savings products that are designed for people with a variety of needs. We have expanded our product range and improved the retention of our existing customer base.
2. **Completing integration** – we have successfully re-branded all N&P savings accounts to Yorkshire Building Society and assisted our current account members to move their banking elsewhere. This allowed us to retire the N&P brand from the high street and streamline our technology infrastructure. It also provides N&P customers with a wider range of products and network of branches and agencies under the Yorkshire Building Society brand.
3. **Reducing the cost base** – we have been creating more efficient business structures and increasing our use of automation, reducing our costs. We have also established a roadmap to reduce the costs further by 2020.
4. **Developing capabilities** - we are transforming our digital capabilities, including building more application programming interfaces (APIs), and preparing ourselves to compete in an Open Banking world, creating innovative customer propositions. This is supported by more effective internal processes and governance including detecting financial crime, managing cyber security and fraud detection capability. Our digital investment will also mean we can offer our members a better customer experience through service and price.
5. **Working better together** – our emphasis has been on being clear about what is expected of us through accountable and engaging leadership. The cultural behaviours that bring our values to life have been defined and we are working together across the business to make them part of how we do things every day.

Successful delivery of these priorities builds strong foundations which will enable the Society to create an even more distinctive identity for our existing customers and one that meets the needs and expectations of new customers.



Our values

We achieve our purpose through our culture which is built on our core values. Our core values, set out on this page, are what influence our everyday behaviour. When our own actions reflect the Society's values we are more likely to achieve our aim of being simply brilliant at mortgages and savings.

We are a building society that:

Is personal

- We really listen.
- We approach every relationship with equal sincerity and respect.
- We are unafraid to speak openly, even when it's tough, to get the best outcome for the Society and our customers.

Is passionate

- We challenge the status quo in order to think in new and different ways.
- We strive to get better, through self-development and by developing others.
- We are curious about new possibilities that may improve how we do things.

Is trustworthy

- We are unafraid to try new approaches, learning from the experience even if it does not work out as planned.
- We take personal responsibility for doing the right thing for our colleagues, customers and the Society.

Has customers at our heart

- We come together to work towards the Society's collective success.
- We do what we say we will, meeting commitments and keeping promises.
- We never forget it's members' money we are spending and consider this in every decision we make.

Strategy overview

Purpose What we are here to do.	**To deliver real help with real life**
Mission What this requires us to deliver.	**Be simply brilliant at:** Helping people to have a place to call home; Helping people save to meet life's challenges and opportunities
The what Our priorities for achieving this, in the prevailing environment.	Trading competitively; Reducing the cost base; Completing integration; Developing capabilities; Working better together
The how How we will need to be to deliver these priorities, our values.	Personal; Passionate; Trustworthy; Customers at our heart

Business model

Our business model is simple: we accept deposits from our savings customers and lend to our mortgage customers to enable them to buy their own homes. We also raise additional funds from the wholesale markets and government funding schemes, which helps to diversify our funding base. The majority of our lending is in the residential property market, but we also provide loans to the buy-to-let, commercial and housing association sectors.

The difference between the interest earned on mortgages and liquid assets and the interest paid to savings members and to providers of wholesale funding is the primary source of our income. We also generate a smaller proportion of our income from other products, such as our Share Plans business as well as through insurance products backed by trusted third party providers.

To ensure the stability and security of the Society, we retain a sufficient level of our funding as liquidity, to make sure we can pay our liabilities when they fall due.

We ensure that the level of income we generate is sufficient to cover our operating expenses, impairment losses, other provisions and taxation.

As a mutual organisation we set our profitability targets around being financially sustainable, so that we can continue to offer value to our members through competitively priced savings and mortgage products.

The average customer interest rate on our savings book has been 0.37% higher than the market average this year, equating to in excess of £100m of benefit given back to our members. In addition to this, we provide a larger network of branches and agencies than our competitors, relative to our size. Although we have taken some difficult decisions to reshape our distribution network to improve our efficiency and protect our long-term sustainability, we are able to balance this with the objective of providing our customers with the ability to transact with us face-to-face.

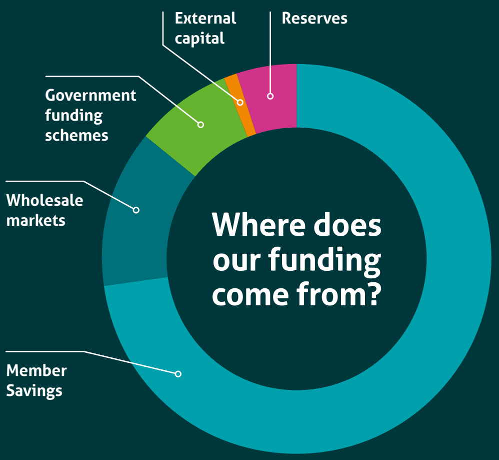
Any additional profit after delivery of our products and services, and the costs of running the business, is invested in the Society's long-term sustainability:

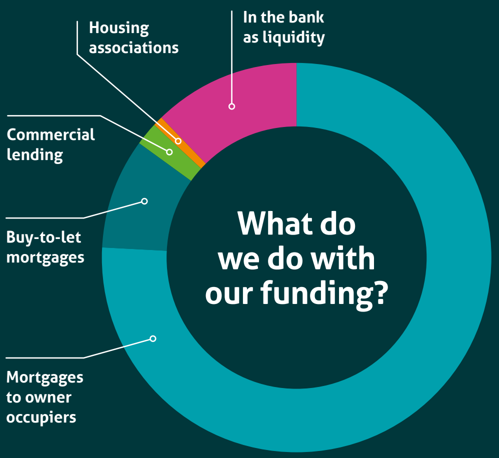
- Protecting the financial position by building our capital strength.
- Investing in our future, through delivery of better products and services.
- Investing in our people, communities and social responsibilities.

Our overall strategy and the decisions we make on how we invest our profits aligns to our purpose, which is to provide real help with real life for our members and customers.

The average customer interest rate on our savings book has been 0.37% higher than the market average this year, equating to in excess of £100m of benefit given back to our members.

Our business model





How we generate income

- We generate income on the difference in interest rates received from borrowers, relative to that paid to savers
- We also receive interest on the money we keep in the bank, and pay interest on our sources of external funding
- We receive commission on third party products, such as insurance and later life planning services

Where our costs come from

- We spend money on running the business
- We put money aside for bad debt

What we use our profits for

- As capital to safeguard sustainability
- To reinvest in the business
- To provide benefits to customers through better products and services
- To provide benefits to the communities in which we operate
- We do not pay any of our profits away to external shareholders - every penny is reinvested for the benefit of members

Having customers at our heart means we can truly focus on providing real help with real life.

Trading performance

The Society has shown a good trading performance by achieving record levels of gross lending and a strong financial return.

Economic and political uncertainty caused by Britain's upcoming exit from the EU, along with regulatory changes leading to the ring-fencing of retail banks led to volatile and competitive trading conditions in 2018.

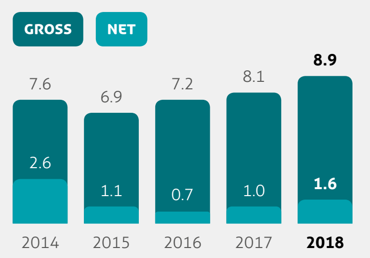
Mortgages	2017	2018
Gross lending	£8.1bn	£8.9bn ↑
Net lending	£1.0bn	£1.6bn ↑
Market share (gross lending)	3.1%	3.3% ↑
Mortgage balance growth	2.8%	4.7% ↑
Savings	**2017**	**2018**
Retail savings balance growth	0.9%	2.1% ↑
Retail savings inflow/outflow	£0.2bn outflow	£0.2bn inflow ↑
Average savings rate differential vs market average	0.28%	0.37% ↑

Definitions of our Alternative Performance Measures are provided on pages 187 to 190.

Mortgage performance

The Society has shown a strong trading performance by achieving record levels of gross lending and mortgage asset growth of 4.7% (2017: 2.8%) which is in line with our Corporate Plan. This has been achieved by providing competitive mortgages to new customers and retaining more of our existing customers.

Gross and net lending £bn



The UK economy performed relatively well in 2018 with moderate rises in house prices and falling unemployment rates. However, concerns over the UK's exit from the EU have been growing and this has led to volatility in wholesale markets and the cost of funding increasing.

In addition to higher funding costs, the ring-fencing of UK retail banks has put pressure on mortgage margins as the larger retail banks try to utilise excess liquidity through increased levels of mortgage lending. We have kept our savings rates as high as sustainably possible and have maintained a strong presence in the mortgage best buy tables across the year. In addition, our legacy portfolios continue to naturally run off over time, with this being replaced by lower risk new lending at lower margins.

Consequently, the amount of net interest margin made by the Society has fallen to 1.11% from 1.23% in 2017. This margin squeeze is experienced industry-wide and we have been able to offset this impact by making efficiencies in other areas of the business and widening our offering.

This has allowed us to continue to provide real help with real life, including:

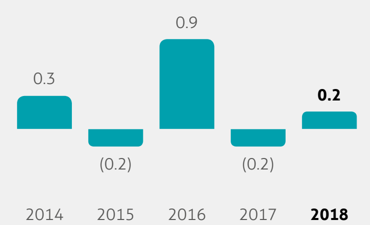
- Launching a range of market leading Help to Buy mortgages, available exclusively to people who are buying a new property through the government Help to Buy scheme.
- Reducing the deposit required for those purchasing a new build house or flat to 10%, from 15%.
- Introducing mortgages with payments fixed for seven and ten years, as customers seek longer-term certainty, as well as the more traditional two, three and five year products.
- Enabling existing mortgage customers to arrange a new competitive mortgage deal online in a matter of minutes, with no requirement to print or sign new documentation.
- Expanding our range of mortgages to allow customers to overpay, make large one-off payments without charge and take payment holidays when their accounts are in credit, to reflect how more complex lives require increased flexibility.

Our cautious approach to lending has resulted in the amount of missed mortgage payments reducing from 2017 and thus loan loss provisions have also decreased contributing to the high quality and low risk mortgage portfolio of the Society.

Savings performance

We monitor our retail savings performance by tracking the net difference between savings deposits and withdrawals in any given period. This is referred to as the net retail inflow or outflow. Our overall savings portfolio had a net inflow of £0.2bn in 2018 with a modest increase in balances compared to 2017. We anticipated some savings outflow as a result of our distribution changes and this, coupled with tighter liquidity management, has meant that lower levels of net savings inflow have been required in 2018.

Retail inflow/outflow £bn



A key highlight in 2018 was retaining our highest ever level of retail savings customers. More than 80% of savers who came to the end of their fixed term account chose to stay with us.

A contributing factor to this increase in retention was improvements in our customer experience, which has been achieved by:

- Improving the layout for customers using our website on a hand-held device or application.
- Making it easier for customers to deposit funds online with a debit card.
- Making it easier for existing customers to open a second account online by streamlining the application process.
- Simplifying the branch account opening process, with most customers now able to open a savings account on their first visit.

In addition to these key changes we have expanded our savings range by launching Single Access Saver (SAS) and SAS ISA online, and have changed our Monthly Regular Saver product to make it a 12 month term at a higher interest rate.

Wholesale performance

We obtain the majority of our funding from retail deposits but also utilise the wholesale funding markets to:

- Create a diversified funding mix ensuring we do not over rely on one source of funding.
- Help with the level of liquidity we need to hold.
- Balance the impact on existing customers.

We have continued to draw down on the government's TFS, whilst starting to repay our FLS borrowings earlier than the contractual due date. Repaying early helps to reduce our refinancing risk at maturity. Both of these low cost government funding schemes have supported our ability to offer better value mortgages and savings products to our members.

The Society has maintained a strong wholesale funding position by completing Senior Unsecured, Residential Mortgage Backed Securities (RMBS) and Covered Bond issuances in the year.

The implications of volatility in the funding markets as a consequence of the UK leaving the EU have been included in our Corporate Plan and stress testing models and we are confident that the risk of issuing debt can be managed with alternative action if required, including reducing planned business growth.

Transformation agenda

Delivering change

To ensure we provide excellent service and remain competitive we are constantly improving the way we operate and the products we offer, through our investment programme.

We continue to progress well with this programme and delivered the following during 2018:

Integration and migration

We underwent a huge integration and migration project to streamline our business and focus on what we do best – mortgages and savings.

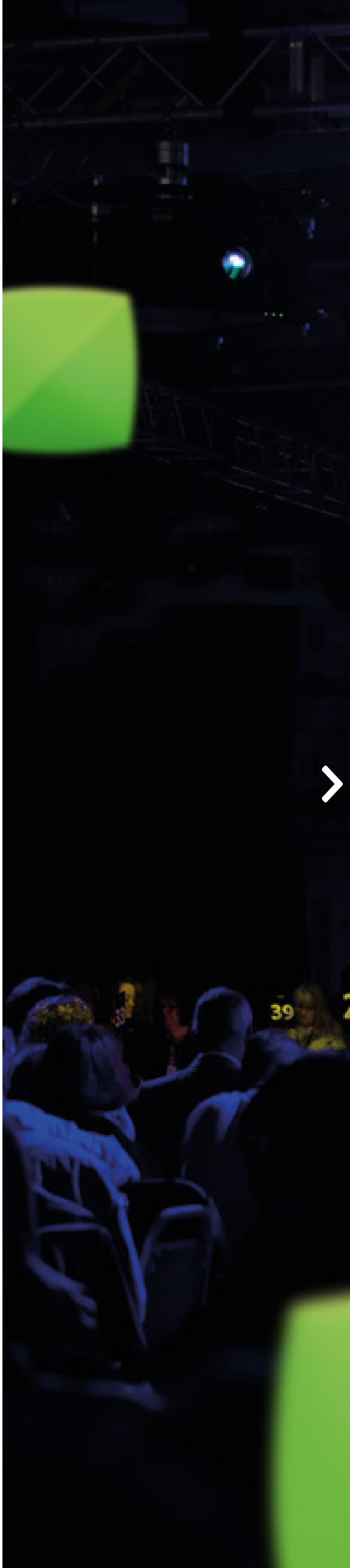
This included:

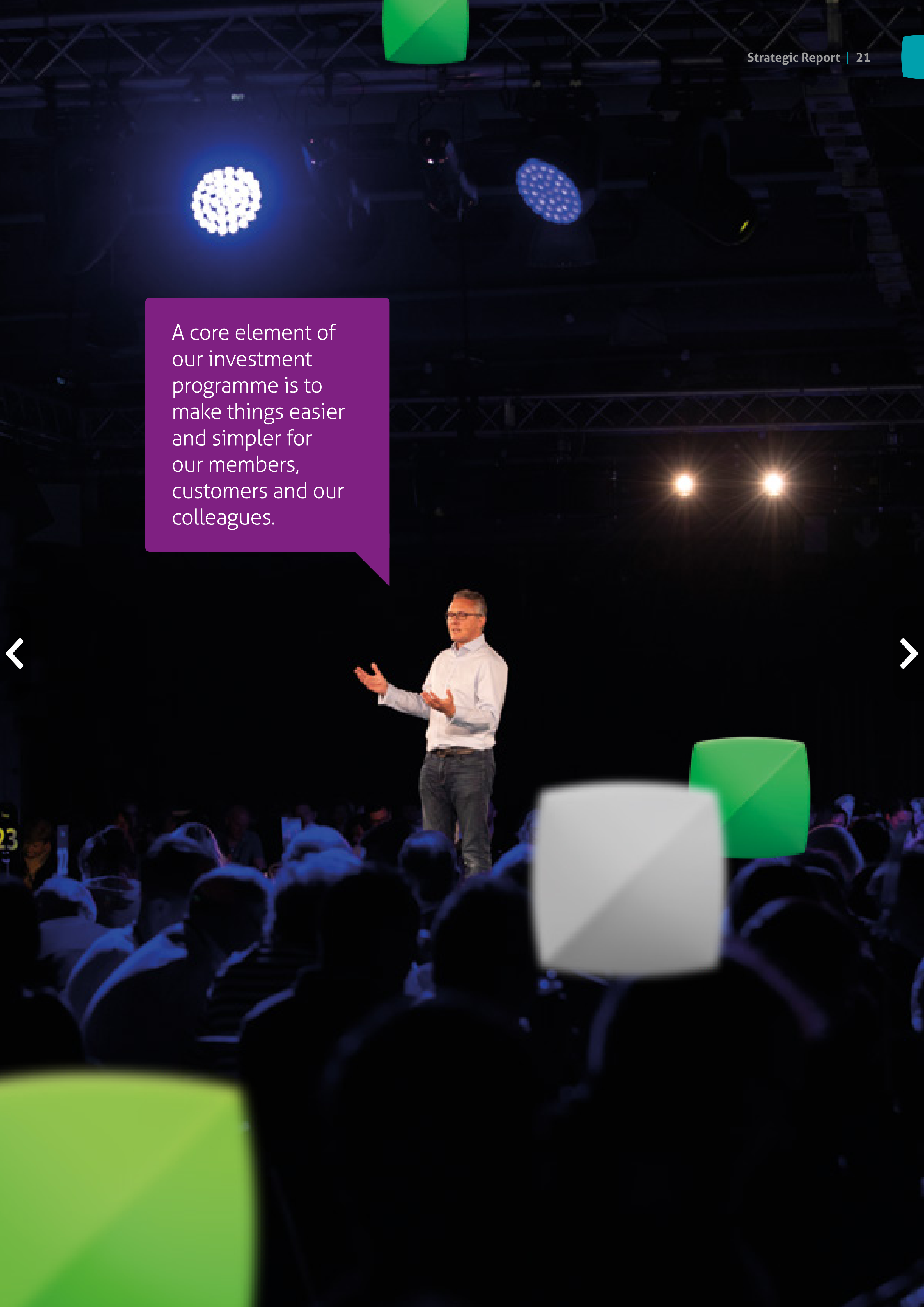
- Successfully completing the re-sizing of the distribution network announced in January 2016.
- Retiring the N&P brand from the high street and the re-branding a number of N&P branches to Yorkshire Building Society. We assisted our N&P account holders in transferring their balances to Yorkshire Building Society or helping them find a suitable alternative.
- Restructuring our head office teams, this includes preparations for the closure of our Cheltenham site and reciprocal increase of teams in Bradford, utilising our resources more effectively.
- Successfully completed the migration of N&P savings customers onto our core Yorkshire Building Society platform.

Other key milestones

- One of our pledges is to protect all our customers and the Society from financial crime. We have launched an initiative called 'Financial Crime Fit for the Future' which marks a significant milestone in improving our anti-financial crime capability.
- Completion of process changes in our management of arrears.
- Successfully completing the implementation of our IFRS9 models to ensure compliance with the standard that came into effect from January 2018, allowing us to calculate our loan loss provisions on this basis.
- During 2018, the Group applied to the PRA for permission to apply the IRB approach to calculating capital requirements. This is a modular (three phase) application process and the PRA is currently reviewing the second phase of the application. This will provide us with greater capability in understanding our underlying business and making decisions based on risk which will improve our business sustainability.
- In January 2018 the Society was the winner for the second year running at the Global Process Excellence Network (PEX) Awards. The Society was shortlisted for three awards and won the award in the Most Innovative Approach to Driving Culture Change category, which is designed to recognise success and innovation in driving cultural change within an organisation.

We successfully closed the N&P current account and integrated the N&P savings business on to Yorkshire Building Society platforms, streamlining and simplifying things under the single high street brand Yorkshire Building Society.





A core element of our investment programme is to make things easier and simpler for our members, customers and our colleagues.

Customer experience

Value for our customers

As a building society we are owned by our members and are committed to providing them with long-term value, providing real help with real life, and delivering the kind of brilliant service we would expect to receive ourselves.

Providing real help with real life enables more people to buy their own home and save for what is important to them. Our ambition is to provide useful and affordable financial products and services that deliver tailored outcomes for all customers by:

- Enabling all individuals to save by offering a variety of options to suit their specific needs
- Supporting customers through every step of their journey to have a place to call home
- Providing personalised support to customers in challenging situations.

We continue to offer strong rewards to our members and customers through our mutual pricing approach. We have helped more members to save by opening 197,000 new savings accounts, including 141,000 for existing customers and 56,000 for new customers. A key focus for 2018 was simplifying the way we open new savings accounts in branches by streamlining processes to reduce the time customers need to spend in a branch, as well as training more than 800 branch colleagues to open accounts. This avoids customers having to come back and see a specialist at a later date.

Savings Pledges

We have six Savings Pledges and these are our commitment to members to act in their best interests, through some common sense policies and services, which we provide to give our customers that extra peace of mind:

- **Learn about new savings accounts first** – members can sign up to receive emails on our new savings accounts.
- **Know your savings account is right for you** – with a free savings review in branch or agency.
- **We value all our savers** – treating new and existing customers equally.
- **Reserve your savings account** – we guarantee branch-based account availability for the next 14 days.
- **Reassuring 14 day rate pledge** – if an equivalent Fixed Rate ISA or Bond is launched with a rate at least 0.20% higher, there are no restrictions for members to switch to it.
- **Support when you need it most** – if our members' circumstances change, we may be able to waive any withdrawal restrictions that might ordinarily apply.

Using money put away by our savings members, we are able to provide mortgages to our borrowers. In 2018 we helped more people own a home by providing over 36,000 mortgages, including 6,960 to first-time buyers.

We have helped more members to save by opening 197,000 new savings accounts, including 141,000 for existing customers and 56,000 for new customers.

We have continued to make improvements in our product range and throughout 2018 have made significant improvements to our existing customers remortgaging service. In March we launched paperless switching, which 12,500 customers and brokers have used to date.

The market place is changing and our customers' challenges are becoming more acute. We responded by offering a range of new mortgage products and features including:

- Mortgages with low or no fees as well as free valuations and cashback features.
- Launching of Help to Buy ISA mortgage, offering preferential interest rates to first time buyers who saved via a Help to Buy ISA account.
- Offering Offset Plus mortgages which enable parents and grandparents to use their savings to reduce the borrower's financial commitment, and therefore interest payments, whilst retaining full access to their own savings.

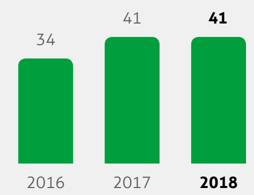
We also know that in uncertain times some customers want mortgages that offer longer-term certainty, so we have introduced mortgages with interest payments fixed for seven and ten years.

We have helped our customers who have vulnerable circumstances or characteristics that may impact their ability to manage their finances, establishing a specialist team which understands the needs of these customers.

Our key measure of customer experience performance is Net Promoter Score (NPS). NPS is a measure of how willing our customers are to recommend the Society to others, and considers the experience across all brands and product lines, whether or not they have interacted with us in the period.

This year our NPS has been maintained at +41 (2017: +41), which is in line with our expectations given the significant changes across the Society, including closure of the N&P Current Account and restructure of our retail distribution and operating models.

Net Promoter Score*



* Our NPS measure was amended in 2017, to incorporate the views of our intermediary network, and therefore the 2016 figure has been stated on a like-for-like basis.

The KPMG Nunwood Customer Experience survey[5] result has dropped this year to 202nd from 87th out of 315 participants (2017: 295 participants). Again this is in line with expectations given the recent brand and distribution changes and, although it may appear a significant drop, this has been impacted by brands in the middle of the survey having very similar rankings.

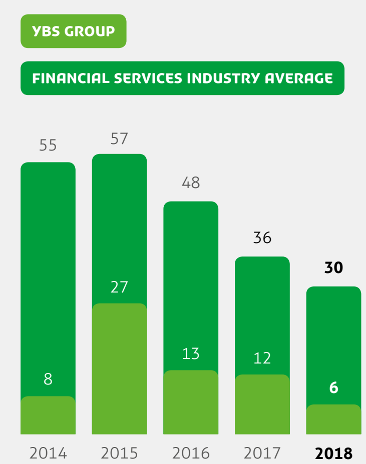
Our focus in 2019 will be to improve our digital functionality, streamline more processes and open more agencies to help enhance our customer engagement and experience. See page 34 for more on our future strategy.

We aim to make sure the service that we provide is as good as it can be, but there are times when things do go wrong. We measure the number of complaints we receive, and for those that we are unable to resolve internally and are referred to the Financial Ombudsman Service (FOS). We also measure the instances where FOS disagrees with our response to the complaint and overturns the decision we made.

Data for the second half of 2018 shows improvement in service across both of our core areas with a decrease in the average complaints; 1.37 per 1,000 savings accounts, (H2 2017: 1.92) and 10.88 complaints per 1,000 direct mortgage accounts (H2 2017: 12.23).

In the first half of 2018[6] the FOS overturned our decisions in 6% of cases (H1 2017: 12%). This is an improvement on the prior year and remains significantly below the industry average of 30% (H1 2017: 36%).

FOS overturn rate %



5 KPMG Nunwood Consulting – Nunwood Customer Experience Excellence Centre Top 100 UK Brands 2018, 315 participants were subject to the study but only the top 100 is published.

6 All figures are for the six months to 30 June due to availability of data at the time of writing and allow comparison to the available industry data.

People experience

Valuing our people

Our colleagues play a vital role in everything we do. In return we make sure that they feel respected, valued and proud to work for Yorkshire Building Society.

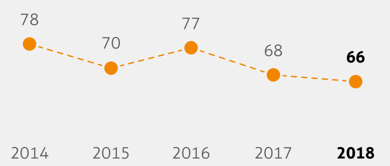
Our ambition is to be a leading employer by:

- Developing a culture of supporting and engaging all colleagues, prioritising their wellbeing and promoting diversity and inclusion.
- Providing opportunities and support for every colleague to develop and reach their potential, celebrating their successes along the way.

Colleague engagement

Great Place to Work[7] runs our annual colleague survey, where we check in with our colleagues to ensure that they feel engaged with the Society; knowing where we are heading and feeling valued by the organisation and fellow colleagues.

Engagement %

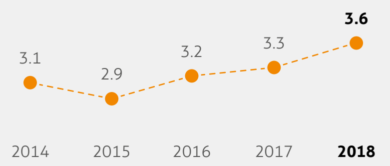


* Our Engagement score was amended in 2017, using the Great Place to Work® survey, and therefore 2016 figure has been stated on a like-for-like basis.

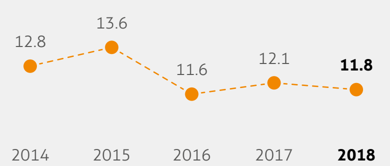
The engagement score has decreased from last year to 66% (2017: 68%), reflecting the significant period of change that the Society has experienced. Our score remains higher than the 56% average engagement in other large organisations. We recognise that there is room for improvement and we want to do better, so we are working hard on improving our colleague experience across the Society. We continue to prioritise wellbeing, learning and development and recognition in this important area.

We held the 'Our Story Live' event for 1,000 of our colleagues with the aim of building understanding, belief and commitment around our strategy and to ensure our colleagues feel committed to playing a part in the Society's future success.

Absenteeism %



Resignation %



Absenteeism and resignation levels are also monitored as a measure of colleague engagement and satisfaction. This year there has been an increase in absenteeism to 3.6% (2017: 3.3%) and a decrease in resignation rate 11.8% (2017: 12.1%). These remain in line with expectations given the organisational change that is underway across the Society.

We believe everyone should be paid a fair wage and have therefore paid all colleagues at least the Real Living Wage (as opposed to the lower paying National Living Wage or minimum wage) for a number of years. At the end of 2018, we extended this commitment to everyone who works on behalf of YBS, by asking and funding our contractor partners to pay their employees who work within YBS the Real Living Wage. From February 2019 around 246 employees in areas such as catering, cleaning and security will receive a pay rise in line with the Real Living Wage.

Culture

A positive culture helps create a healthy, thriving organisation where talent can flourish, which in turn improves colleague performance, promotes better risk management and supports the delivery of our business strategy.

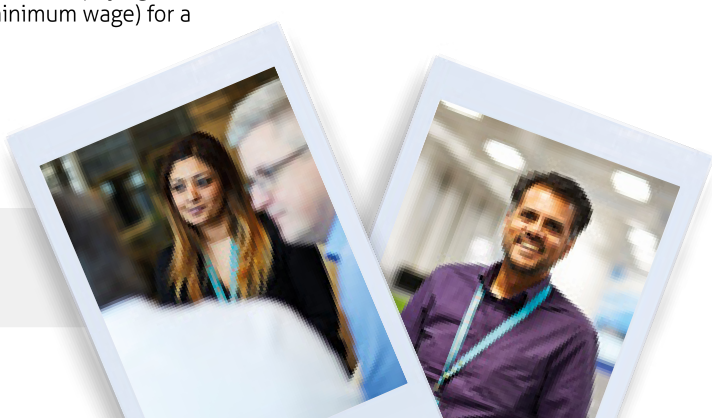
We are proud of our culture, where a passion for customer care delivered with warmth and friendliness is commonplace.

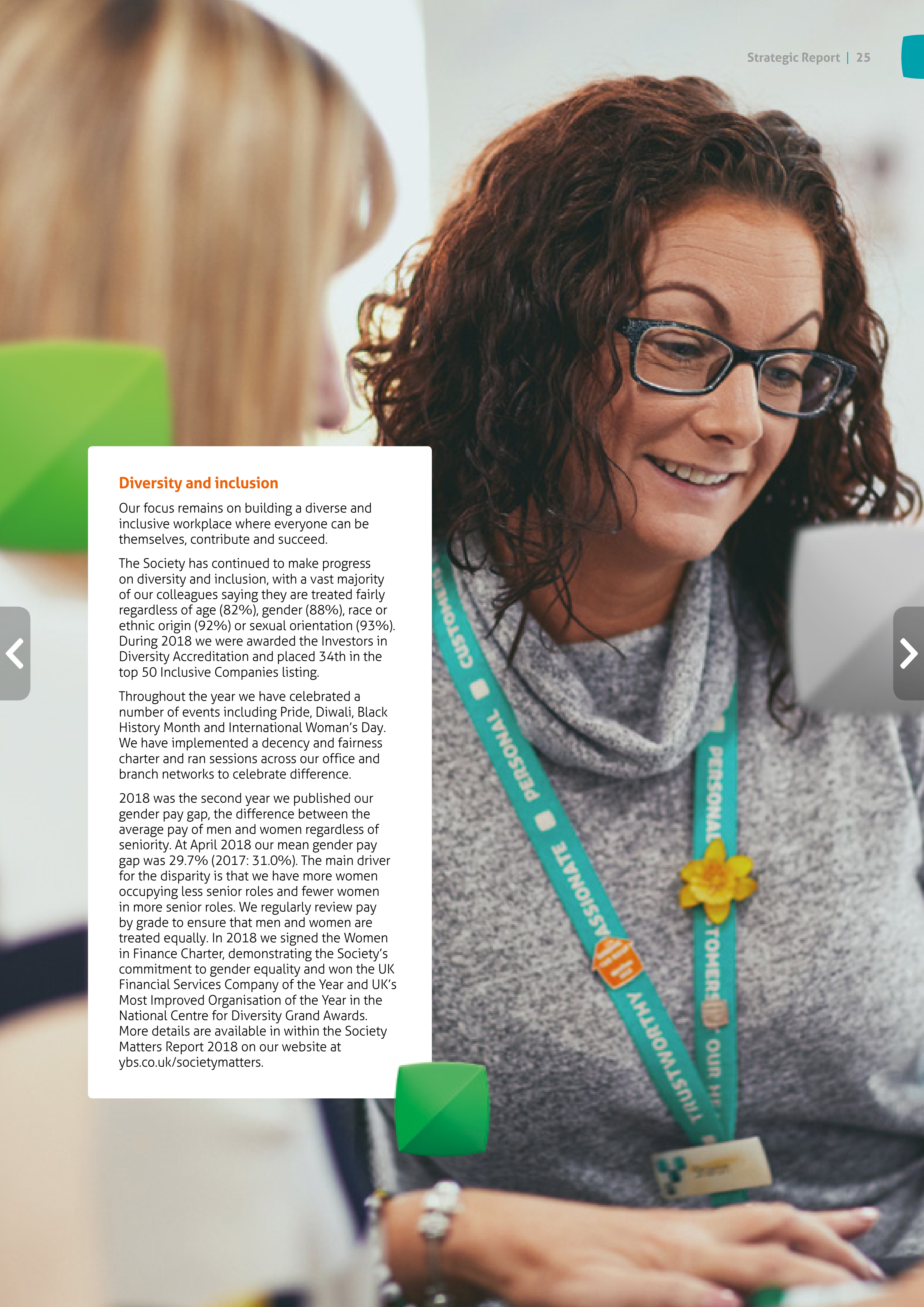
We have just under 200 cultural role models, at all levels of the organisation, chosen because of the real impact and influence they have on how people behave by setting expectations in terms of behaviour. These colleagues are actively demonstrating how the desired behaviours, and the Society's values, come to life day-to-day to rapidly and organically modify patterns of behaviour. In addition, we are continually aligning our people policies and processes, including performance and recognition, to our culture as it evolves.

The effectiveness of our approach and changes we have made in 2018, have won us a number of awards including:

- **Best Change Management Initiative** at the Chartered Institute of Personnel and Development (CIPD) People Management Awards
- **Most Innovative Approach to Driving Culture Change** at the Global Process Excellence Network Awards.

[7] The Best Workplaces survey is an external benchmarking exercise conducted by Great Places to Work®, involving an employee survey and a culture audit.





Diversity and inclusion

Our focus remains on building a diverse and inclusive workplace where everyone can be themselves, contribute and succeed.

The Society has continued to make progress on diversity and inclusion, with a vast majority of our colleagues saying they are treated fairly regardless of age (82%), gender (88%), race or ethnic origin (92%) or sexual orientation (93%). During 2018 we were awarded the Investors in Diversity Accreditation and placed 34th in the top 50 Inclusive Companies listing.

Throughout the year we have celebrated a number of events including Pride, Diwali, Black History Month and International Woman's Day. We have implemented a decency and fairness charter and ran sessions across our office and branch networks to celebrate difference.

2018 was the second year we published our gender pay gap, the difference between the average pay of men and women regardless of seniority. At April 2018 our mean gender pay gap was 29.7% (2017: 31.0%). The main driver for the disparity is that we have more women occupying less senior roles and fewer women in more senior roles. We regularly review pay by grade to ensure that men and women are treated equally. In 2018 we signed the Women in Finance Charter, demonstrating the Society's commitment to gender equality and won the UK Financial Services Company of the Year and UK's Most Improved Organisation of the Year in the National Centre for Diversity Grand Awards. More details are available in within the Society Matters Report 2018 on our website at ybs.co.uk/societymatters.

Corporate responsibility

Making a difference

We focus on making a positive difference to the communities where our members and colleagues live and work.

End Youth Homelessness

2018 was the second year of our partnership with End Youth Homelessness (EYH), a national movement of local charities working together to tackle youth homelessness in the UK. With the fantastic support of our colleagues and customers we have raised £546,683 for EYH so far, against our three-year aim of £750,000. These donations fund the Rent Deposit Scheme, which helps young people to secure a home of their own. In addition we offer a £200 grant towards household essentials, and during their tenancy young people benefit from support with finances, life skills and budgeting.

This Scheme has helped over 180 young people into secure accommodation so far, enabling them to take the first steps to becoming self-sufficient

Colleague volunteering

We want to be as active in our communities as possible and one of the ways we do this is by encouraging our colleagues to use up to 31 hours a year to volunteer, with 47% of colleagues using their volunteering hours in 2018 (2017: 56%). It allows colleagues to use their skills and experience to make a difference in their local areas, and thanks to their passion and support, we celebrated the milestone of 100,000 hours of volunteering time donated to charities and good causes since the launch of the programme in 2007.

We believe that giving young people access to financial education and the opportunity to develop skills and experience relevant to employment will benefit their future. Our Money Minds programme aims to give young people confidence to make sound financial decisions and manage their money. Since it launched in 2015, we have delivered 567 sessions to over 17,000 young people throughout the UK.

Yorkshire Building Society Charitable Foundation

In 2018, the Yorkshire Building Society Charitable Foundation celebrated its 20th anniversary. In that time it has donated over £7m to local communities where our members and colleagues live and work.

YBS Charitable Foundation is an independent registered charity governed by a board of external and internal trustees. It makes donations of up to £2,000 to charities nominated by members and colleagues. The purpose of YBS Charitable Foundation is to provide support to help alleviate poverty and improve health and save lives. In 2018, YBS Charitable Foundation donated over £439,000 to 312 charities.

YBS Charitable Foundation is able to support charities thanks to members who take part in the Small Change Big Difference® scheme, where they donate pennies from the interest they earn on their savings accounts or round up their mortgage payment and donate the difference once a year.

Environment

The Society continuously strives to reduce its environmental footprint through more efficient energy and water usage, reducing the amount of waste we produce, and working with environmentally responsible suppliers. In addition, we focus on increasing awareness and promoting the understanding of colleagues and customers on environmental risks and opportunities.

We have reduced our carbon footprint by 16% in 2018 (2017: 19%), thanks to various energy saving initiatives such as installing solar heat reflective film on windows and upgrading LED lighting at our Bradford office.

Solar panels installed at our Bradford and Peterborough office sites contributed greatly to the reduction in our carbon emissions in 2018, due to the exceptional weather the UK experienced last summer. The solar panels at Peterborough have generated over 20% of the site's total usage for the year, with the Bradford installation contributing to 4% of the sites usage.

We continue to be CarbonNeutral®[8] certified, in line with the carbon neutral protocol. Carbon offsetting is an internationally recognised way of balancing out carbon emissions by investing in projects that will reduce a similar amount of carbon emissions elsewhere. Whilst working hard to reduce our emissions year-on-year, carbon offsetting provides us an opportunity to compensate for the emissions that we do produce, whilst also improving the lives of people living in poverty. In 2018, we purchased 6,357 tCO_2e of carbon offsets, supporting two projects in Guatemala and Sub-Saharan African countries.

In 2018, the Charitable Foundation donated over £439,000 to 312 charities.

[8] The carbon footprint assurance statement can be found here: ybs.co.uk/policies.

100,000 hours

of volunteering time donated to charities and good causes since the launch of the programme in 2007.

Non financial information statement

Yorkshire Building Society has complied with the requirements of s414CB of the Companies Act 2006 by including certain non-financial information within our annual report and accounts, intended to help stakeholders understand our position on key non-financial matters.

Information regarding the following matters can be found on the following pages:

The Society's business model	**16**
Environmental matters	**26**
Employees	**24,25, 54,55**
Social matters	**26**
Respect for human rights	**22 to 23**
Anti-corruption and anti-bribery matters	**66 to 67**
Principal risks	**32**
Where principal risks have been identified in relation to any of the matters listed above, including a description of how the principal risks are managed.	
All key performance indicators of the Group, including those non-financial indicators	**2,3,18,23 to 32**
Business performance	**18 to 32**
Includes, where appropriate, references to, and additional explanations of, amounts included in the entity's annual accounts.	

Financial performance

The Society has delivered a strong financial performance in 2018 consistent with our aim of generating long-term value for members.

This has been a year of strong financial performance and we have over-performed against our Plan in a number of key areas including both statutory and core operating profit. This is despite a challenging environment, particularly in the mortgage market.

	2017	2018	
Statutory profit before tax	£166m	**£193m**	↑
Core operating profit	£160m	**£181m**	↑
Common equity tier 1 capital	15.8%	**16.3%**	↑
Liquidity ratio	15.7%	**13.9%**	↓
Net interest margin	1.23%	**1.11%**	↓
Cost income ratio	63%	**61%**	↓
Management expense ratio	0.83%	**0.73%**	↓
Leverage ratio	5.7%	**5.8%**	↑

Definitions of our Alternative Performance Measures are provided on pages 187 to 190.

We have achieved record levels of gross lending, helping more customers purchase their homes than ever before.

We have also continued to reduce our cost base in line with our strategy, and see improvements in the quality of our mortgage portfolio through lower arrears levels.

The Board monitors the Group's performance on both a statutory profit before tax and core operating profit basis. Statutory profit before tax is defined by accounting regulations and provides a clear comparison between organisations. Core operating profit excludes items that do not reflect the Society's ongoing activities, and the Board considers this to be a more appropriate measure of underlying performance than statutory profit before tax.

Statutory profit before tax for 2018 was £193m (2017: £166m). Our core operating profit was £181m (2017: £160m).

This strong financial performance enabled us to improve our key measure of financial sustainability and our CET1 ratio, described more fully on page 32.

Income Statement

£m	2014	2015	2016	2017	2018
Net interest income	549	535	476	502	472
Fair value volatility	(11)	(7)	1	13	20
Net realised gains	1	2	2	6	8
Other income	26	18	36	15	10
Total income	**565**	**548**	**515**	**536**	**510**
Management expenses	(331)	(346)	(346)	(340)	(311)
Loan loss provisions	(20)	(13)	-	10	1
Other provisions	(26)	(16)	(17)	(40)	(7)
Statutory profit before tax	**188**	**173**	**152**	**166**	**193**

Core operating profit

£m	Ref	2014	2015	2016	2017	2018
Statutory profit before tax		**188**	**173**	**152**	**166**	**193**
Reverse out:						
FSCS levy	1	12	11	5	2	(1)
Non-core investments	2	(11)	1	(1)	(6)	(7)
Timing differences - fair value volatility	3	22	6	(1)	(7)	(13)
Credit day 1 fair value	4	(32)	(4)	(3)	(4)	(3)
Restructuring provision	5	-	-	-	14	10
GMP equalisation	6	-	-	-	-	2
Other non-core items		-	(2)	(24)	(5)	-
Core operating profit		**179**	**185**	**128**	**160**	**181**

Core operating profit is calculated by reversing out the following:

1. **The Financial Services Compensation Scheme (FSCS) levy (£0.9m)** - which is our share of the overall cost of funding failed institutions through this scheme. This is excluded from core operating profit as it does not represent part of the Society's underlying performance.

2. **Non-core investments (£6.9m)** - An improvement in the market price of our non-core assets in our structured credit portfolio generated gains during the year. As structured credit investments are no longer part of our liquid asset investment strategy, these are deemed non-core and hence any gains or losses are excluded from core operating profit.

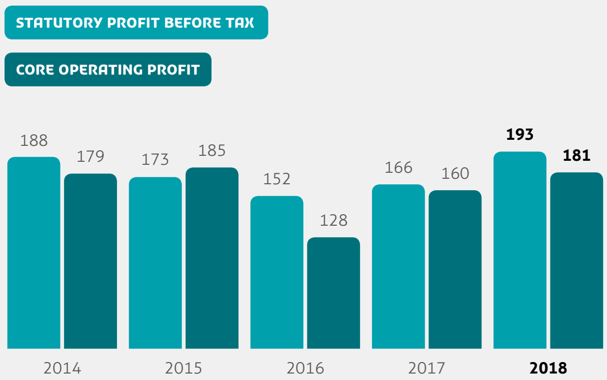
3. **Fair value volatility (£13.2m)** - reflects changes in market rates on some of our assets and liabilities. These are mostly timing differences which will reverse in time.

4. **Credit day 1 fair value (£2.5m)** - The release of fair value adjustment made on merger for the provision of expected lifetime losses. This arises as acquired loans redeem with lower credit losses than projected at the time of acquisition.

5. **Restructuring provision (£10.5m)** - This charge relates to restructuring costs expected to be incurred as a result of the business and organisational changes announced in 2018.

6. **Guaranteed Minimum Pension (GMP) equalisation (£1.7m)** - This relates to the High Court ruling that the Lloyds schemes had to equalise pension scheme benefits between males and females for the effects of GMP.

Statutory profit before tax / Core operating profit £m



Net interest income

Net interest income has fallen by £30m to £472m from £502m in 2017 reflecting ongoing competition in retail markets, which is reducing interest rates on new products and decreasing mortgage income. The ring-fencing of retail banks has meant that any excess liquidity held by larger financial institutions will most likely be used to lend in the retail mortgage market. Although this regulation takes effect from the 1 January 2019, throughout 2018 banks have already started to manage this change by increasing competition and thus putting pressure on pricing.

Net interest margin has decreased to 1.11% (2017: 1.23%) as a result of the declining mortgage margins and sustained low Bank Rate environment on our increasing asset base. During the year our retail deposit balances have grown and we have continued to pay savings rates above the market average.

The successful delivery of our brand, product and distribution model changes have played a key part in reducing management expenses by £29m to £311m (2017: £340m).

Fair value volatility

Fair value volatility represents adjustments to the value of some of our assets and liabilities to reflect changes in underlying market rates.

The most significant contribution to fair value volatility is from interest rate swaps which do not qualify for hedge accounting. This has led to a gain of £11.0m in 2018 that will unwind in subsequent years. In addition, our structured assets portfolio generated a gain of £6.9m due to the market value increasing on our investments.

We also generated a gain of £1.7m in relation to our holdings of VISA shares as the share price increased over the year.

Net realised gains

Realised gains reflect profits made on disposal of liquid asset investments during the year, predominantly from gilt sales.

Other income

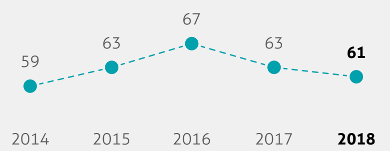
Other income reduced by £4.1m as there has been a reduction in one-off items compared to the prior year. In 2017 we realised income from property disposals (£2.1m) and the sale of Vocalink shares to MasterCard (£3.2m).

Management expenses

The successful delivery of our brand, product and distribution model changes has played a key part in reducing management expenses by £29m to £311m (2017: £340m). During 2018 the number of colleagues has decreased in line with our efficiency initiatives, and we are also seeing the full year impact on the branch closures carried out in 2017.

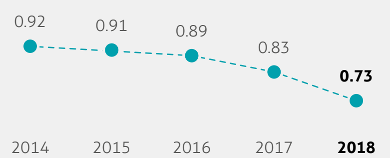
A key measure used by the Society to monitor and manage its overall cost position is the cost:income ratio, which looks at the relationship between the income we generate and our costs. The lower the ratio, the less an institution is spending to generate every pound of income. Income has decreased in 2018 as well as costs, resulting in the ratio decreasing to 61% (2017: 63%).

Cost:income ratio %



The Society also measures its overall cost efficiency via the management expenses ratio, which measures the Society's costs as a proportion of its mean assets during the year. This ratio has decreased more sharply than cost:income in the year to 0.73% (2017: 0.83%). This is due to the growth in our assets compared to the decline in income.

Management expenses (cost to mean assets) %



Provisions

Provisions include those set aside to cover losses on our loan portfolio, FSCS, customer redress and restructuring costs.

A new reporting standard, IFRS 9, became effective from the 1 January 2018 which the Society has adopted for its impairment calculations. This new standard results in a change in modelling approach from an incurred loss basis to an expected credit loss (ECL) basis. Under the incurred loss basis, evidence of the loss event had to be visible in order for an impairment provision to be made (e.g. if the loan had defaulted). Under the expected loss basis a calculation of 12 month ECL is made on every account (looking at whether the account will default in the next 12 months) and this is extended to a lifetime ECL if there has been a significant increase in risk since we lent the money (including if the account is now in arrears).

Further information on the changes as a result of IFRS 9 is contained within Note 1 on pages 100 to 106.

Due to continued improvement in mortgage arrears and growth in the House Price Index (HPI), a release of £0.4m for impairment of our loan portfolio has been recorded (2017: £9.8m release).

A further £10.5m charge for organisational changes announced in 2018 has been recognised in the year. This has been partially offset by releases across PPI, property and FSCS provisions.

Taxation

The tax charge for the year of £42.7m (2017: £41.4m) represents an effective tax rate of 22.2% (2017: 25.0%) which is higher than the UK statutory corporation tax rate of 19.0% (2017: 19.3%).

This is primarily due to a charge of £9.2m (2017: £5.6m) in respect of the banking surcharge. In addition there was a prior year adjustment credit of £2.7m, which is mainly due to adjustments to prior year tax computations for the tax treatment of certain customer redress provisions that arose on merger with the Chelsea Building Society and N&P.

Balance Sheet

£bn	2014	2015	2016	2017	2018
Liquid assets	4.8	4.4	4.7	6.1	5.5
Mortgage and other loans	32.2	33.3	34.1	35.1	36.7
Other assets	0.6	0.5	0.8	0.8	0.9
Total assets	**37.6**	**38.2**	**39.6**	**42.0**	**43.1**
Retail savings	27.2	27.4	28.7	28.9	29.6
Wholesale funding and other deposits	7.5	7.9	7.9	9.8	10.1
Other liabilities	0.6	0.5	0.5	0.3	0.3
Total liabilities	**35.3**	**35.8**	**37.1**	**39.0**	**40.0**
Remunerated capital	0.3	0.3	0.3	0.6	0.6
Reserves	2.0	2.1	2.2	2.4	2.5
Total members' interest, equity and liabilities	**37.6**	**38.2**	**39.6**	**42.0**	**43.1**

Asset growth of 2.4% has been driven by the increase in mortgage balances from strong gross lending and improved customer retention. This has been accomplished whilst also improving the asset quality of our residential lending book.

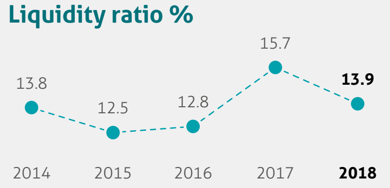
This growth has been funded by an increase in both retail savings and wholesale balances in the year. Retail savings balances have grown despite the changes to our distribution and brand strategies and result in 88% (2017: 90%) of our mortgages being funded by retail savings and retained profits.

Liquidity

One of our key measures is the liquidity ratio, which expresses the total of cash 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 in general, excess liquidity generates less income than it costs to fund. For this reason the Society seeks to maintain prudent but not excessive levels of liquidity, to manage risk whilst optimising the cost of holding it.

Throughout the year we remained above the liquidity thresholds set by the PRA (and by our own stress testing models). The ratio has reduced from 15.7% in 2017 as we have managed our position more effectively. At the end of 2018 our liquidity ratio was 13.9%.

Liquidity ratio %



In addition to reducing the overall amount of liquidity held, over the course of 2018 we have further diversified our liquidity portfolio across a range of Level 1 High Quality Liquid Assets (HQLA).

Wholesale funding

We began the year with further drawdowns on TFS, described earlier as a low cost funding source. In support of a diversified funding programme, we completed successful issuances in the Covered Bond, RMBS and Medium Term Note (MTN) markets.

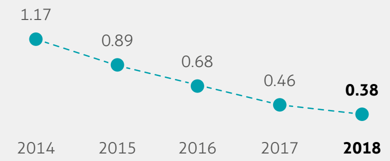
Pensions

The Society's pension scheme entered into a pensioner buy-in to de-risk the pension book, reducing the risk of there being insufficient assets to meet future liabilities. The pension scheme liabilities decreased by c.£250m, and the asset loss from the buy-in was approximately £25m on the accounting basis. More information on this can be found in Note 26.

Arrears

The quality of our mortgage portfolio is monitored by management on a monthly basis using a number of indicators.
The most important indicator is the percentage of outstanding retail mortgage balances in arrears by three months or more (including possessions). The quality of our loan book has improved in the year and therefore the value of such loans reduced to 0.38% at 31 December 2018 (2017: 0.46%).

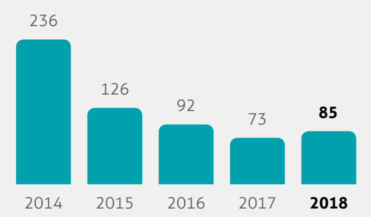
Three months arrears %



The industry average for mortgage arrears is measured as the number of accounts more than three months in arrears (including possessions). At 0.50% (2017: 0.58%) our performance continues to remain significantly below the industry average of 0.80% (2017: 0.84%)[9].

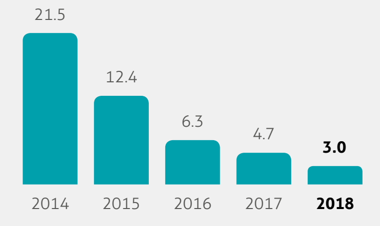
At 31 December 2018 we had a total of 85 retail mortgage properties in possession (2017: 73). The amount written off our loans and advances to customers in 2018 was £3.0m (2017: £4.7m)

Number of retail mortgage properties in possession



[9] Source: UK Finance. Figures are as at Q3 2018 and Q4 2017 due to availability of data.

Retail mortgage write offs (£m)



The graphs illustrate our consistently low levels of arrears and possessions, reflecting the high quality low risk lending that the Society writes, and the run-off of loans from our inherited books as part of our past mergers.

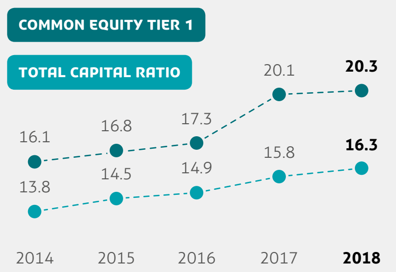
Capital

The Board continues to monitor key capital ratios including CET1 and leverage ratios, ensuring we are financially sustainable. The CET1 ratio represents the relationship between our strongest form of capital (largely accumulated profits that have built up over time) and our assets, weighted by the level of risk they carry. The leverage ratio (a non-risk based measure) compares Tier 1 capital with total assets, including a proportion of off balance sheet items such as mortgage offers that have yet to complete.

As at 31 December 2018 all three of our key capital ratios have increased, demonstrating our strong and sustainable position:

- Our CET1 ratio was 16.3%, (2017: 15.8%).
- Our leverage ratio was 5.8%, (2017: 5.7%).
- Our total capital ratio was 20.3%, (2017: 20.1%).

Capital ratios %



The amount of capital that we will be required to hold in future will change due to new regulations from the finalisation of Basel III (Basel IV) and the implementation of MREL on 1 January 2020. However, the impacts of these changes will also be determined by the outcome of our IRB application which we submitted to the PRA in 2018. More detail on this can be found in the Risk Management Report on page 66.

The Society will be subject to the lower of the transitional MREL requirements (18% of risk weighted assets) or the end state requirements (double pillar 1 and 2A) plus applicable buffers from 1 January 2020. At December 2018 this would be based on the end state requirements, which equated to 17.2% of RWAs plus buffers and the Society anticipates that its MREL requirement will be based on the end state when implemented in 2020. As a result, the Society expects to be fully compliant with final MREL rules in 2020.

At December 2018 total MREL resources were equal to 20.3% of risk weighted assets. The Society is well positioned to meet the MREL requirements in 2020 through retained profits and further issuance of qualifying MREL instruments. Whilst there is a risk that a disorderly Brexit may impact on the ability to issue debt at a reasonable coupon, the Society is highly confident that this risk can be comfortably managed with alternative action taken if required, including reducing planned business growth.

Principal risks and uncertainties

The Society's risk profile changes as we move through the economic cycle.

The areas of the risk framework that currently impact us most significantly, and the way in which we mitigate these, are described more fully in the Risk Management Report which starts on page 60, and are summarised below:

Risk	Principal mitigation	KPI 2018 status vs 2017
Retail and commercial credit risk	The Society sets a risk appetite for its retail and commercial lending activities which limits exposure to higher risk lending areas, and monitors adherence to this.	**Improving** page 64
Wholesale credit risk	The Society sets a risk appetite for wholesale credit risk and monitors adherence to this. It adopts a low risk approach to wholesale credit, investing most of its liquidity in the highest quality assets.	**Stable** page 64
Funding and liquidity risk	The Society sets a risk appetite and stress tests its positions against this risk appetite. The Society operates a diversified funding base, primarily through retail savings, supported by a strong wholesale funding franchise.	**Stable** page 65
Market risk	The Society adopts a low risk approach to market risk, and stress tests all positions against a range of scenarios.	**Stable** page 65
Operational risk	The Society operates an internal control framework in line with the Board risk appetite and monitors adherence.	**Stable** page 66
Business risk	The Society maintains a capital risk appetite and regularly stress tests its positions against severe scenarios.	**Improving** page 66
Compliance and conduct risk	The Society operates an internal control framework in line with the Board risk appetite and monitors adherence.	**Improving** page 67

We recognise that the environment within which we operate and the nature of the threats which we face are continually evolving. Consequently, we continue to invest in our risk management capability ensuring emerging and evolving risks continue to be closely monitored and that timely and appropriate action is taken to protect the interests of the Society and its customers. Significant emerging risk headwinds are regularly reviewed through the senior risk committees and are considered as part of our planning process.

Macroeconomic (business risk)

Political uncertainty in the UK

There is continued uncertainty surrounding the exit agreement. Until this is resolved there is a risk of disruption to the UK economy and financial system. As a result any adverse implications from the UK's exit from the EU will continue to be closely monitored.

Market pressures on core business

Despite two interest rates rises in less than 12 months (November 2017 and August 2018) market expectations of near term increases remain subdued. A continuation of low interest rates is likely to constrain margins; although this combined with rising wage growth should help affordability for homeowners.

Funding markets and government schemes

We have considered and factored in future anticipated pressures on funding markets and the end of government funding schemes such as FLS and TFS within our five year Corporate Plan. We will ensure a stable and diversified funding base is maintained, to support lending and to meet operational requirements. Repayment timings of TFS and FLS have been phased in such a way to allow for greater flexibility to funding plans in addition to reducing refinancing risk. Our Plan anticipates an increase in funding costs which has been factored into margin projections.

Financial crime and cyber security (operational risk)

Rapidly evolving financial crime threats

We continue to operate in a hostile financial crime environment. Continued focus on our financial crime capability remains paramount in order to keep these evolving financial crime exposures within our risk appetite. We have continued to invest in this area, focusing particularly on money laundering, terrorist financing and sanctions compliance by looking at appropriately upgrading business standards, due diligence, IT and people capability.

New and evolving cyber security threats

The increasing use of technology and the pace of technological change, expose the UK financial services sector to ever increasing and evolving cyber security threats – including ransomware, data breaches and weaknesses in the supply chain. Resilience to such threats and an ability to effectively respond in the event of an attack are essential in order to protect the Society, maintain the trust of our customers and the confidence of our regulators.

Operational failure (operational risk)

Ensuring the provision of resilient services

Traditionally, resilience has largely referred to the ability to recover from an incident in the shortest time possible. However, customer and regulator expectations are now such, that any interruption in service may result in significant reputational damage. Consequently, resilience must form an integral part of any new service.

Maintaining and enhancing resilience controls will safeguard the Society's reputation, help meet the expectations of regulators and avoid or reduce the costs associated with disruption in service. However, the continued provision of a highly reliable service, coupled with the need to effectively respond to customer expectations, is likely to mean that maintaining IT systems and infrastructure becomes increasingly time-consuming and expensive.

Legal and regulatory compliance (business risk)

Changing regulatory landscape

Compliance and conduct is central to our values and behaviours. It is recognised that ongoing focus is required to ensure we continue to encourage robust challenge and keep pace with the rapidly changing technological and globalised legal and regulatory environment.

Changing market for financial services (business risk)

Increased competition and new technology

The activities of challenger banks and FinTech firms, as well as the rapidly accelerating digital transformation within direct competitors, continues to gather momentum, further serving to pressure margins as cost:income ratios fall across the sector. Consumer expectations influenced from other sectors and increasingly within financial services, further increase the risk of us losing relevance amongst savers and home buyers. Digitalisation of the business in order to respond to market conditions may create a need to further enhance our risk management capabilities across a number of risk categories. The cost of delivering the level of change necessary to keep pace with rapidly changing technology may also prove unsustainable and require investment choices which may not fully meet customer expectations.

Outlook

The intensifying political and economic uncertainty surrounding the UK leaving the EU may harm the general economy in the near term, adversely impacting inflation, growth, interest rates and house prices. A disruptive exit could also result in a market dislocation, increasing the cost and reducing the availability of wholesale funding. With a strong capital base, predominantly branch-based retail liabilities and low-risk assets the Society is well positioned to navigate the impact of the UK's exit from the EU.

The UK mortgage market is highly competitive as ring-fenced banks and new entrants seek to gain share, and this looks set to continue. To adapt to these challenges we are investing in our various customer channels and enhancing our digital capability, offering better access to our customers whilst being more efficient.

Delivery of our efficiency programme is on track and we expect to reduce costs further in the coming years, whilst still growing our business. In light of competition, we will continue to evaluate and improve our service and product offerings, whilst ensuring sustainability of our business in the long-term.

Projects that we will be working on and delivering in 2019 include:

- Further investment in our digital capabilities, transforming our Society into a digital organisation. There will be three main areas of focus:

  1. We will be making it easier and simpler for customers to access our services online and via their mobile devices.
  2. We will be transforming our processes, removing paper and improving the way we work to make it easier for colleagues to deliver for our customers and save costs.
  3. We will be improving the connectivity we have with our commercial clients and customers, making it easier for them to do business with us.

- Continuing our efficiency programme by migrating all of our N&P residential mortgage customers onto a third party system, following the successful migration of savings customers in 2018, allowing the N&P systems to be decommissioned.
- Focusing on efficiency, we will complete the closure of the Charlton Kings office in Cheltenham with operational activity moving to the Bradford head office site.
- Finalising of a number of system and process changes for the remainder of our key regulatory and transformation programmes of work including PSD2. We will be opening third party access to our Open Banking API gateway, for our payment account customers, enabling the service for live customer access and delivering increased levels of customer security and authentication.
- Further investment in our mortgage programme is a priority, and will deliver significant efficiency improvements to brokers and customers through the mortgage application process. We will also deliver system enhancements which will allow the Society to offer a wider range of products to a wider customer base.
- Delivering a new high tech platform that improves payment screening and suspicious activity monitoring to safeguard our customers and business by preventing, detecting and managing financial crime and fraud.
- Further work on our IRB project to address feedback from the PRA on the second phase of the application that we submitted during 2018.

Viability and going concern

The Directors confirm that they consider that the Society has adequate resources to continue in existence for at least 12 months from the date of signing these financial statements, and so the requirements of the principles surrounding going concern accounting requirements can be met. This confirmation is made after having reviewed assumptions about future trading performance, liquidity requirements, capital requirements and sustainability contained within our Corporate Plan. The Directors also considered potential risks and uncertainties in business, credit, market and liquidity risks, including the availability and repayment profile of funding facilities. Based on the above, together with available market information and the Directors' knowledge and experience of the Society and markets, the Directors continue to adopt the going concern basis in preparing the accounts for the year ended 31 December 2018.

For the purposes of the viability statement the Directors have determined three years to be the most appropriate period to consider as this covers the typical term of a large proportion of our products and is the longest period over which the Board considers that it can form a reasonably firm view over the possible macroeconomic environment and associated key drivers of business performance. The fourth and fifth years of the Corporate Plan may not be sufficiently reliable for this purpose due to the uncertainty in the economic environment, along with the pace of regulatory and technological change.

The Directors have assessed the viability of the Society over the next three years to December 2021, taking account of the Society's current position and the potential impact of the risks documented elsewhere in this Strategic Report. The Society's financial planning process comprises of an Operating Plan for the next financial year, together with a forecast for the following four financial years. Achievement of the one-year Operating Plan has a greater level of certainty and is used to set near-term targets across the Society. Achievement of the five-year Corporate Plan is less certain than the Operating Plan, but provides a longer term outlook against which strategic decisions can be made.

The financial planning process considers the Society's profitability, capital position, liquidity and other key financial metrics over the period, including impending regulatory changes such as MREL. These metrics are subject to sensitivity analysis through the annual Group ICAAP (Internal Capital Adequacy Assessment Process) and ILAAP (Internal Liquidity Adequacy Assessment Process). The Society stresses its capital and liquidity plans, under 'severe but plausible' stress test scenarios, in line with PRA requirements.

The scenario was more severe than the global financial crisis and encompassed a wide range of UK macroeconomic outcomes that could be associated with the UK's expected withdrawal from the EU.

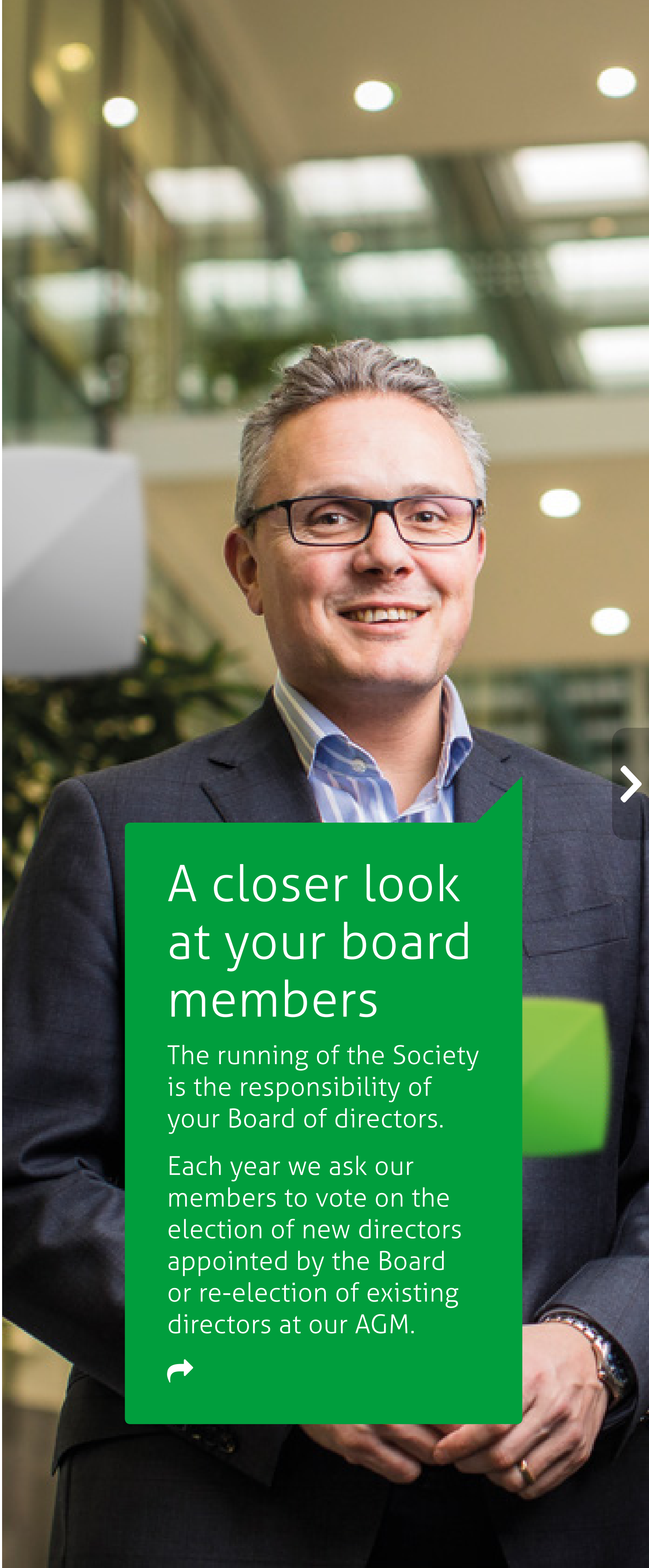
The ICAAP stress test ensures that the plan projections for capital requirements and capital generation are resilient to stresses should the environment deteriorate beyond the levels currently envisaged. The Society maintains capital buffers that are sufficient to absorb the level of capital erosion in the stress scenario over and above its minimum capital requirement, ensuring that the Society can continue to meet its minimum capital requirements throughout a 'severe but plausible' stress. The ILAAP stress test ensures that the Society holds adequate liquid assets in terms of both quality and quantity sufficient to meet both its business as usual liquidity needs and any increased requirement that could occur as a result of the Society entering into a period of stress. Planned liquidity levels meet the Society's key risk appetite measures over a period of three years.

The Board has undertaken a robust assessment of the principal risks and uncertainties that could threaten the business model, future performance, solvency or liquidity of the Society.

These risks are described on pages 32 to 33 of this Strategic Report and in the Risk Management Report which starts on page 60.

The Society's risk management framework and governance structure are described in the Risk Management Report.

Based on the assessment set out above, the Directors have a reasonable expectation that the Society will continue in operation and meet its liabilities as they fall due over the period to December 2021.



A closer look at your board members

The running of the Society is the responsibility of your Board of directors.

Each year we ask our members to vote on the election of new directors appointed by the Board or re-election of existing directors at our AGM.

Chairman

Non-executive directors

John Heaps LLB
Chairman

Joined the Board in 2014 as Chairman Designate, becoming Chairman in 2015.

Background and career

As a qualified lawyer, John worked in the legal profession for 40 years, joining the senior management team of the corporate law firm Eversheds in 1999. He was appointed Chairman of Eversheds in 2010 for a four year term and retired in 2015.

Skills and experience

John has extensive commercial and legal experience. He contributed considerably to the long-term strategy at Eversheds and helped drive considerable change, as it grew from a group of affiliated UK offices into a major international law firm.

Other roles

Member of the Law Society Business and Oversight Board, member of the Audit and Constitutional Committees of the International Bar Association and a member of the board of TheCityUK.

Committee membership

Chairman of the Board Governance and Nominations Committee and a member of the Remuneration Committee.

Neeta Atkar BSc
Independent Non-executive Director

Joined the Board in 2017.

Background and career

Neeta began her career at the Bank of England, including roles in the Bank's own banking department and its supervisory function. She moved to the Financial Services Authority (FSA) on its creation, leaving in 2000 to move into consulting, working with a range of financial services clients. Following this Neeta held senior positions in the financial services sector, including Chief Risk Officer at TSB until the end of 2016 where she was a member of the executive team that created and listed the bank on the Stock Exchange.

Skills and experience

Neeta has 30 years' experience working in financial services, both in the private and public sectors across a range of risk disciplines, including credit, operational, financial crime and regulatory risks.

Other roles

Non-executive Director of the British Business Bank plc and Chair of their Risk Committee.

Non-executive Director of Nomura Europe Holdings plc, Nomura International plc, Nomura Bank International and Nomura Financial Products Europe and Chair of their Risk Committees.

Trustee of the National Skills Academy for Financial Services.

Neeta has also been a magistrate for over 20 years.

Committee membership

Chair of the Group Risk Committee and a member of the Audit Committee.

Guy Bainbridge MA (Cantab), ACA
Independent Non-executive Director

Joined the Board in January 2019.

Background and career

Guy has spent 36 years with KPMG, of which the previous 24 were as a partner including seven and five as a Member of KPMG's UK and European Boards respectively. He has been Lead Partner for a number of banking clients during the last ten years including most recently Barclays and ING since 2015. Guy was also the Lead Partner for HSBC from 2010 until 2015.

Skills and experience

Guy is a banking expert and brings recent and relevant experience of the UK banking sector having been the lead partner for HSBC and Barclays over the last ten years. He has comprehensive knowledge of the regulatory environment within which the Society operates.

Other roles

Guy currently carries out some advice to a charity but currently has no other directorships having retired from KPMG in September 2018.

Committee membership

Member of the Audit Committee.

Non-executive directors

Alison Hutchinson BSc, CBE

Independent Non-executive Director

Joined the Board in 2015.

Background and career

Starting her career at IBM, Alison progressed to become Global Director of Online Financial Services. In 2000, she joined Barclays Bank and held senior management positions including Marketing Director of Barclaycard. In 2004 Alison moved to specialist mortgage provider Kensington Group plc, as Management Director and then Group CEO, leading the successful sale of the business to Investec in 2008.

After leaving Investec in 2008, Alison launched The Pennies Foundation, a registered charity which supports digital donations to good causes. She has been the Chief Executive Officer of the Foundation since 2009.

Skills and experience

With a strong background in technology and financial services, Alison has extensive experience in the retail financial services sector. She has more than twenty years of management experience and Board level experience.

In 2016, Alison was awarded a CBE for services to the economy and charities.

Other roles

Chief Executive of The Pennies Foundation and a Non-executive Director of Liverpool Victoria Friendly Society and DFS Furniture plc.

Committee membership

Member of the Group Risk Committee, Remuneration Committee and Board Governance and Nominations Committee.

Gordon Ireland BSc, FCA

Independent Non-executive Director

Joined the Board in 2015.

Background and career

Gordon is a chartered accountant and worked for 36 years at PwC, including 24 years as a partner, where he specialised in the financial services sector. His role included Vice Chairman of PwC's UK supervisory board and Chairman of the partner admissions panel and senior management remuneration committee. Following this, he was CEO of a professional indemnity captive insurer of PwC's network.

Skills and experience

Gordon's role at PwC included auditing many of the UK's leading insurance companies, and acting as an audit review partner. He also represented PwC on external technical advisory groups at a UK and European level.

Other roles

Non-executive Director of Aspen Insurance Holdings Ltd where he is Chair of the Audit Committee and a member of the Risk Committee. Gordon is also a Non-executive Director of Aspen Insurance UK Ltd and Iccaria Insurance ICC Ltd.

Committee membership

Member of the Group Risk Committee and Audit Committee.

Mark Pain BSc, FCA

Independent Non-executive Director and Vice Chairman

Joined the Board in 2013 and appointed as Vice Chairman and Senior Independent Director in 2015.

Background and career

Mark spent 16 years with Abbey National Group, including roles as Group Finance Director, CEO of Abbey National Treasury Services and Customer Sales Director. He was also Group Finance Director at Barratt Developments PLC. He has 10 years' experience in a number of non-executive positions across several sectors, including LSL Property Services plc, Punch Taverns plc, Spirit Pub Group plc, Johnston Press plc, Aviva Insurance Ltd and Ladbrokes Coral Group plc.

Skills and experience

With 20 years' experience of director level roles within FTSE100 companies, Mark brings a wide range of skills and experience in risk management and governance, strategic planning, treasury services, business leadership and change. Mark has a strong technical finance background and in depth knowledge of retail financial services.

Other roles

Chair of London Square Ltd, LSQ Management Ltd and Empiric Student Property plc and also Non-executive Director of Axa UK plc.

Committee membership

Chairman of the Audit Committee and a member of the Group Risk Committee and Board Governance and Nominations Committee.

Non-executive directors

Executive directors

Guy Parsons BA
Independent Non-executive Director

Joined the Board in 2013.

Background and career
Guy was a director of Accor UK, responsible for sales, marketing and operations for the Novotel hotel chain. He has also held director positions at Whitbread Plc as Sales and Marketing Director for the hotel division and as Managing Director for TGI Fridays. In 2004 he joined Travelodge, becoming CEO in 2010 and successfully grew the business to over 500 hotels in the UK, Ireland and Spain. In August 2015, Guy was appointed as easyHotels plc CEO.

Skills and experience
Guy has more than 25 years' experience of director level roles in the leisure and hospitality industry.

Other roles
Chief Executive of easyHotel plc and easyHotel UK Ltd.

Committee membership
Chair of the Remuneration Committee.

Mike Regnier MEng, MBA
Chief Executive

Joined the Society and Board in 2014, and was appointed Chief Executive Officer in January 2017.

Background and career
Mike began his career with ten years in strategic management consulting, latterly with the Boston Consulting Group, with a focus on Retail and Retail Financial Services. After management positions at Asda he joined the banking sector and has held a number of senior positions at Lloyds Banking Group, including Personal Current Accounts and Credit Cards Director. Most recently, he was the Products and Marketing Director for TSB. Mike joined the Society as Chief Commercial Officer and Executive Director and became Chief Customer Officer in December 2015.

Skills and experience
Mike has a strong background in strategy and general management, mainly within the Financial Services sector. He has served as a Board Director of Visa UK, and Chairman of the merchant acquirer LTSB Cardnet. He is currently also the Vice-Chairman of the Building Societies Association.

Stephen White BComm
Chief Operating Officer

Joined the Society and the Board in 2016.

Background and career
Started his career as a retail branch manager for Abbey National, Stephen subsequently gained further experience in management roles at Ernst & Young and Abbey National. He was also an Executive General Manager at National Australia Bank looking after Payments and Customer Operations and prior to YBS he was Group Chief Operating Officer at Allied Irish Bank.

Passionate about the mutual sector and customer service, Stephen is responsible for the Group's Operations and Customer Service functions, including Customer Relations, Lending, Customer Services, Arrears and Collections, Property and Procurement, the Group's IT, Information Security and Change Management. Stephen is also Chairman of Accord Mortgages Limited.

Skills and experience
Stephen has 25 years' experience in financial services and has worked at a senior level globally, including significant time in Australia, Asia, Ireland and the UK.

Executive directors

Chief officers

Alasdair Lenman MA, ACMA
Chief Finance Officer

Joined the Society and Board in 2017.

Background and career
Alasdair began his career on the management training programme at Mars Inc. where he spent a number of years working in sales, before making the decision to move into finance. Since then he's gained significant experience in the financial services sector, including as Finance Director of Retail Products for Lloyds Banking Group, and as Group CFO for BGL Group.

Skills and experience
Alasdair has a strong finance background with over 20 years' experience, including running the finance function for a large mortgages and savings business and having previously acted as a Group CFO. Alasdair has served as a Non-executive Director and Audit Committee Chairman for both Sainsbury's Bank and the Coventry Building Society.

Charles Canning
Chief Customer Officer

Joined the Society in 1987.

Background and career
Charles was promoted to the Leadership Team in 2005 and has held a variety of roles including Head of Branch Network and Head of Distribution responsible for the branch and agency network and telephony sales. More recently he was promoted to Chief Customer Officer and has overall responsibility for all aspects of distribution and the delivery of an exceptional customer experience.

Skills and experience
Charles has over 30 years' experience with the Society across many areas and is also a director of Accord Mortgages Limited, the Society's wholly owned intermediary lending subsidiary.

Suzanne Clark MCIS, FCA
Chief Internal Audit Officer

Joined the Society in 2017.

Background and career
Suzanne has held a variety of roles throughout her banking career, including leadership roles at the Bank of England and several global banks. She joined the Society in April 2017 as Head of Internal Audit and more recently was promoted to Chief Internal Audit Officer.

Suzanne is responsible for ensuring the Board is provided with an independent view of how effective the Society is at managing its risks.

Skills and experience
Suzanne has over 20 years internal audit experience in the Financial Services sector and is currently a Non-executive Director and member of the Audit Committee for the Leeds Teaching Hospitals NHS Trust.

Chief officers

David Morris BA (Hons), MA
Chief Commercial Officer

Joined the Society in 2018.

Background and career

David began his career at Citigroup and has also worked for private bank Arbuthnot Latham and the Commercial Bank of Qatar. Most recently David was the Head of Products at Coventry Building Society.

He is responsible for the innovation, development and ongoing management of mortgages and savings products, marketing, and our commercial strategy.

Skills and experience

David has more than 12 years' experience in financial services and product management with a strong track record of driving commercial performance in financial services, including the mutual sector.

Richard Wells FCIB
Chief Risk Officer

Joined the Society in 2010.

Background and career

Richard has held a number of senior risk management roles at several of the UK's major banks and building societies. Richard is responsible for ensuring that appropriate procedures and capability exists within the Society for the management of all the risks that it has planned to take, or that it encounters. He is also responsible for the Legal and Group Secretariat functions.

Skills and experience

Richard has extensive experience of risk management within the financial services industry. He is also a director of Accord Mortgages Limited.

Greg Willmott MA, BPhil
Chief Strategy and Digital Officer

Joined the Society in 2018.

Background and career

With extensive experience in retail financial services, Greg's corporate roles include Development Director for Zurich UK, Strategy and Development Director for Aviva in the UK and Principal in Barclays' in house strategy team. He also has extensive experience in strategy consulting with PA, KPMG, Towers Watson and as a freelance advisor.

Greg and his team are responsible for developing and embedding the Society and digital strategies, strategic and customer centre insight and proposition development, building our external brand, reputation and influence and driving the Society Matters agenda on behalf of the Society.

Skills and experience

Greg has 20 years' experience in corporate strategy and development, from major corporations to private equity start ups, with significant recent work in digital, innovation and disruption.

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 2018.

Business objectives, future developments and key performance indicators

Information on the Society's vision and strategy, and future outlook are set out in the Strategic Report on pages 12 to 35 together with its principal key performance indicators.

Profit and Capital

The profit and capital position of the Society are set out in the Strategic Report on pages 12 to 35.

Mortgage arrears

Details of the Society's mortgage accounts which were 12 months or more in arrears at 31 December 2018 were as follows:

	2018	2017	2018	2017
			% of mortgage account/balances	
Number of accounts	**128**	155	**0.05**	0.06
Balances outstanding on accounts	**£18.5m**	£21.3m	**0.05**	0.06
Amount of arrears included in balances	**£2.1m**	£2.5m	**0.01**	0.01

Further details of the Society's arrears position are set out in the Strategic Report on pages 31 to 32. Note 39 on page 168 describe the various forbearance measures offered by the Society to borrowers experiencing difficulties in meeting their repayments.

Disclosure requirements under CRD IV country-by-country reporting

The following information has been disclosed in this report in compliance with the Regulations of Article 89 of the Capital Requirements Directive IV (CRD IV) country-by-country reporting (CBCR). Yorkshire Building Society has a number of subsidiaries; these can be found in Note 10 of these accounts.

The principal activities of the Society can be found in the Strategic Report on page 16 and in Note 12.

All Group companies operate in the United Kingdom except Yorkshire Guernsey Ltd which is registered in Guernsey and is in the process of liquidation. Therefore total income and profit before tax shown in the Income Statement and corporation tax paid shown in the Statement of Cash Flows, as well as the average number of employees disclosed in Note 7, are related to the United Kingdom. No public subsidies were received in 2018.

Risk management

As a result of its normal business activities, the Society is exposed to a variety of risks, including credit, market, liquidity and funding, conduct, operational and business risk.

These are discussed in the Risk Management Report on pages 60 to 68.

The Society seeks to manage all the risks that arise from its activities and has established a number of committees and policies to do so.

Details of these are set out in the Risk Management Report on pages 60 to 68 and Corporate Governance Report on pages 43 to 52.

Charitable and political donations

In 2018 the Society made charitable donations of £1,404,372 (2017: £1,199,285) which included donations of £254,430 to End Youth Homelessness (2017: £293,352). In addition employees have contributed time for volunteering to the community of £283,968 (2017: £378,151) and the Society donated £30,000 (2017: £30,000) to the Yorkshire Building Society Charitable Foundation. No political donations were made during the year.

Colleagues

In 2019 we will continue to listen and respond to our colleagues needs' during a period of change, with a particular focus on practical tools and support for colleague wellbeing and resilience through change. There is a comprehensive internal communications structure to cascade relevant business information to employees throughout the organisation in an appropriate and timely way. The Society has an ongoing commitment to building a diverse workforce that genuinely represents the best interests of our colleagues and customers; and fostering an inclusive environment where everyone connected to the Society can contribute to its success. We recognise that people from different backgrounds and experiences enhance the way we work and make adjustments for colleagues wherever we possibly can.

Further details on colleague engagement can be found in the People experience section of the Strategic Report on pages 24 to 25.

Directors

The names of the directors of the Society who served during the year and to the date of this report, their roles and membership of Board Committees are described in the Corporate Governance Report on pages 43 to 52.

At the 2019 Annual General Meeting (AGM) Guy Bainbridge will stand for election and the other directors will retire and stand for re-election. Biographical details of all directors are outlined on pages 36 to 40.

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 Society's auditor is unaware, and each director has taken all the steps that they ought to have taken as a director in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

Directors' responsibilities in respect of preparation of the Annual Report and Accounts

The following statement, which should be read in conjunction with the statement of the Auditor's responsibilities on page 91, 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 Group and the Society for the financial year and of the state of the affairs of the Group and the Society 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 suitable accounting policies and apply them consistently.
- Make judgements and accounting estimates that are reasonable and prudent.
- State whether the Annual Accounts have been prepared in accordance with IFRS.
- Prepare the Annual Accounts on a going concern basis, unless it is inappropriate to presume that the Group will continue in business.

In addition to the Annual Report and Accounts and this report, the Act requires the directors to prepare, for each financial year, an Annual Business Statement 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 in respect of 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 Act.
- 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 PRA under the Financial Services Act 2012.

The directors have general responsibility for safeguarding the assets of the Society 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 are fair, balanced and understandable and provide the information necessary to assess the Society's performance, business model and strategy.

Going concern

The directors have confirmed that it is appropriate to adopt the going concern basis in the preparation of the financial statements in the Strategic Report on pages 34 to 35.

Auditor

Following an audit tender process details of which are contained in the Audit Committee report on pages 57 to 59, PricewaterhouseCoopers LLP have expressed their willingness to accept appointment as auditors, and the resolution is to be proposed at the AGM.

Approved By the Board of directors and signed on their behalf by

John Heaps
Chairman

27 February 2019

An ongoing commitment to building a diverse workforce that genuinely represents the best interests of our colleagues and customers; and fostering an inclusive environment where everyone connected to the Society can contribute to its success – this is our Diversity & Inclusion intent.

Corporate Governance Report 2018

Chairman's statement

I am pleased to present our Corporate Governance Report for 2018.

Our approach to Corporate Governance

In my role as Chairman I am responsible for leading the Board and ensuring that it maintains the highest standards of corporate governance whilst promoting the long-term sustainable success of the Society. We have a clear framework in place for the way in which the Board, the Society as a whole, and the other Group entities, operate to ensure we are working for the benefit of our current and future members, whilst taking into account all our other key stakeholders, in a legal, ethical and transparent manner.

Our approach to corporate governance is based upon the principles and provisions of the UK Corporate Governance Code (the Code) published by the Financial Reporting Council (FRC). Whilst the Code sets out the requirements for premium listed companies, the Society is expected by its regulator to have regard to the Code when establishing and reviewing its corporate governance arrangements. The Society is committed to the highest standards of corporate governance and, as such, aims to comply with the spirit of the Code wherever relevant to a building society. The following Corporate Governance Report sets out how the Society has applied the Code during the 2018 financial year based upon the 2016 version of the Code (which applies for this period).

Your Board

The Board composition has remained unchanged during 2018 which has provided the opportunity to consolidate and develop as a team following the changes to membership seen in 2017. There has been a significant focus on succession planning with the Board committed to ensuring that there is a robust plan in place to maintain an effective Board in the future. I am, therefore, pleased to confirm the appointment of Guy Bainbridge as a Non-executive Director to the Board with effect from 1 January 2019. Guy brings recent and relevant experience of the financial services sector to the Board and the Audit Committee. As well as strengthening the existing skills on the Board, Guy's appointment will assist future succession planning and continuity.

Looking forward

A new version of the Code was published in July 2018 with some far reaching changes which reflect the significant level of interest there continues to be in relation to corporate governance. Whilst the new Code did not apply until 1 January 2019, with reporting in the 2019 Annual Report and Accounts, the Board is committed to adopting the principles and provisions of the new Code where relevant to the Society as soon as is practicably possible.

We are proud of our mutual status and feel that the way we operate means we are already in a strong position in relation to the requirements of the new Code. We are not driven by the requirements of shareholders and do not have to balance their needs with providing excellent customer service in the way some established 'plc' banks do. Our principal focus is on our members who are also our customers and they are an important influence on the Board's approach to corporate governance.

I would now like to share with you some of the progress we have already made in relation to the key requirements of the new Code.

Investing in our culture

We have a strong, positive culture of doing the right thing by each other and our members. Warmth, friendliness and a passion for customer care are important traits to us, particularly in respect of our mutual status, and we fiercely protect them.

The new Code has made culture a key principle for the first time requiring the Board to ensure that the Society's culture is aligned with the purpose, values and strategy of the Society. This move reflects work already begun at the Society in early 2016, with our Board already responsible for and leading on the development of the Society's culture. The aim of the work is to enshrine existing strengths and encourage four particular themes of behaviour:

- Commercial focus and pace.
- Trust and empowerment.
- Working together.
- Open and honest conversations.

The Board will remain committed to the ongoing development of the Society's culture and will continue to assess and monitor progress in respect of these four themes.

Our principal focus is on our members who are also our customers and they are an important influence on the Board's approach to corporate governance.

Stakeholder engagement

The new Code expects that the Board understands the views of the Society's key stakeholders and takes account of their interests in discussions and decision making. In order to be a sustainable business, the Society is committed to being financially secure so our members can rely on us for the long-term. At the same time, we also want to ensure that we have a positive and meaningful impact on the communities we serve together with the wider society. As well as our customers, the Board's approach to corporate governance is influenced by and takes account of the interests of other key stakeholders, including customers, colleagues, suppliers, investors, regulators and our local communities.

We are reviewing our key stakeholders and our existing engagement mechanisms as part of our work in relation to the requirements of the new Code to ensure that there continues to be a strong stakeholder voice in our decision making. Details of some of our existing stakeholder engagement is set out in this report on page 52 and I look forward to bringing you further updates on our progress in the 2019 Annual Report and Accounts.

Workforce engagement

As part of the requirements for effective engagement with stakeholders, the new Code recommends using one, or a combination, of the following methods for workforce engagement: (i) a designated non-executive director, (ii) a director appointed from the workforce or (iii) a formal workforce advisory panel. An alternative effective method that delivers meaningful, regular dialogue with the workforce could also be used as long as the alternative method is explained.

When considering the options the Board has sought to ensure that there is a balance between those requirements, building on the excellent engagement processes we already have as a Society and ensuring that any action we take serves to provide valuable insights to the Board.

Following a detailed review, the Society has chosen to assign a designated Non-executive Director, which we aim to have completed shortly. This approach will ensure that the views of the workforce can be understood and considered more accurately and completely in Board discussions and decision making.

We have a strong, positive culture of doing the right thing by each other and our members. Warmth, friendliness and a passion for customer care are important traits to us, particularly in respect of our mutual status, and we fiercely protect them.

Whistleblowing

We are committed to ensuring all our colleagues are protected when making a whistleblowing report and to provide the mechanisms for making such reports. As such, we already have in place a robust Whistleblowing Policy which has been monitored by the Audit Committee in accordance with the 2016 version of the Code. The new Code includes a provision to ensure that there is a means for the workforce to raise concerns and that the Board should review this. The Board has, therefore, agreed that approval and oversight of our Whistleblowing Policy should be a matter reserved for the Board, with support from appropriate Board Committees in relation to specific issues which fall within their remit. For the 2019 Annual Report and Accounts an update on the oversight of our Whistleblowing Policy will be included in the Corporate Governance Report.

Conclusion

The revised Code reflects the significant interest which has been shown in the need for effective corporate governance and is just one of a number of developments in legislation, regulation and guidance over the last year. We are committed to ensuring we have the highest standards of corporate governance and during 2019 will continue to monitor all future developments, implementing changes to enhance our existing good practice if required.

John Heaps
Chairman

27 February 2019

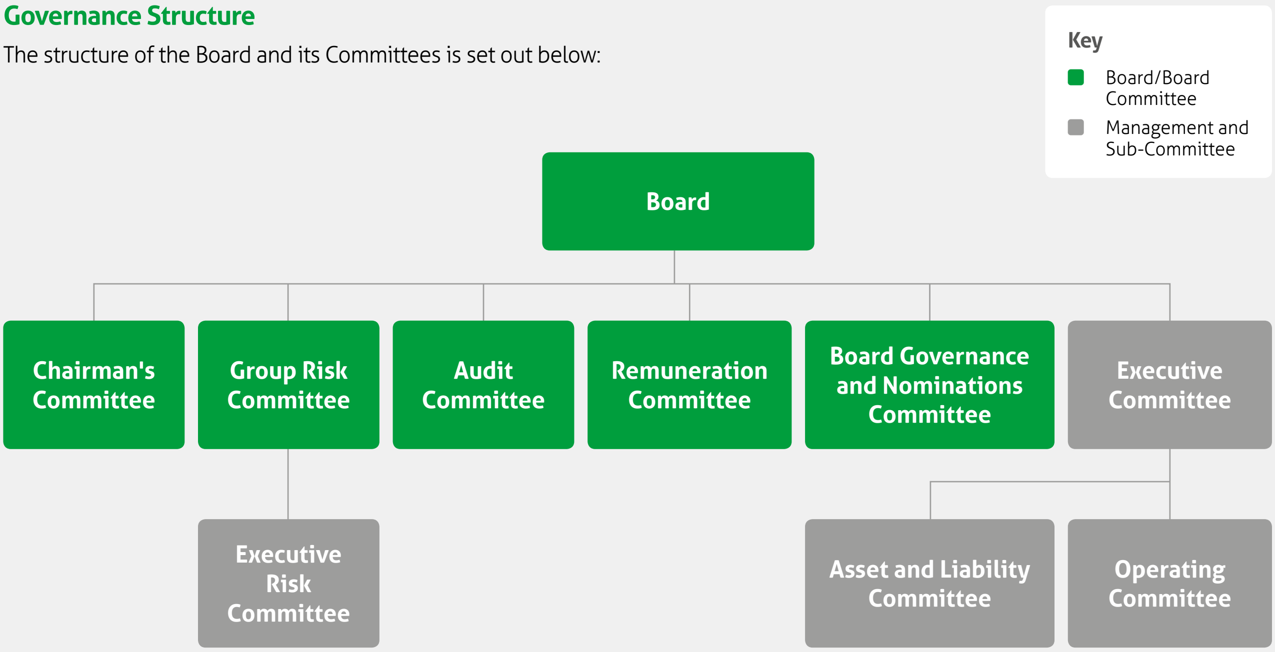
UK Corporate Governance Code

For the 2018 financial year, the Society has applied the Principles and complied with the Provisions of the UK Corporate Governance Code (available on the FRC's website frc.org.uk) to the extent they are relevant to building societies (according to the Building Societies Association Guidance available on their website at bsa.org.uk).

Leadership

Governance Structure

The structure of the Board and its Committees is set out below:



Directors of the Board

The roles of the Directors of the Board are set out in writing in role profiles and are summarised below.

Chairman

The Chairman is responsible for leadership of the Board and for ensuring that the Board acts effectively, promoting high standards of corporate governance. This includes the annual review of the performance of the Board, its Committees and individual directors, at least once a year, as well as identifying the ongoing development needs of the Board.

The Chairman is also responsible for leading the development of the Society's culture by the Board and setting the 'tone from the top'.

Vice Chair / Senior Independent Director

The Vice Chair, who is also the Society's Senior Independent Director, deputises for and provides support and guidance to the Chairman when appropriate. If required the Vice Chair will also act as an intermediary for the other directors and leads the performance evaluation of the Chair. As Senior Independent Director, the Vice Chair 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.

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 Leadership Team.

Chief Executive

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.

Executive directors

In addition to playing their part on the Board as a whole, the executive directors have responsibility for the day-to-day management of specific areas of the business and bringing the associated skills and knowledge to the Board.

In addition, under the Senior Managers Regime, Prescribed Responsibilities have been allocated where relevant to the Chief Executive and Chairman (as well as to other senior managers).

The roles of the Chairman and Chief Executive are held by different people.

In accordance with the new UK Corporate Governance Code published in 2018, a summary of the roles of the Chairman, Vice Chairman / Senior Independent Director and Chief Executive are published on the Society's website at ybs.co.uk/board.

Role of the Board

The Board is the governing body of the Society and is accountable to its members. It has formal Terms of Reference and its responsibilities include:

- Collective responsibility for the success, including the long-term success, of the Group and for acting in the best interests of the Society and its members as a whole (both current and future) and having regard to the interests of other customers, colleagues, suppliers and the wider community.
- Overall management of the Society within a framework of risk management which supports and directs financial security and fair outcomes.
- Maintenance of a sustainable business model and a strategy for the Society which is consistent with that model.
- Continuous development of the culture of the Society (including a culture of risk awareness, prudent management and openness with the regulators), ensuring that the desired values and behaviours are Board led.
- Oversight of the Society's operations ensuring:
    - Competent and prudent management.
    - Sound planning and risk management.
    - Adequate systems of internal control.
    - Adequate accounting and other records.
    - Compliance with statutory and regulatory obligations.
    - Adequate financial resources.
    - Fair treatment of all customers.
    - Appropriate risk aligned remuneration systems.
- Review of the performance of the Society in the light of the strategy and Corporate Plan and ensuring that any necessary corrective action is taken. An essential part of this exercise is the review of the Board management information.

Matters reserved to the Board

The Board keeps specific matters for its own approval, set out in the Schedule of Matters Reserved to the Board, which include the approval of:

- Annual Report and Accounts and the Interim Financial Statements.
- Strategic aims of the Society.
- Corporate Plan.
- Core strategies.
- Key policies.
- Society's Risk Appetite.
- Appointment of executive directors, non-executive directors and chief officers.
- Any matter which must be approved by the Board under legislation and the Society's Rules.

The Board delegates the implementation of the strategy and the day-to-day management of the Society to the Leadership Team which is led by the Chief Executive. It delegates some other responsibilities to Board and Management Committees as set out in the Committees' Terms of Reference.

A copy of the Board's Terms of Reference and Matters Reserved to the Board are available on request from the Group Secretary or can be found on the Society's website at ybs.co.uk/board.

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 Board has established the following Committees:

- Audit Committee.
- Board Governance and Nominations Committee.
- Group Risk Committee.
- Remuneration Committee.

Details including membership and responsibilities of each of the Committees are contained in the individual Committee reports on pages 53 to 84.

The Board has also established a Chairman's Committee to consider any matter which the Board specifically delegates to it. The members of the Committee are:

- Chairman of the Board -John Heaps.
- Vice Chairman - Mark Pain.
- Chief Executive - Mike Regnier.

Other directors may be co-opted onto the Committee, as agreed by the Board, to consider specific matters.

The Terms of Reference of the Audit, Group Risk, Remuneration and Board Governance and Nominations Committees are available on request from the Group Secretary or on the Society's website at 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 Board directors unless it is considered inappropriate to do so.

Management Committees

The Society has a number of Management Committees which have a delegated mandate from the Board or appropriate Board Committee, including:

Executive Committee (ExCo)

The role of ExCo is to oversee and direct the management of all aspects of the Society with the specific aim of delivering the Society's purpose, vision, values, strategies and operating plan. Its membership is made up of all the chief officers, including executive directors.

Operating Committee (OpCo)

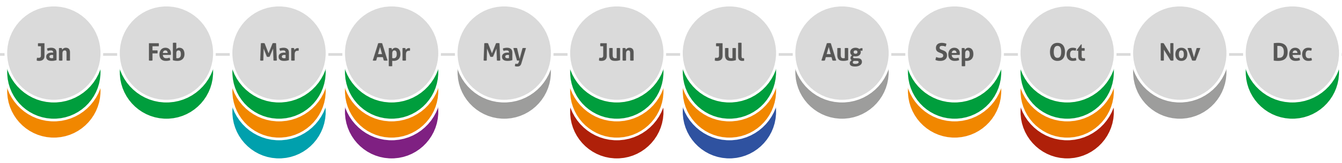
OpCo is a sub committee of ExCo which has delegated authority to take Group level operational decisions with a specific focus upon trading, service, people, cost and risk. Its membership is made up of the members of the Executive Committee and the Leadership Team.

The Society also has an Executive Risk Committee. Further details of which can be found in the Risk Management Report on page 62.

Board meetings and activities

The Board held nine scheduled meetings in 2018. It has also held two strategy sessions outside of the usual Board meeting schedule to provide focus on the development of the Society's strategy.

The following diagram sets out the timing of the Board meetings and other key Board activities which took place during 2018:



Key

- Board Meetings
- Full Year Results
- Board Strategy Session
- No Board Meeting
- Board Training Sessions*
- Annual General Meeting
- Interim Financial Results

*** Training Session Topics**

- Artificial Intelligence
- Strategy and Purpose
- FinTech
- Culture
- Diversity and Inclusion
- Innovation
- Balance Sheet Management
- IRB

Board and Committee attendance record 2018

The table below sets out the directors during 2018 and their attendance record at scheduled Board and relevant Board Committee meetings. The figure in brackets indicates the number of meetings that the director was eligible to attend as a member of the Board and relevant Committee(s) during 2018. The Chairman and Chief Executive usually attend all Board Committee meetings at the invitation of each Committee Chair. The Chief Risk Officer attends all Board meetings at the invitation of the Chairman.

Director	Board	Board Committees				
		Chairman's	Audit	Board Governance and Nominations	Remuneration	Group Risk
John Heaps - Chairman	9 (9)	2 (2)	–	4 (4)	7 (7)	–
Neeta Atkar - Non-executive Director	9 (9)	–	5 (5)	–	–	5 (5)
Alison Hutchinson - Non-executive Director	8 (9)	–	–	4 (4)	7 (7)	5 (5)
Gordon Ireland - Non-executive Director	9 (9)	1 (1)	5 (5)	–	–	5 (5)
Alasdair Lenman - Chief Finance Officer and Executive Director	9 (9)	1 (1)	–	–	–	–
Mark Pain - Vice Chairman / Senior Independent Director	9 (9)	2 (2)	5 (5)	4 (4)	–	3 (5)
Guy Parsons - Non-executive Director	9 (9)	–	–	–	7 (7)	–
Mike Regnier - Chief Executive Officer and Executive Director	9 (9)	2 (2)	–	–	–	–
Stephen White - Chief Operating Officer and Executive Director	9 (9)	–	–	–	–	–

Where a director is unable to attend a meeting they will receive the papers and provide comments on the agenda items to the Chairman prior to the meeting.

Written resolutions

If an urgent decision is required outside of the formal Board meeting schedule, a decision can be taken in writing if there is unanimous approval from all directors (or all members in the case of a Committee), for example the appointment of a new non-executive director. The written resolution procedure is set out in the Society's Rules and in 2018 was used to conduct business twice by the Board and on one occasion each by the Remuneration Committee and the Board Governance and Nominations Committee.

Board agenda items

The key matters considered by the Board are planned on a rolling 12 month basis with additional items included throughout the year as appropriate. At each Board meeting, the Board receives:

- A comprehensive management information pack covering business performance including financial and non financial information.
- Scorecards to monitor progress against key performance indicators (KPIs) (including customer and people metrics) and the business risk appetite.
- A report on the external and competitive environment, including ongoing monitoring of a range of potential economic indicators and, where relevant, the potential impact arising from the vote to exit the European Union.
- A report from the Chief Executive highlighting the current trading and financial performance and any other relevant matters he wishes to bring to the attention of the Board.
- A report from the Chairman, including an update on key issues and events relating to the Society.
- Minutes of Board Committee meetings held since the previous Board meeting and verbal updates from the Chairs of Board Committees on the main issues discussed and matters agreed to ensure that all Board members are aware of the key discussions and decisions made by the Committees.
- Minutes of the monthly meetings of the Executive Committee.

Where appropriate, the relevant executive director or chief officer provides a verbal update to the Board on the particular aspects of performance and highlights any emerging issues.

In addition to the above, Board agendas also include the following at the appropriate scheduled meeting(s) in the year:

- Bi-annual reports from the Chairman of the Board of Accord Mortgages Limited, our intermediary lending subsidiary and the minutes of each quarterly meeting.
- A quarterly report on risk including performance against the agreed risk appetite and details of compliance / monitoring reports undertaken.
- A quarterly report on the progress of the key strategic priorities.
- Items for decision and key matters which need to be debated. For example, in 2018 the matters that the Board considered included:
  - Approval of the 2017 Annual Report and Accounts and the 2018 Interim Financial Statements.
  - Approval of the appointment of an external auditor following a competitive tender process.
  - Continued implementation of the distribution strategy.
  - Interest rates and the response to the Bank of England Bank rate change.
  - Management of conduct and prudential risk including regulatory dialogue and correspondence.
  - Results of the annual colleague survey.
  - Updates in relation to the management of cyber security.
  - General Data Protection Regulation (GDPR).
  - Senior executive succession planning.
  - Non-executive director and chief officer appointments.
  - Updates on the approach to culture and diversity.
  - Consideration of the Society's risk position and its management.
  - Internal Ratings Based (IRB) application process.
  - Approval of the Groups Risk Appetite and ongoing monitoring of adherence.
  - Approval of the Modern Slavery Act Statement.
  - Changes to the UK Corporate Governance Code.
  - Approval of the 2018 Internal Capital Adequacy Assessment Process (ICAAP).
  - Approval of the 2018 Internal Liquidity Adequacy Assessment Process (ILAAP).
  - Review of the Society's position in relation to cyber security and operational resilience.

Where an item requires further detailed consideration then the Board may delegate this to the appropriate Board Committee.

The Board holds two separate strategy sessions each year and in 2018 these sessions undertook detailed reviews of a number of matters including:

- The Corporate Plan.
- Retail strategy: customer, proposition and distribution.
- Digital and IT strategy.
- People Strategy.

Effectiveness

Independence

The Board has reviewed and is satisfied that all of the non-executive directors are independent based upon the guidance set out in the Code, including the Chairman on appointment.

Composition, diversity and succession planning

As at 31 December 2018, the Board is comprised of:

Chairman

Non-executive directors

Executive directors

77.8% men

22.2% women

The size and composition of the Board and the Board Committees are kept under constant review by the Chairman and the Board Governance and Nominations Committee. This is to ensure that there is adequate and orderly 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 Society's activities and to populate and chair the Board Committees.

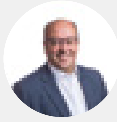
The Board gives consideration to all aspects of diversity when reviewing its composition and in identifying suitable candidates for the position of director.

Further details in relation to diversity and inclusion can be found in the Board Governance and Nominations Committee Report on pages 54 to 55.

The Board seeks to maintain a balance between experience and the benefits of bringing fresh perspectives into decision making as part of its overall approach to succession planning.

The table below sets out the year of appointment of the Chairman and each of the non-executive directors.

Guy Parsons
Non-executive Director
Appointed 2013

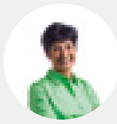


Mark Pain
Non-executive Director
Appointed 2013

John Heaps
Chairman
Appointed 2014

Alison Hutchison
Non-executive Director
Appointed 2015

Gordon Ireland
Non-executive Director
Appointed 2015



Neeta Atkar
Non-executive Director
Appointed 2017

Further details on succession planning can be found in the Board Governance and Nominations Committee Report on page 54.

Changes to the Board

During 2018 there were no changes to the Board.

Following a recruitment process undertaken during 2018, and taking account of the current Board Composition and Succession Plan, the Board appointed a new Non-executive Director, Guy Bainbridge, with effect from 1 January 2019.

Further details on the recruitment process can be found in the Board Governance and Nominations Committee Report on page 54.

Performance evaluation

Board and Committee evaluation

The Board undertakes a formal review of its performance, that of its Committees and individual directors on an annual basis. In accordance with the Code, which recommends the evaluation of the Board to be externally facilitated every three years, an external effectiveness review was carried out by SCT Consultants (SCT) in 2017 and reported in the Annual Report and Accounts 2017. Following the external evaluation in 2017, it was agreed that an internal evaluation would be completed in 2018. The outcomes of the review were presented to the January 2019 Board meeting.

The table below sets out the progress made against the themes identified from the 2017 external evaluation, progress made during 2018 and the subsequent themes arising from the 2018 internal evaluation together with next steps.

Themes for 2017	Progress made	Themes for 2018 and next steps
Composition		
Further strengthen the composition of the Board to bring additional expertise.	Following a robust recruitment process Guy Bainbridge was appointed to the Board with effect from 1 January 2019 bringing recent and relevant experience from the financial services sector.	Continue to challenge and identify opportunities to further strengthen work in relation to the diversity of the Board, with ongoing monitoring through the Board Governance and Nominations Committee.
Ensure that the Board has a comprehensive succession plan.	Good progress continues to be made with both Board and senior management succession planning. The Board Governance and Nominations Committee has carried out a review of succession planning arrangements at each of its meetings in 2018. Further details are set out in the Committee's Report.	Ensure that succession plans for executive and non-executive directors remain robust with ongoing monitoring through the Board Governance and Nominations Committee.
Engagement		
Seek to identify additional ways of bringing the members' and customers' voice into the boardroom.	As a mutual organisation run for the benefit of our members, our customers are at the heart of our decision-making. Ensuring the voice of our members and customers is brought into the Boardroom remains an ongoing priority and this is supported through a quarterly report on customer and member feedback. In addition, every paper considered by the Board or a Committee sets out any implications the recommendations will have for our members and customers.	Continue to ensure opportunities are available for non-executive director's involvement in member engagement.
Culture		
Continue to identify the fundamental drivers of culture within the Society.	Culture has remained a strong focus of attention during 2018 with the Board responsible for and leading its development. This work will continue in 2019 with the Board assessing and monitoring progress.	Whilst there were no specific themes arising relating to culture during 2018, work will continue in 2019 with the Board assessing and monitoring progress.
Meetings		
Review the format of all Board and Committee papers to ensure that they allow directors to make informed decisions and that agendas are appropriately managed.	A new internal Corporate Governance Framework was launched in May 2018 which contains guidance on the content of minutes as well as a revised Board and Committee paper template. The new Framework ensures a consistent approach and supports improved decision making.	Whilst there were no specific themes arising in relation to meeting administration in 2018, the information provided to the Board will remain under ongoing review to ensure it enables the Board to continue to make informed decisions.
Investment appraisal process for major investments should continue to be improved.	A review of the process has been completed and an update on investment appraisals has been incorporated in monthly reporting.	

Further details on the evaluation process for the Board and its Committees in 2018 can be found in the Board Governance and Nominations Committee Report on pages 53 to 56.

Individual director evaluation

Individual non-executive director evaluations are completed annually on a one-to-one basis by the Chairman with a half year progress review. Executive directors are evaluated by the Chief Executive against agreed performance targets on an annual basis.

The Vice Chairman and Senior Independent Director leads the Board's evaluation of the Chairman's performance. The results of the Chairman's evaluation were discussed at the January 2019 Board meeting and it was concluded that he continued to provide strong and effective leadership to the Board.

Conflicts of interest

The Board has a Conflict of Interest Policy which sets out procedures for regularly reviewing and, if appropriate, authorising any conflicts or potential conflicts. The Policy applies to executive directors, non-executive directors and chief officers.

During the term of their directorship with the Society, any external position that a director is proposing to take must first be referred to, and if appropriate approved by, the Board to enable any impact on time commitment or any potential conflict of interest to be considered.

The Board maintains a Register of Interests which records any conflicts or potential conflicts which may arise and is monitored through the Board Governance and Nominations Committee.

Time commitment

One of the criteria which the Board takes into consideration when recruiting a non-executive director, including the Chairman, is their ability to have sufficient time to undertake the role. The letters of appointment for the non-executive directors set out the expected time commitment, taking into account any Committee or other roles to which they are appointed. Copies of the letters of appointment of each of the non-executive directors are available for inspection on request from the Group Secretary.

The time commitment of individual non-executive directors may be subject to change dependent on any additional Committee membership, chair or other roles undertaken in the future. The time commitment for a Committee Chair is expected to be significantly greater than that of Committee members. The overall time commitment of all directors will also increase, inevitably, when a significant transaction or development is being considered.

Time commitment is also taken into account when the Board reviews and authorises any additional external appointments, together with the requirements of the Capital Requirements Directive IV to confirm that no director holds more than the prescribed number of directorships. There have been no significant changes to the time commitment of the Chairman during the year.

The new UK Corporate Governance Code requires the Board to take into account demands on directors' time as part of the appointment process and also requires that Board approval is provided for any additional external appointments. Whilst the requirements reflect existing Society processes, in order to ensure that the requirements of the new Code are fully reflected in advance of the implementation on 1 January 2019, specific reference has been incorporated into the Board Governance and Nominations Committee Terms of Reference and to the non-executive directors letter of appointment. In addition, the non-executive director annual one-to-one reviews with the Chairman incorporate a specific consideration of time commitment.

Induction and development

The Chairman, supported by the Group Secretary, ensures that all non-executive directors receive a comprehensive tailored induction programme on appointment which provides an introduction to the Society's business and the regulatory environment. The progress of the induction programme is monitored by the Board Governance and Nominations Committee until completion.

The Chief Executive ensures that a tailored induction programme is provided for all executive directors.

The Board has a Training and Development Plan which is agreed on an annual basis by the Board Governance and Nominations Committee. As well as addressing ongoing requirements to ensure directors update their skills, knowledge and familiarity with the Society, the Training and Development Plan is also tailored to the Society's future strategy as well as potential impacts from the external and competitive environment.

Training and development includes input from external presenters, internal presentations by specialists within the Society, training courses, visits to branches and operational areas and attendance at member events.

Individual training requirements for non-executive directors are discussed as part of the performance evaluation process with the outcomes documented in a personal development plan. An annual training record for each non-executive director is maintained by the Group Secretary.

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, Simon Waite, who is responsible for ensuring that Board procedures are complied with and for advising the Board, through the Chairman, on governance matters.

Accountability

The Board is responsible for the systems of internal control. The Audit Committee Report on pages 57 to 59 sets out the internal control framework which is designed to safeguard member and Society assets and to facilitate the effectiveness and efficiency of operations. This 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 Society and ensuring that there is a robust system for risk management in place to ensure the security of members' funds.

The Society's risk management framework is set out in the Risk Management Report on pages 60 to 62.

The Board has delegated to the Audit Committee oversight of the relationship with the external auditor to ensure that they remain independent, objective and effective.

Further details can be found in the Audit Committee Report on page 59.

Remuneration

The Board has delegated to the Remuneration Committee the setting of policy on remuneration for the Chairman, the executive directors and other members of the Executive Committee and the Leadership Team.

A review of its activities and the remuneration policy is set out in the Directors' Remuneration Report on pages 69 to 84.

The approval of non-executive director remuneration is a matter reserved to the Board and is considered by the executive directors and Chairman only.

Relations with members

Member engagement

The Society's owners are its individual members who are made up of savers and borrowers, subject to a small number of exceptions. This is different to the shareholders of a listed company, whose owners include institutional shareholders. The vast majority of the Society's customers are its members, and the Society encourages feedback from them on any aspect of the Society's activities. Members have the opportunity to feed back at 'Your Time to Talk' events. These events are held at different locations across the UK and are an opportunity for members to meet the leadership team and branch colleagues to let them know what is important to them. In 2019, we plan to hold more events across the country which local members will be invited to.

The Society also operates 'My Voice', our online research community. 'My Voice' gives customers the opportunity to feedback on a variety of topics that really matter through regular collaborative discussions, quick polls and surveys. It enables the Society to have a dialogue with our customers about what they want, what we could do better and what they want us to keep doing and to help shape the future of the Society.

In addition, a monthly customer perception tracker with over 2,500 customers across all Yorkshire Building Society brands is undertaken to monitor the strength of the relationship customers have with the Society. The results provide a key performance indicator of customer advocacy (called the Net Promoter Score) which is monitored by the 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 Society and how we can improve our products and services.

Annual General Meeting (AGM)

At the AGM, presentations on the previous year's trading, financial performance and on future plans are given by key representatives of the Society.

The meeting provides an opportunity for members to question the Chairman, Chief Executive and other executive and non-executive 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. A separate resolution is proposed on each matter, including a resolution on the Annual Report and Accounts.

Eligible members are asked to vote on a number of resolutions and in particular are entitled to vote on the election and re-election of all directors in accordance with the Society's Rules.

In accordance with the requirements of the new UK Corporate Governance Code, published in July 2018, the Society has a process in place should there be 20% or more of votes cast against a Board recommendation for a resolution.

Relations with stakeholders

Relations with other investors

The Society also places great importance on 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 meetings with external stakeholders in order to provide updates on the Society's performance and respond to market queries.

Relations with our colleagues

Our current approach to colleague engagement is set out on pages 24 to 25 of the Strategic Report. As set out in the Chairman's Statement introducing this report, the Society has chosen to assign a designated Non-executive Director in relation to workforce engagement. This will build on the strong existing mechanisms we have in place and ensure that the views of our colleagues are understood and considered more accurately and completely in decision making.

Relations with other stakeholder groups

The Board recognises the importance of all the Society's stakeholders and seeks to ensure that their views are taken into account as part of decision making. This includes:

- Suppliers.
- Community Groups.
- Member of Parliament (MPs).
- Media.
- Investors.
- Mortgage Brokers.
- Regulators.

During 2019 we will be reviewing our key stakeholders and existing engagement measures to take account of the new UK Corporate Governance Code.

In summary, I believe the Society operates robust governance arrangements which are aligned with the requirements of the Code, as far as applicable to a building society. Our commitment to the highest standards in corporate governance will continue in 2019 as we seek to ensure we are aligned with the requirements of the new Code published in 2018.

On behalf of the Board

John Heaps
Chairman

27 February 2019

Board Governance and Nominations Committee Report

As Chair of the Board Governance and Nominations Committee, I am pleased to present the Committee's report on its work during 2018.

There have been significant developments in corporate governance over the last year, not least the publication of the new UK Corporate Governance Code in July 2018, and the Committee has once again had a key role in ensuring that your Board and the Society as a whole continue to meet the highest standards of corporate governance.

Membership and attendees

The Board Governance and Nominations Committee is appointed by the Board and comprises three non-executive directors:

- John Heaps (Chair of the Committee)
- Mark Pain
- Alison Hutchinson

Attendance at meetings during 2018 is shown on page 47 and information on the skills, qualifications and experience of directors can be found in the biographies on pages 36 to 40 of the Annual Report and Accounts.

Only members of the Committee have the right to attend Committee meetings, however, other individuals may be invited to attend for all or part of the meeting, as and when appropriate. This includes the Chief Executive and Chief People Officer who are usually invited by the Chair to attend each meeting.

Roles and responsibilities

The Committee is responsible for:

- Reviewing the structure, size and composition of the Board including the required skills, knowledge, experience and diversity and making recommendations on any changes to the Board or to the membership of Board Committees.
- Considering the succession planning for directors and other senior executives (unless this is considered by all of the non-executive directors in respect of executive directors) taking into account the challenges and opportunities facing the Society and the skills and expertise needed on the Board in the future.
- Leading the appointment process for director roles for approval by the Board.
- Approving the Directors' Conflicts of Interest Policy and monitoring any potential conflicts.
- Approving the Board Diversity Statement.
- Reviewing the Training and Development Plan for the Board.
- Reviewing other governance arrangements and making recommendations to the Board, as appropriate.
- Monitoring developments in relation to corporate governance issues and where appropriate reviewing the potential impact on the Society and making any recommendations to be implemented.
- Making recommendations to the Board in respect of the re-election of directors and ongoing independence of non-executive directors.
- Making recommendations to the Board in respect of the process for Board and Committee annual evaluations.

In 2018 the Committee met four times to discuss matters within its Terms of Reference. The Committee's terms of reference can be found on the Your Society section of our website at ybs.co.uk/committees.

Non-executive director recruitment

The Committee is responsible for leading the recruitment process for non-executive directors which is set out below.

Role requirements

- Development of a role specification for the position which sets out the skills, knowledge, experience and other attributes required for the role.
- The role specification takes account of the existing skills, future composition and succession requirements and the Board's policy on diversity.

Search process

- Appointment of an external search agency to develop a list of candidates for consideration by the Committee based upon the requirements of the role specification.
- Search agencies will be engaged who have signed up to the Standard Voluntary Code of Conduct for Executive Search Agencies.

Interviews and appointment

- Interviews by a selection panel with short listed candidates against the agreed person specification.
- Subject to relevant checks, recommendation to the Board to appoint the preferred candidate.

During 2018 a recruitment process was undertaken with a view to appointing an additional non-executive director to the Board to strengthen the existing skills and experience in relation to retail financial services, in particular retail banking and to support succession planning for future years.

Zygos Partnership search agency, acquired by Russell Reynolds in December 2017, were engaged to assist in the above process. Both the Zygos Partnership and Russell Reynolds are signatories to the Voluntary Code of Conduct for Executive Search Firms in Board Appointments. Zygos Partnership have previously assisted the Society in the recruitment of non-executive directors, Mark Pain and Guy Parsons but otherwise has no other connection with the Society.

Following a robust process taking account of the Board's commitment to diversity and the requirements for the current and future composition of the Board, the appointment of Guy Bainbridge as a Non-executive Director was agreed with effect from 1 January 2019.

Executive director recruitment

There were no changes in relation to the executive directors during 2018, therefore, a recruitment process was not required.

Succession planning

Non-executive director succession planning

The Board Governance and Nominations Committee reviews the Board Skills Matrix each year, which sets out a schedule of desired skills and experience for the overall composition of the Board taking into account strategic plans. Each executive and non-executive director completes a self-evaluation of their personal level of experience against each skill taking into account experience gained both inside and outside of the Society.

The Committee also reviews succession planning at each meeting, taking into account the:

- Non-executive director succession timeline, including anticipated retirement dates.
- Continued independence of each non-executive director.
- Impact of future changes on Board Committee membership.
- Board Diversity Statement and the importance of maintaining a diverse Board.

This approach enables the Committee to identify and address any future potential issues in Board composition and to put in place forward planning for recruitment, ensuring that the skills and experience required of the successful candidate have been identified.

As part of its scheduled meeting in March 2018, the Committee held a strategy session which included an in depth assessment of the current position in relation to succession planning and future activities required.

Executive director and senior management succession planning

The Society has a Talent Management Strategy which aims to create a consistent and robust approach to succession planning, including the executive director roles. The members of the Executive Committee are fully engaged in succession planning for their roles, their direct report roles and for considering key person risk. Talent reviews are conducted twice yearly based upon a review of existing data, identification of development needs, Talent Forums and individual data.

Executive director succession planning was considered as part of the strategy session on succession planning in March 2018.

Details of the Society's directors and chief officers are set out on pages 36 to 40.

Diversity and inclusion

The Board's statement on diversity is reviewed on an annual basis in conjunction with the Society's Diversity and Inclusion Manager. Following the 2018 review, the statement was updated to reflect the new UK Corporate Governance Code and approved by the Board in December 2018 on the recommendation of the Board Governance and Nominations Committee.

The Society's diversity and inclusion ambition is to foster an inclusive environment where everyone can contribute to the Society's success. The Board believes investing in this culture is fundamental in ensuring it attains its aspirations as a Society. The importance of having a diverse Board and workforce generally is recognised not least because it reflects the make-up of our membership and the wider community but it also makes commercial sense, being the governing body of the Society. The Board places great emphasis on ensuring that its composition will reflect a comprehensive range of differing skills, experience and perspectives, whilst supporting good governance through different insights, challenge and dynamics. Nevertheless, it continues to adopt the principle that all appointments should be based on merit and the skills and experience an individual can bring to the Board as a whole.

The Board Diversity Statement also notes the commitment to investing in the senior talent pipeline, particularly nurturing black, Asian and minority ethnic (BAME) and female talent and delivering tailored leadership development and robust succession planning. This is underpinned by the Board's commitment to developing an inclusive culture while undertaking appropriate training to support delivery.

The Board Governance and Nominations Committee will continue to review the position in relation to the Board Diversity Statement and report annually on the agreed objectives and the progress against those objectives, together with other initiatives to promote diversity.

The Board previously approved an aspirational target to have 25% women directors by the end of 2015. This aspirational target was reviewed by the Committee in November 2016 following which the Board approved a recommendation to increase it to 30% women directors in the medium term to bring it more into line with the latest Hampton-Alexander Review recommendation of 33% of women on the boards of FTSE 350 companies by 2020. The Committee also agreed that search and specialist recruitment agencies for director appointments should only be engaged if they have signed up to the Standard Voluntary Code of Conduct for Executive Search Agencies, with a preference to use those signed up to the Enhanced Code.

The percentage of women on the Society's Board at 31 December 2018 was 22% (2017: 22%). The revised aspirational target was therefore not met during 2018.

> The Society's diversity and inclusion ambition is to foster an inclusive environment where everyone can contribute to the Society's success.

In keeping with the Society's focus on diversity, by way of further information there were the following percentages of women colleagues at the Society as at 31 December 2018 (and for comparison 2017):

Executive Committee*

12.5% 31 December 2018 | 17% 31 December 2017

Senior Managers**

43% 31 December 2018 | 40% 31 December 2017

All colleagues

65% 31 December 2018 | 65% 31 December 2017

* The Society's first layer of management below the Board, in accordance with the UK Corporate Governance Code.

** Our senior managers are our colleagues in roles Grade E or above. This figure is reported for the first time in 2018 as part of our commitments in relation to the Women in Finance Charter

As part of the Board and the Society's commitment to gender diversity, the Society signed HM Treasury's Women in Finance Charter in 2018 and by doing so made a commitment to improve gender balance, particularly at senior levels in the business. The Charter includes a number of commitments that firms agree to sign up to that will lead to greater diversity over time. This includes a commitment of 50/50 for gender at what the Charter defines as 'senior management' level (with a floor of 40% and a ceiling of 60%) We are, therefore, pleased to report these figures for the first time in this report which are shown in the diagram above.

Progress in 2018

Creating a workforce with genuine diversity of thought and experience is really important to the Society, as is being an inclusive employer. However, gender is just one element of this and we continue to pursue our strategy of creating an inclusive environment where all colleagues can contribute and succeed.

There has been significant progress towards achieving our overall diversity and inclusion ambitions. The Society has been working with three key external partners:

- **The National Centre for Diversity** in achieving the **Investors in Diversity Accreditation**;
- **Creating Inclusive Cultures** to share best practice with a range of organisations cross sector (social mobility programmes in particular); and
- **Inclusive Companies** recently achieving a **Top 50 ranking of Inclusive Companies in the UK**.

Key deliverables over the last 12 months have focused on three themes which were awareness, identity and inclusion. The following milestones have been achieved in 2018:

- Launch of the Society's Decency and Fairness Campaign sponsored by the Chief Executive, Mike Regnier.
- Unconscious Bias workshops attended by 500 colleagues, including the Board.
- International Women's Day Event held at the Society's offices in Leeds.
- Working in partnership with the Baroness Warsi Foundation (Social Mobility) engaging students from Kings Academy in Bradford and running a 'mock assessment centre' experience for them to enhance employability skills.
- Working in partnership with Creating Inclusive Cultures – (Social Mobility), engaging students from schools in Leeds – resulting in students presenting their 'the Ideal workplace' presentation to business leaders and experiencing a simulated 'Boardroom' environment.
- Support to Pride events including co-sponsor of Bradford Pride and hosting a stall at and support for Leeds Pride.
- Decency and Fairness 'Drop In' sessions hosted at our Leeds and Bradford offices.
- Activities hosted across all sites for National Inclusion Week on all aspects of celebrating difference, including external speakers from 'End Youth Homelessness', 'Windrush', 'Friends of Dorothy', transgender awareness, local deaf community associations and a keynote address from Paralympian Karen Darke.
- Decency and Fairness Conference held in November where businesses from across the North of England were invited to talk about how we can work together to build inclusive workplaces.

Board and Committee evaluations

The Committee Terms of Reference require it to consider and make a recommendation to the Board on the process to be undertaken for the annual Board and Committee evaluation process. Taking into account the requirements of the UK Corporate Governance Code to undertake an external evaluation every three years, which for the Board was last completed in 2017, for 2018 the Committee recommended that:

- An internal questionnaire based evaluation be completed for the Board, from which an action plan would be developed based on any key themes arising.
- An annual review of each Committee be completed, aligned to the timing and approach of the Board evaluation, to ensure a consistency of approach and enable a comparison of outcomes.

Further detail on the outcomes from the Board evaluation process is provided on pages 49 to 51.

BGNC evaluation

The Committee undertakes an annual review of its effectiveness in accordance with its Terms of Reference and good practice. The 2018 review was completed in accordance with the process set out above. The outcomes of the review were discussed at the Committee's meeting in November 2018 and it was noted that the Committee continued to be effective.

A number of themes were considered in relation to:

- Induction and training specific to the Committee's role noting that the Group Secretary's induction session for directors included the role of Committees and that ongoing Committee training was incorporated in the Board Training Plan.
- The widening remit of the Committee, as a result of which it was agreed it would be important to develop a more formal link between the role of the Committee and the Society's People Plan.

Board governance

The Committee also has a key role in ensuring the Board is able to discharge its responsibilities in relation to corporate governance. It maintains an ongoing oversight of forthcoming governance developments in relation to corporate governance and their potential impact on the Society together with proposed actions for recommendation to the Board. In particular, during 2018 the Committee has had an important role in monitoring the developments in relation to the new UK Corporate Governance Code, including reviewing and recommending key actions to the Board for approval as part of the implementation of the new Code.

Further details on the Committee's role in relation to conflicts of interest and induction and development can be found in the Corporate Governance Report on page 51.

The Committee's priorities for 2019 will be to embed the changes agreed as a result of the new UK Corporate Governance Code, including its role in relation to diversity and inclusion, succession planning and to continue to ensure that the Society operates to the highest standards of corporate governance.

On behalf of the Board

John Heaps
Chair of the Board Governance and Nominations Committee

27 February 2019

Audit Committee Report

Membership and attendees

The Audit Committee is appointed by the Board and in 2018 comprised three independent non-executive directors. Membership and attendance during 2018 is shown on page 47.

Neeta Atkar, Gordon Ireland and I have recent and relevant financial experience gained through either current or previous roles, other current non-executive directorships, and our relevant qualifications. The Committee as a whole has appropriate, relevant competence of the sector in which the Society operates. Guy Bainbridge was appointed to the Board as a Non-executive Director and as a member of the Audit Committee with effect from 1 January 2019. Guy also brings recent and relevant experience of the financial services sector to the Committee.

More information on the skills, qualifications and experience of the Committee members can be found in the Directors' Biographies on pages 36 to 40.

During the year the Committee met five times. Where appropriate, meetings began with a private session between the executive Leadership Team and the committee members, and concluded with a private session between the Committee members and both the internal and external auditors.

The Committee invites the Chief Executive, Chief Finance Officer, Chief Internal Audit Officer and the external auditor to attend the meetings along with other members of the Leadership Team where appropriate.

Roles and responsibilities

The roles and responsibilities of the Committee are set out in its Terms of Reference, which are reviewed and approved by both the Committee and the Board each year. They can be found in the 'Inside Your Society' section of our website ybs.co.uk/your-society/inside-your-society/corporate-governance/committees.html.

Following the publication of the revised UK Corporate Governance Code (the Code) in July 2018, the Committee updated its Terms of Reference to reflect the new Code provision which makes oversight of the Society's arrangements for its employees and contractors to raise concerns in confidence (i.e. 'whistleblowing'), a Board responsibility for the first time. The Board has, therefore, agreed that approval and oversight of such matters should be reserved to the Board, with support from appropriate Board Committees in relation to specific issues which fall within their remit. From the 2019 Annual Report and Accounts onward, updates on these matters will be included in the Corporate Governance Report.

Financial reporting issues and judgements

Our role in monitoring financial reporting is key to ensuring that all of our stakeholders maintain their trust in the Society. We are responsible for ensuring that the key accounting policies and key judgements supporting our financial statements are appropriate. We have been supported by our external auditor, Deloitte LLP (Deloitte), in this endeavour.

During 2018, the Leadership Team reviewed changes to accounting standards and related guidance including IFRS9, IFRS15 and IFRS16. The introduction of IFRS9 led to changes to the accounting policies, which the Committee reviewed and approved. No other material changes to accounting policies were made during the year.

We considered the following significant issues during 2018:

- **IFRS9**. The IFRS9 accounting standard sets out the requirements for the classification and measurement of financial assets, financial liabilities and certain contracts to buy or sell non-financial items. It includes requirements on impairment and hedge accounting. The Committee has overseen the transition to meeting IFRS9 requirements, including the impacts in respect of the treatment of impairment and reserves, and Leadership Team activity comparing the Society's intended approach with the approaches of industry peers. The Committee is satisfied with the actions taken by the Leadership Team and will continue to oversee related disclosures.
- **Loan loss provisions**. The Leadership Team analysed the outputs of the loan loss provisioning models. Changes to the loan loss provisioning approach were also made to reflect the transition to IFRS 9. The Committee reviewed the results of the Leadership Team's industry peer analysis, along with challenging the approaches and key assumptions adopted by the Leadership Team. The most significant assumption relates to the economic scenarios applied and their associated probability weightings, including ensuring this appropriately reflects the risks from the UK's expected withdrawal from the EU. More information on loan loss provisions can be found in Note 9 to the Accounts.
- **Run-off of fair values associated with acquired books**. The Society has mortgage books which were acquired following the mergers with Chelsea Building Society and Norwich & Peterborough Building Society, where the fair values inclusive of lifetime losses of these books on acquisition was estimated by the Leadership Team. As these acquired assets run off over time, any adjustments to their fair values are recognised in the Income Statement. The Committee reviewed all the judgements made in this regard and discussed these at length with chief officers, the Leadership Team and the external auditors. As a consequence, the Committee is comfortable that a cautious but appropriate approach has continued to be taken.
- **Hedge accounting**. The Society holds derivative financial instruments to mitigate various risks as set out in Note 34. Where the IAS 39 requirements of hedge accounting are met, the changes in the value of these instruments, recognised in the Income Statement, may be offset by the corresponding changes in the value of the hedged items. The Committee has overseen the Leadership Team's control activities in this area including reviewing the methodology and key assumptions applied. This oversight activity enables the Committee to be confident that amounts recognised in the Income Statement are fairly stated and that appropriate disclosures have been made.

- **Other provisions**. The Leadership Team reviewed other provisions throughout the year with an increase in the provision for restructuring costs. The Committee reviewed and challenged these provisions and agreed with the overall level held. The Committee's review of the provision for PPI took account of the estimated impacts of changes made by the Financial Conduct Authority (FCA) during 2018 with respect to the regulation of eligible complaints. More information on these provisions can be found in Note 28 to the Accounts.
- **Revenue recognition**. The Society recognises income in relation to the provision of mortgages on an effective interest rate basis. Fees and commissions are spread over the expected behavioural life of the mortgage. During the year the Committee considered the results of the Leadership Team's detailed reviews of the calculation methodologies used, and the resultant changes to the assumptions and models used, and concluded that the balance sheet was fairly stated. There was no material impact on the revenue recognition approach from the adoption of IFRS 9 and IFRS 15 during the year.
- **Viability and going concern**. When preparing the Society's Annual Report and Accounts the directors are required to confirm that the Society is a going concern, unless it is inappropriate to presume that the Society will continue in business. In addition, the directors are also required to confirm the longer-term viability of the Society as set out in the Strategic Report on pages 34 to 35. The Committee reviewed and challenged papers prepared by the Leadership Team and was in a position to recommend to the directors that the Annual Report and Accounts should be prepared on a going concern basis and that there is a reasonable expectation that the Society will be able to continue in operation and meet its liabilities as they fall due over the next three years.

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 Society's position, performance, business model and strategy. The Committee reviews and recommends specific representations, to allow the Board to approve the Letter of Representation to the external auditor and advises the Board whether it considers the Annual Report and Accounts to be fair, balanced and understandable.

The Committee is 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 Society 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 Society 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 Society's ability to react accordingly. It is the Board's responsibility to develop policies on risk and control. All colleagues have responsibility for internal control as part of their accountability for achieving objectives. Colleague training and induction are designed to ensure that colleagues are clear on their accountabilities in this area and are competent to operate and monitor the internal control framework.

We review this framework through regular reporting from chief officers, the Leadership Team, Internal Audit and our external auditor who set out the views of the Leadership Team as well as their own independent opinions. The Committee works closely with the Group Risk Committee (GRC) to ensure the risk assurance framework is operating effectively throughout the business.

Further details of risk management practices are provided in the Risk Management Report on pages 60 to 68.

The main types of information on internal controls considered during 2018 were:

- Internal audit reports. The Committee approved the Internal Audit plan for the year, the proposed revisions to that plan and the resource needed to support it. It also received reports on the outcomes from the delivery of the plan. The Committee considered an annual report giving an overall assessment of the effectiveness of internal control.
- Our external auditors provide 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.
- The Committee regularly reviews updates on the status of issues raised in control reports, both from our internal and external auditors. The volume and age profile of control issues have remained within tolerable limits.

The Committee has received regular reports on the use of the confidential reporting channels in the Society to enable effective oversight of any concerns raised by colleagues and stakeholders.

The information considered by the Committee provided assurance that in 2018 the Society maintained an adequate internal control framework that met the principles of the UK Corporate Governance Code, and that there were no material breaches of control or regulatory standards. Where weaknesses were noted in the internal control framework these were not material. Management were proactive in tackling control deficiencies and, where possible have sought to enhance the control framework in order to further underpin financial and operational resilience.

Oversight of Internal Audit

The Committee receives regular reports from Internal Audit setting out the results of their assurance activity including their performance against a range of measures. The function reports annually on the skills and resources necessary to discharge its role, and its plans are approved by the Committee.

The Internal Audit function is governed by a Charter which is reviewed annually by the Committee and was reapproved in September 2018. A copy of the Charter can be found on the Society's website ybs.co.uk/your-society/inside-your-society/corporate-governance/committees.html. The Chief Internal Audit Officer reports directly to me, and Internal Audit has full and unrestricted access to all functions, systems, records and colleagues.

During 2018 the Committee commissioned an independent external expert assessment, which concluded that Internal Audit demonstrates general conformance with the Institute of Internal Auditors' professional standards and the Chartered Institute of Internal Auditors' 'Guidance on Effective Internal Audit in the Financial Services Sector'. Internal Audit has also continued to operate its own quality assurance and improvement programme. The Committee considered the outputs from these sources which have assisted its ongoing assessment of the effectiveness, quality, experience and expertise of the Society's Internal Audit function and its approach.

The Committee will continue to oversee the development of Internal Audit, including the monitoring of action plans resulting from the external and internal assessments, to ensure that the function remains equipped for the role it plays in the Society's risk environment.

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.

The Committee carries out an assessment of the effectiveness of the external audit process each year. This follows a process based on practice aid guidance from the Financial Reporting Council (FRC). The Committee's assessment is informed by the perceived quality of the external audit team and process, based on responses to a questionnaire issued to members of the Committee and senior managers in the Finance Division. During the year, the Committee concluded that overall the external audit process was effective and an action plan was agreed for areas identified for improvement.

During the year the FRC's Audit Quality Review team selected Deloitte's audit of the Group's 2017 financial statements as part of their 2018 annual review of audit firms. The Committee subsequently reviewed the FRC's report, discussing it with Deloitte and scrutinising their plan for addressing the FRC's limited findings. The Committee noted that there was nothing included in the report which might have a bearing on the auditor appointment and agreed with the actions proposed by Deloitte for the audit of the Group's 2018 financial statements.

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 as the Society's external auditor in July 2009. Given Deloitte's length of tenure, and the requirement for rotation of the audit partner after the 2018 audit, the Committee decided to undertake a formal competitive tender for external audit services during the year. Throughout the process, the Committee was mindful of the need to preserve the independence of the external auditor. As a result, all participating firms were required to disclose all existing relationships with the Society and ensure that those relationships would not cause any conflict of interest after 1 January 2019.

The Committee oversaw the tender process which included a thorough and robust assessment of written proposal documents received from KPMG, PricewaterhouseCoopers LLP (PwC), Ernst & Young and Deloitte. This was followed by presentations from, and interviews with, the final two firms (PwC and Deloitte) who had been selected based on their strength of capability, depth of talent, commitment and audit quality. The final evaluation was undertaken without the involvement of Gordon Ireland, who had previously been a partner with PwC, from whom he retired in 2010 before joining the Society in 2015. The tender resulted in the Board accepting the recommendation from the Committee to appoint PwC as external auditor for the year ending 31 December 2019, subject to members' approval at the 2019 AGM.

The Committee has also overseen the process designed to ensure the effective transition of the external auditor and independence of PwC in readiness for their proposed appointment as external auditor.

External auditor objectivity and independence

The Society 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. The policy sets out examples of services which the external auditor can and cannot perform. The services which the external auditor cannot perform include: the preparation or maintenance of accounting records and financial statements; the design and implementation of financial information systems or financial controls and; internal audit services. Fees for individual assignments which exceed pre-defined limits require prior notification to the Chairman of the Audit Committee, who then considers whether formal Committee approval is required. The level of fees incurred is regularly monitored, and the Committee is satisfied that the Society has operated in compliance with the policy during 2018. There are no significant non-audit engagements that require explanation as to why the external auditor was used. Fees of £634,000 (2017: 684,000) were payable to Deloitte for audit and audit related assurance engagements and £113,000 (2017: £92,000) for other assurance engagements for the year ended 31 December 2018.

Details of the fees paid for non-audit services during the year can be found in Note 7.

Audit Committee effectiveness

The effectiveness of the Committee is assessed annually. A self-assessment exercise is performed, co-ordinated by the Group Secretariat, and a summary of the results is reported to the Board. The 2018 review concluded that the Committee operated effectively during the year and that no actions for improvement were required.

Committee members are expected to undertake relevant training as part of their ongoing development as individual Board members. The approach to this development, overseen by the Board Chairman, is set out in the 'Induction and development' section of the Corporate Governance Report on page 51. Each year, as well as undertaking individual training as members consider appropriate, the Committee receives training on current topics. In 2018 this focused on IFRS16 (which deals with the accounting treatment for leases) and used a combination of external and internal specialists so as to include both industry developments and application within the Society.

On behalf of the Board

Mark Pain
Chairman of the Audit Committee

27 February 2019

Risk Management Report

The purpose of this Risk Management Report is to describe the Society's approach to the management of risk through its Enterprise Risk Management Framework (ERMF) and to set out the principal risks to which the Society is exposed.

Enterprise Risk Management Framework

Introduction

The Society recognises that for the business to grow and achieve its commercial aspirations, effective risk management is essential. The key elements of risk management encompass the activities relating to the assessment, control, monitoring and reporting of risk.

During 2018 the Society enhanced its ERMF in order to further improve robust yet efficient risk management which has an important and integral role in the Society:

- Delivering against its strategy with an appropriate culture.
- Protecting itself against unplanned financial outcomes.
- Building greater resilience to operational risks.
- Protecting its customers from unfair outcomes.
- Demonstrating its credibility to external stakeholders.

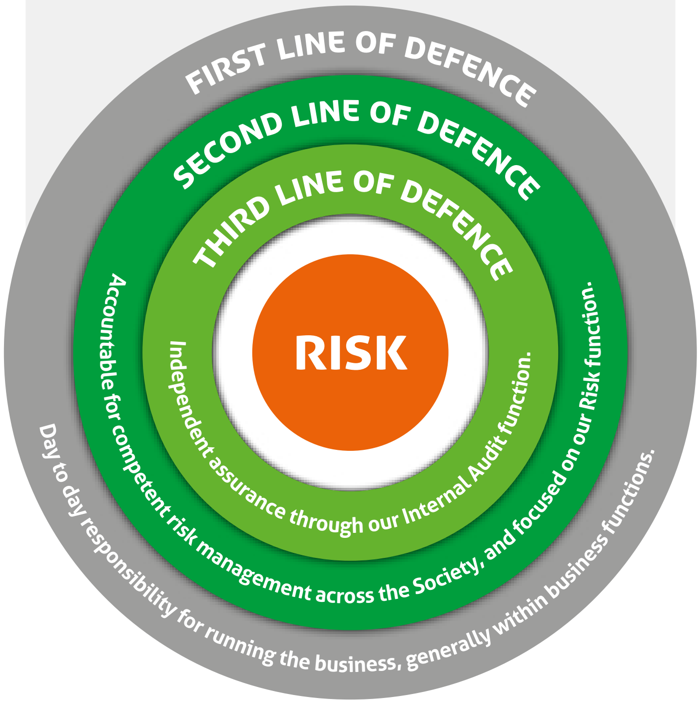
The ERMF explains how a variety of processes fit together to create a consistent and effective way of managing risk across the Society. It is reviewed and approved annually by the Group Risk Committee and consists of:

- **Risk vision and strategy** - the Society's vision for risk management and what we need to do to achieve it.
- **Society culture** – the values and behaviours that shape our risk decisions.
- **Risk appetite** – how much risk we can take in order to deliver the Society strategy while ensuring fair customer outcomes and a sustainable business.
- **Policy and governance** – how we organise ourselves, make decisions and take approved risks.
- **Risk assessment and control** – how we understand our risks and limit undesirable outcomes from occurring.
- **Risk events** – how we respond when things go wrong and stop the same things happening again.
- **Monitoring and assurance** – how we check that controls are working and highlight when risks require attention.

Three Lines of Defence

The Society operates a Three Lines of Defence (LoD) approach towards risk management which seeks to differentiate between those:

- With direct responsibility for the management and control of risk.
- With responsibility for overseeing the effectiveness and integrity of the ERMF.
- Providing independent assurance across the first and second LoD.



The critical outcome that Group Risk is trying to achieve is that neither the Society nor its members and customers are exposed to risks beyond their appetite or that were unplanned.

A summary of these respective responsibilities is set out below:

First Line of Defence

Risk category owners (Colleagues who determine how a particular group of risks should be managed):

- Articulate risk(s) in the Group Risk and Control Library.
- Design key controls.
- Direct Group policy.
- Oversee Society management of specific risk(s).

Directors / Business functions (Colleagues who are responsible for ensuring risks are effectively managed):

- Identify relevant risks from the Group Risk and Control Library into a risk register.
- Own risks relevant to the business function.
- Operate applicable key controls and develop and operate supplementary controls as necessary.
- Assess risks and controls and determine if further actions are required.

Second Line of Defence

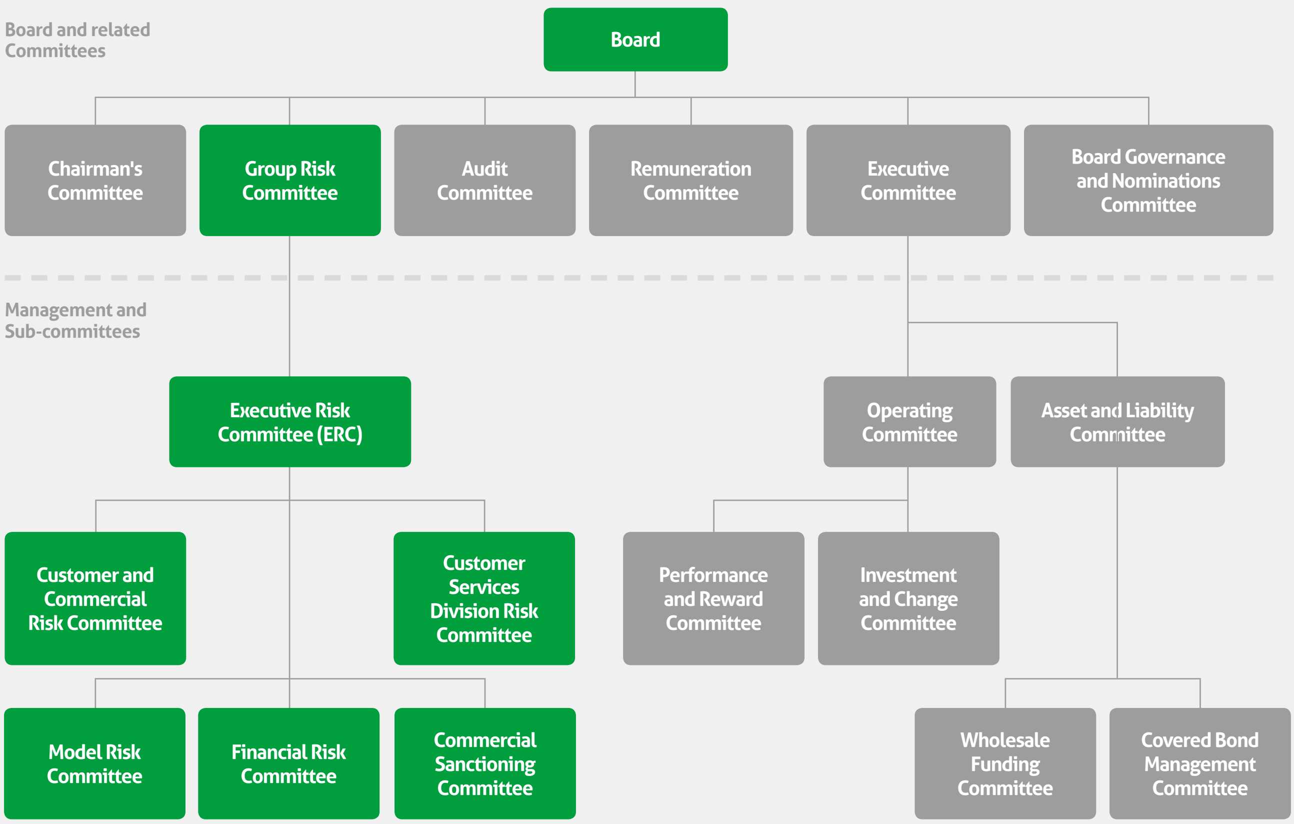
The second LoD is fulfilled through the Group's Risk Division. It defines the Society's approach towards risk management and supports, coaches, facilitates, independently monitors, challenges, reports and if necessary gives direct instruction to the first LoD. Second line is responsible for managing our regulatory relationships and for providing independent briefings and insights to the Board.

Third Line of Defence

Third line is fulfilled through the Internal Audit function and independently assesses whether the risks are adequately controlled, challenging the Executive Team to improve the effectiveness of governance, risk management and internal controls. Internal Audit reports directly to the Audit Committee which is a Board Committee.

Governance

The Society's Board and senior management committee structure is illustrated below, with risk committees duly highlighted.



The Board is ultimately responsible for the effective management of risk. The approval of risk appetite and associated high level risk strategy are amongst a number of specific areas which are matters reserved for the Board.

Group Risk Committee is a Board Committee that reviews, on behalf of the Board, the key risks inherent in the business and the system of control necessary to manage such risks, presenting its findings to the Board.

Executive Risk Committee is responsible for the oversight of day-to-day risk management activity including, but not limited to, review of the effectiveness of the Society's risk management framework and system of internal controls. It has authority to direct the business in relation to mitigating actions and to approve or endorse risk acceptance within defined levels.

Below the Society's Board and senior management committee structure is a set of Divisional Risk Committees. These committees oversee risk management activity across the Society's core divisions, acting as the point of escalation for matters of Society level significance. Again, the Committees have authority to direct mitigating actions and to approve or endorse risk acceptance for risks within the Division, in accordance with defined levels.

Group Risk Committee

The Group Risk Committee oversees the Society's risk management framework and assists the Board by providing an enterprise-wide perspective on all risk matters. It normally meets four times a year, but will meet more frequently when the need arises. As Chair of the Committee, I provide regular updates to the Board on matters considered by the Committee.

In addition to myself, the Committee's membership comprises three other non-executive directors: Mark Pain, Alison Hutchinson and Gordon Ireland. It is also attended by members of the Executive Team including the Chief Executive Officer, the Chief Operating Officer, the Chief Finance Officer, the Chief Risk Officer and the Chief Internal Audit Officer. The Committee invites certain members of the Leadership Team when it is felt that this would help it discharge its duties. The Committee's Terms of Reference are available from the Corporate Governance section of our website at ybs.co.uk/committees.

The Society maintains an independent second line risk management function (Group Risk) that is responsible for ensuring that appropriate risk management and measurement techniques are used that are commensurate with the Society's strategic aims, its appetite for risk and the risks it faces at any time. The Group Risk function ensures that the Group Risk Committee receives a comprehensive programme of decision papers and reviews to ensure that it is fully sighted on such matters. The Society's Chief Risk Officer provides a formal update to the Board and to the Group Risk Committee on a quarterly basis covering all areas of risk management, including routine reporting, emerging risks, the results of his team's independent oversight and additional issues that merit escalation.

During 2018 the Committee met five times and the matters considered included:

Approval of:

- Enterprise Risk Management Framework and Strategy.
- Risk appetite setting ahead of approval by the Board.
- Lending and Prudential Risk policies ahead of approval by the Board.
- Financial Crime, Regulatory Risk and Information Security policies.
- Regulatory application for Internal Ratings Based (IRB) approach to capital requirements for credit risk ahead of approval by the Board.
- Internal Capital Adequacy Assessment Process (ICAAP) regulatory submission ahead of approval by the Board.
- Internal Liquidity Adequacy Assessment Process (ILAAP) regulatory submission ahead of approval by the Board.
- Appropriate stress testing including Reverse Stress Tests.
- Recovery Plan and Resolution Packs.
- Three LoD capability update.
- Second LoD oversight plans (prudential, operational, compliance and conduct).
- Operational Continuity in Resolution readiness.
- Business overlay (risk) process for Material Risk Takers' bonus/other variable benefits.
- Money Laundering Reporting Officer's annual report.
- Delegation of mandates to sub-committees.

Monitoring of:

- Economic, political, market and cyber risks and their potential impact on risk appetite.
- The Group Risk Map including the Horizon Risk Register.
- Risk appetite adherence.
- Second LoD monitoring of compliance and conduct risk, prudential risk and operational risk.
- Regulatory compliance reporting.
- Performance of IRB models.
- Risk and Control Self-Assessment evaluations.
- A cyclical programme of deep dives into key areas. Examples included Commercial Lending, IRB, Operational Risk, Credit Risk, Balance Sheet strategy and Data & Information.
- In addition to the deep dives, specific ad hoc topics are considered at the request of the Committee. These included:
  - Operational Continuity in Resolution.
  - Enterprise-wide risk and control register analysis.
  - Operational Risk upgrade.
  - Third party risk.

Principal Risks

The Society has a risk category model comprising of four 'Level 1' risks and 26 'Level 2' risk categories, as illustrated below.

Level 1	Operational Risk	Compliance and Conduct Risk	Prudential Risk	Business Risk
Level 2	Business Continuity Risk	Customer Treatment Risk	Market Risk**	Business Model and Strategy Risk
	Change Risk	Product Governance Risk	Capital Risk	Media Relations Risk
	Financial Management, Reporting and Tax Risk	Sales Suitability Risk	Treasury Dealing Risk***	Legal and Governance Risk
	Health and Safety/ Physical Security Risk*	Complaints and Redress Risk	Funding and Liquidity Risk	Financial Sustainability Risk
	Information Management Risk	Reward and Incentivisation Risk	Pension Funding Risk	
	Information Security Risk	Financial Crime Risk	Retail and Commercial Credit Risk	
	IT Risk			
	Payments Risk			
	People Risk			
	Third Party Risk			

* Formerly Health and Safety and Physical Assets Risk
** Formally Balanced Interest Margin Risk
*** Formerly Wholesale Credit Risk

Our risk profile evolves as we move through the economic cycle. Set out below are the principal risks or risk categories that currently impact the Society. We have also explained how we manage and measure the risk, along with progress achieved in 2018:

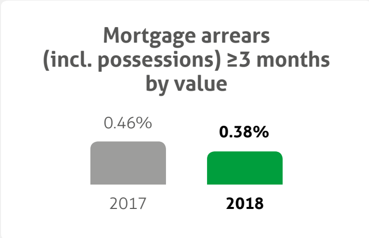
Retail and Commercial Credit Risk

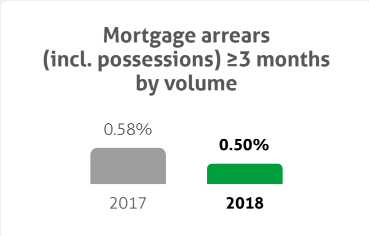
The risk to the Society of credit losses as a result of failure to design, implement and monitor an appropriate credit risk appetite.

Risk mitigation

- Retail and commercial credit risk is constrained by a risk appetite, which is approved by Board and further governed through the Retail and Commercial Lending Policy.
- A robust credit risk framework ensures that lending remains within risk appetite limits and appropriate remedial action is taken if a breach occurs. Adherence is monitored regularly through governance committees.
- Stress testing confirms portfolio resilience.
- A model governance framework ensures that credit risk models are operating as intended.

Key risk indicators





Commentary

- 2018 has seen continued improvements in arrears performance and favourable HPI movements overall.
- In 2019, the credit risk focus will continue to be delivery of strong asset quality aligned to responsible growth of the mortgage book.
- The asset quality of our loan portfolio remains strong with no signs of deterioration in the performance of our originated loans. In addition, the credit fair value charge held against our seasoned acquired loan book (including loans which were considered credit impaired on acquisition of assets) is decreasing. The Society continues to exhibit a low level of mortgages in arrears. UK finance (previously CML) market average for ≥3 months arrears by volume is currently 0.80%.

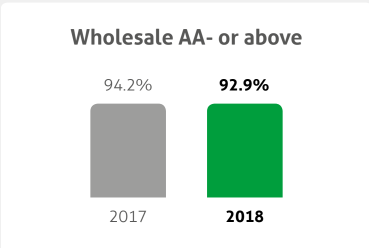
Wholesale Credit Risk

The risk of credit losses following default on exposures arising from balances with other financial institutions, liquid asset holdings and the use of derivative instruments to manage interest rate and foreign exchange risk.

Risk mitigation

- Wholesale credit risk is constrained by a Board approved risk appetite, which is further governed through the Treasury Risk Policy.
- Most of the Liquid Asset Buffer portfolio is invested in the highest quality assets.
- The majority of derivative contracts are subject to centralised clearing to minimise credit risk exposures to counterparties. Where this is not possible, derivative exposures are restricted to high quality counterparties which are subjected to regular review and scrutiny by the Asset and Liability Committee (ALCO) within overall risk limits.

Key risk indicators



Commentary

- Each wholesale counterparty limit is reviewed at least on an annual basis, or sooner if a risk event occurs in the interim.
- The size of the credit limit allocated per counterparty is driven by their credit status as determined by internal analysis and is calibrated to the size of the Society's capital position to ensure that the financial viability of the Society is not overly exposed to any single counterparty.
- The slight reduction in exposure to AA- or above counterparties is due to an initiative to increase the diversity of the liquid assets, reducing concentration risk and improving earnings whilst maintaining a low risk profile in accordance with Board risk appetite.

Funding and Liquidity Risk

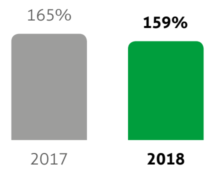
The risk of the Society having inadequate cash flow to meet current or future requirements and expectations.

Risk mitigation

- Liquidity and funding risk is constrained by a Board approved risk appetite, which is further governed through the Liquidity and Funding Policy.
- The key assumptions, risks and controls around the management of liquidity risk are outlined in the ILAAP document which is approved annually by the Board.
- The Society operates a range of internal stress tests to ensure that sufficient liquidity is available at all times to address stress and business as usual requirements.
- The Society also manages to the external regulatory measure, the Liquidity Coverage Ratio (LCR).
- The Society is primarily funded through retail savings balances, supported by a strong franchise in key wholesale funding markets.

Key risk indicators

Liquidity Coverage Ratio



Commentary

- The LCR reduced from 165% to 159% during 2018. This was primarily due to higher levels of excess liquidity at the previous year end caused by drawings on the government's Term Funding Scheme (TFS).
- The impact of volatility in the wholesale funding markets as a consequence of the UK leaving the EU have been included in our Plan and stress testing scenarios and we have concluded we can meet funding requirements of the Society.

Market Risk

Repricing Mismatch Risk: The risk that the value of, or income derived from, the Society's assets and liabilities changes unfavourably due to movements in interest rates and foreign currency rates. Interest rate mismatch risk arises from the different re-pricing characteristics of the Society's assets and liabilities.

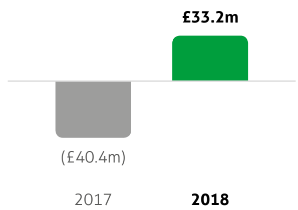
Basis Risk: Basis risk arises from possible changes in spreads where assets and liabilities re-price at the same time, but move in differing amounts causing unfavourable impacts to earnings.

Risk mitigation

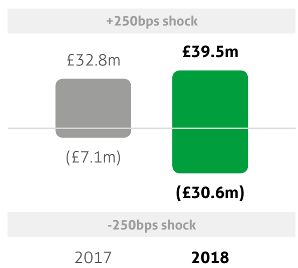
- Market Risk is constrained by a Board approved risk appetite, which is further governed through the Market Risk Policy.
- The Society adopts a risk averse approach to interest rate mismatch although some scope for position taking is allowed in line with an agreed in house rate view, subject to the agreed risk appetite.
- The Society operates a wide range of measures and scenarios that review this risk in respect of both earnings and value. Earnings are stressed over a 12 month period for +/- 250bps changes in rates. Rates are assumed to floor at 0%.
- The Society's limits for basis risk include limits for sensitivities around isolated movements in underlying rates (LIBOR/SONIA), for overall mismatch ratios and for ensuring the Society has sufficient levels of margin management capability.

Key risk indicators

PV250 Market Value



12 Month Earning Sensitivity



Commentary

- The PV250 (Market value change on the Group Balance Sheet of a parallel 250bps increase in interest rates) has switched direction primarily due to a reduction in the Society's discretionary risk position relative to the previous year. The metric now primarily reflects the natural hedging positions in the retail mortgage portfolios. Further information is included in Note 36.
- The increase in the 12 month earnings sensitivity for a down 250bps scenario reflects a change in the assumption around the flooring of retail savings products if Bank Rate falls to 0%.

Operational Risk

The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Risk mitigation

- Operational risk is constrained by a Board approved risk appetite, which is further governed through the ERMF.
- The ERMF sets out how colleagues are expected to identify, assess, monitor, manage and report their risk exposures.
- A Risk & Control Self-Assessment (RCSA) process outlines the controls that must be followed and the frequency of assurance in order to determine whether the current set of controls is appropriate to manage its risks going forwards.
- The Executive Risk Committee provides oversight across the Society's operational risk exposures.

Key risk indicators

Commentary

- The increase in the value of Society Operational Losses in 2018 is predominantly driven by PPI payments totalling £5.7m; an increase of £1.7m on 2017.
- The Group's functional risk registers have been baselined through 2018 using the Group's Risk and Control libraries, following which the new RCSA process has been embedded Society-wide.
- A Society-wide Risk Management System was implemented in December 2018 which will be used to manage the ERMF and its components including RCSA.
- In H2-2019 the Risk Management System will be further expanded to include both Compliance and Legal and Internal Audit modules in order to enable integrated risk management across all three LoD.
- A joint first and second LoD taskforce was mobilised in H2-2018 to upgrade capability across four operational risk focus areas: Information Security, Third Party, Business Continuity and IT.

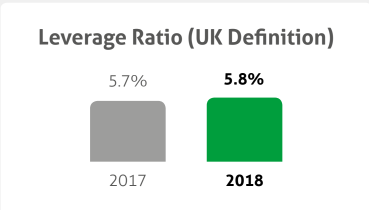
Business Risk

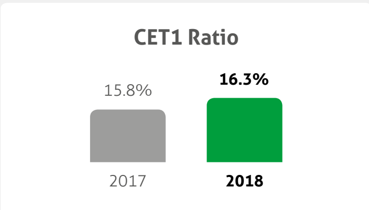
The risk of direct or indirect loss as a result of the pursuit of inappropriate strategy or a failure to effectively manage the Society's corporate affairs.

Risk mitigation

- Capital risk is constrained by a Board approved risk appetite, which is further governed through the Capital Strategy.
- Current and projected capital positions are regularly monitored and also considered in stress scenarios as part of the ICAAP.
- Specific details on capital management can be seen in the Society's Pillar 3 disclosures (available on the Society's website).

Key risk indicators





Commentary

- All key capital ratios including the leverage ratio increased from 2017 to 2018 and remain above both regulatory requirements and internal risk appetite levels. The leverage ratio presented uses the PRA's revised exposure criteria which excludes central bank deposits from the exposure measure.
- The Society maintains a strong capital position both currently and in forecast, while developing its capability to move to an IRB method of calculating capital requirements for credit risk and preparing for upcoming regulatory changes including the finalisation of Basel III and the implementation of MREL. The Society will be subject to the lower of the transitional MREL requirements (18% of risk weighted assets) or the end state requirements (double pillar 1 and 2A) plus applicable buffers from 1 January 2020.

Compliance and Conduct Risk

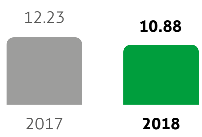
The risk of direct or indirect loss as a result of a failure to comply with regulation or to ensure fair customer outcomes.

Risk mitigation

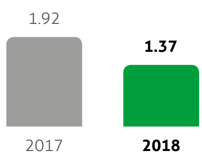
- Compliance and Conduct risk, including financial crime risk, is constrained by a Board approved risk appetite, which is further governed through the Conduct Risk Strategy and Group Risk Management Policy.
- Key conduct risk metrics are in place to protect customer outcomes in all key areas including sales, service, complaints and collections.
- Clear responsibilities have been determined in a revised governance model that established defined risk management and oversight accountability within the divisions.
- A comprehensive programme of independent oversight with reporting to Group Risk Committee takes place.

Key risk indicators

Complaints per 1,000 accounts - Mortgages (H2)



Complaints per 1,000 accounts - Banking, Savings and Loans (H2)



Commentary

- The reduction in Banking, Savings and Loans complaints was mainly due to the withdrawal from the Current Account market, improvements in the ISA Transfer process and how we communicate Interest Rate reductions and changes. Home Finance complaints reduced despite a 15% increase in application volumes, largely due to improvements in the acquisition and sales process.
- A Compliance Monitoring plan, approved by the Group Risk Committee, has been completed during 2018 allowing robust oversight of the key areas of conduct risk.
- All oversight findings, whether of a compliance, conduct or financial crime nature are the subject of a formal action plan overseen to closure by the Group Risk Committee.
- Areas prioritised for review in 2018 included: financial crime; data protection and privacy; brand and distribution changes; and vulnerable customers.
- The Society is committed to ensuring that it has effective processes and procedures to counter the risk of bribery and corruption. A formal anti-bribery and corruption policy is in place and all colleagues are required to undertake appropriate training annually.
- The pace and extent of external regulatory change is high and appears to be increasing. The implementation of new regulation such as GDPR and PSD2 has also increased the requirement for compliance support and oversight.

The Society recognises that for the business to grow and achieve its commercial aspirations, effective risk management is essential.

Model Risk

Model risk is the potential for adverse consequences from decisions based on incorrect or misused model outputs. The Society does not separate model risk out as a principal risk, but instead manages it across existing principal risks because it features across many of those principal risks.

To ensure effective model risk management within the Society, model risk controls are centred on three key activities: model development/change, periodic review and model monitoring. These are referred to as the three pillars of model risk management and are described below:

- Development / change: All new model developments/model changes must be reviewed through the governance process prior to their use within the business.
- Period review: All models must undergo periodic review to ensure the model remains fit for continued use.
- Monitoring: Models should be monitored on a regular basis to identify model performance issues in a timely fashion.

The Society uses the following framework documents to manage model risk:

- Yorkshire Building Society Model Policy: This outlines the framework in place to manage model risk.
- Modelling Principles: These set out more detail with regards the key concepts across all model types.
- Standards: These exist in some areas to provide consistency across models of the same type, or to fulfil regulatory requirements.

Model risk is governed principally through the Model Risk Committee, the designated committee for IRB purposes (the Society is in the process of applying for IRB status), which approves and manages high materiality models. Model Review Panels for Credit Risk & IRB, and ALM, Finance & Other provide technical review and challenge for high and medium materiality models, and approval for medium materiality models. The performance of IRB models is reported to GRC every quarter.

Stress testing

Stress testing is a proactive risk management tool used throughout the Society to better understand potential vulnerabilities in our business model and to derive effective management actions. All stress test scenarios are approved by ALCO before GRC reviews key stress tests, providing a further level of governance.

The key uses of stress testing are:

- To test the robustness of the Society's financial plan to adverse economic conditions, ensuring a sustainable financial performance within our risk appetite.
- Scenario analysis of the Society's recovery plan and contingency funding options.
- To support regulatory returns such as the ICAAP and ILAAP, informing the setting of regulatory capital and liquidity requirements.
- Daily stress testing of liquidity and market risk, keeping up-to-date with market movement and developments.
- To understand through the Society's annual reverse stress tests how to prevent risks crystallising and/or mitigating them if the impact has occurred.

It should be noted that unlike other stress tests, reverse stress tests start from the identification of a predefined outcome, that being the point at which the firm's business model becomes unviable, or at which the firm can be considered to be failing because the market has lost confidence in it.

Concurrent Stress Test

During 2018, the Society assessed the PRA's Concurrent Stress Test as part of its stress testing framework, which included a high rate and a low rate scenario. The Annual Cyclical Scenario assessed firms' resilience to a severe economic downturn, characterised by an increase in the Bank of England Bank Rate to 4%, a compound 33% fall in UK house prices, unemployment increasing to 9.5% and a 4.7% fall in UK GDP. Despite the severity of the Annual Cyclical Scenario, the results illustrate the financial strength and resilience of the Society, with low point CET1 and leverage ratios of 14.8% and 6.4% respectively. The Society comfortably met all regulatory requirements across the plan horizon under stress.

Further information on risk and risk management can be found in the Strategic Report (Principal risks and uncertainties on pages 32 to 33) including the most significant emerging business and operational risks the Society continues to manage. The Pillar 3 Disclosure Report, which contains details on capital requirements, including Pillar 1 requirements and descriptions of risks considered for Pillar 2 requirements, and the following notes to the accounts: Conduct Risk: Note 28, Capital Risk: Note 31, Liquidity and Funding Risk: Note 35, Market Risk: Note 36 and Credit Risk: Notes 38 and 39 all contain detail on risks and risk management.

Future developments

Good progress has been made in 2018 on enhancing the Society's approach to risk management and measurement, including completion of improved Risk Registers across the Society, developing and implementing a new RCSA process and implementing a Society-wide Risk Management System. We will continue developing the Society's approach to risk management and measurement during 2019. This is a continuing necessity given key changes in technology driven business models and changing preferences for how customers interact with us.

Notwithstanding the statements above, the UK is entering an unprecedented political environment which could lead to unprecedented outcomes. Whilst our analysis and stress testing confirms the resilience of the Society in all plausible and deeply stressed scenarios, an unprecedented environment can of course cause a disconnection between previous outcomes and future outcomes. The Society remains highly alert to this risk.

On behalf of the Board

Neeta Atkar
Chair of the Group Risk Committee

27 February 2019

Directors' Remuneration Report

Letter from the Chair of the Remuneration Committee

I am pleased to share the Directors' Remuneration Report, including details of the directors' pay, for the year ended 31 December 2018. Our role as a Remuneration Committee, (the Committee), is to make sure that all of our remuneration policies align with the Board-approved strategy to ensure that the business is run safely, successfully and sustainably for our members.

At the 2019 Annual General Meeting (AGM), both the Directors' Remuneration Report and the Remuneration Policy will be subject to an advisory vote. As in previous years, where possible this report discloses information in line with the Building Societies (Accounts and Related Provisions) Regulations 1998; and the Pillar 3 disclosure requirements under CRD IV relevant to a Proportionality Level 2 firm. The Society also voluntarily complies, where possible, with the disclosure requirements of the Large and Medium-sized Companies (Accounts and Reports) Regulations 2008.

Looking back to 2018

For 2018, the executive directors' were set stretching objectives in the context of a challenging trading and economic environment. The Committee have considered their performance against this backdrop and believe a strong performance has been delivered in a sustainable and balanced way. Further information is detailed within the annual report page 18.

In determining bonus awards, the Committee has carried out a comprehensive review of the remuneration outcomes of the executive team, taking into consideration the context of wider colleague pay in the Group, both in relation to financial performance and delivery to our members and customers. Full details of how pay and bonus is awarded for executive directors are included within this report. In 2018, on average, an eligible executive director received a pay increase of 1.8%. Across the Society, the average pay increase was 2.6%. From a bonus perspective, on average, an eligible executive director achieved 73.6% of their maximum bonus opportunity, with all eligible colleagues receiving an average of 50.6% of their maximum opportunity.

We support the changes outlined in the 2018 UK corporate governance code in relation to remuneration, as they reflect how we operate today. Through the Committee's review of the remuneration policy, these changes have remained a key consideration.

The full remuneration policy is available on pages 78 to 81.

The remuneration policy

Looking forward to 2019 we've reviewed the way in which bonus is distributed to both colleagues and executive directors to support the Society's aspirational culture of working together. Care has been taken to ensure that the bonus scheme is motivational for all colleagues and is market competitive whilst maintaining compliance with regulations applicable to financial services organisations.

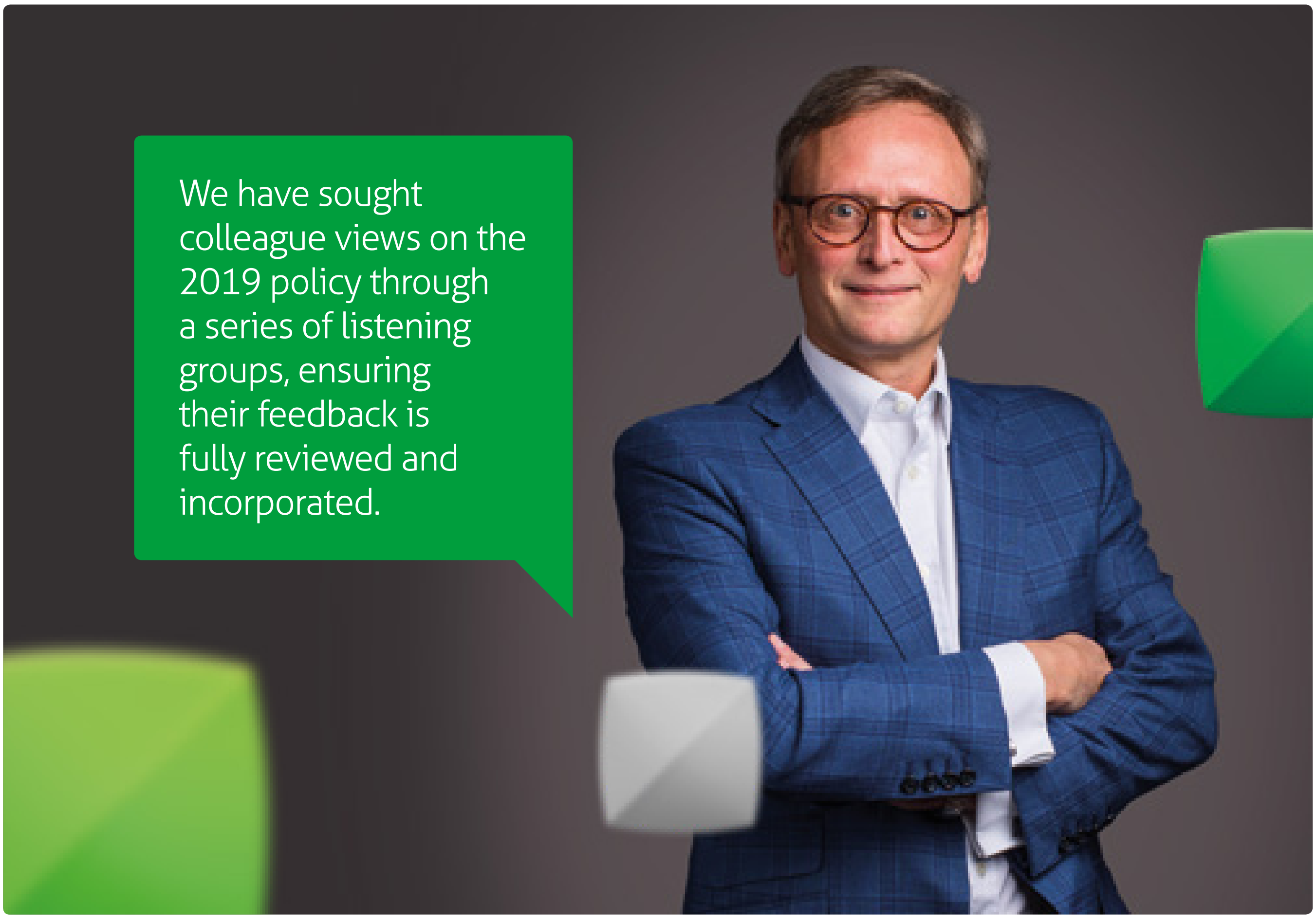
We have maintained our conscious decision of offering a lower level of performance related pay (bonus) than many of our competitors, capping our maximum bonus potential at 50% of salary (more than 50% lower than the regulatory maximum). We do however recognise the need to deliver competitive levels of bonus for our senior leadership, recognising their contribution to the delivery of the business strategy and corporate plan.

We are introducing a new scheme - Building Together - through which all colleagues will share in the success of the Society in the same way. A collective approach to bonus serves to reinforce our target culture of 'working together', ensuring all colleagues are working towards the same business outcomes. Everyone will have the opportunity to earn an 'on-target' 7% of salary with a maximum of 10%. Building Together will be awarded on successful achievement of financial and non-financial performance indicators. The targets will be the same for all colleagues.

For our senior leadership team, including executive directors, there will be an opportunity to earn an additional bonus taking the total bonus opportunity up to a maximum of 50% of salary. Payment of this element will be awarded based on a combination of business and individual performance and financial and non-financial criteria, measured via a stretching individual balanced scorecard. When setting targets for both elements, we always seek to drive performance that benefits the Society and its members, ensuring a sustainable business over the long-term which is true to our heritage and values, for the coming years.

Full details are included within the remuneration policy.

Going forward we will also be making a change to our pension contribution rates, aligning them for all new colleagues across the Society. Existing directors will remain eligible for pension contribution rates of up to 16%. New executive directors will be eligible for pension contribution rates of up to 11%; this is in line with the wider colleague eligibility.



Looking ahead to 2019

We recognise the fundamental role the culture of an organisation plays in terms of engaging colleagues, creating inclusiveness and collaboration, and ensuring value for members. The aspired culture of the Society is centred on four key themes: commercial focus and pace; open and honest conversations; trust and empowerment; and working together. The way in which we encourage and motivate our colleagues to achieve this is a key part of the People Plan.

Our aim is to build a working environment where all colleagues feel engaged and committed to the Society's journey, ensuring they feel valued and respected to give their best. Our reward offering is integral to that aim. As a mutual, we are committed to considering both colleagues and members' interests when designing our remuneration policy at all levels in the organisation. Our remuneration policy and practice is designed to reflect our culture and ensure the successful delivery of the business strategy.

This year the Committee has reviewed the executive director remuneration policy, including how that aligns to the wider colleague population, in preparation for an advisory vote at the 2019 AGM. As part of this process, we have also sought colleague views on the 2019 policy through a series of listening groups, ensuring their feedback is fully reviewed and incorporated. The reward policy seeks to balance the need for total remuneration to be competitive in the wider financial services sector, whilst remaining commensurate with our mutual status.

Gender pay

In November 2018 the Society reported its gender pay gap for the second time (the difference between the average pay of men and women regardless of seniority). The Society's mean gender pay gap at April 2018 was 29.7%, which has marginally reduced from 2017. If the Society had an equal (50:50) split of males and females at each level, the gap would be much lower at 2.2%. The full gender pay gap report is available at ybs.co.uk/your-society/inside-your-society/corporate-governance/committees.html#remuneration-committee

I'm pleased to report that in June 2018 the Society also signed the Women in Finance Charter, confirming the Society's commitment to target a 50:50 split of men and women in senior leadership positions. Executive directors now have specific objectives to support this target. The Society continues to strive to create an environment where diversity in all forms is encouraged and barriers in the way of colleagues fulfilling their potential are removed. The Committee contribute to this by ensuring that the Society's remuneration policy is inclusive in both its design and practice.

In conclusion

I trust that members will agree that the performance of the Society and its leaders in 2018 warrants your continued approval of the Directors' Remuneration Report and Directors' Remuneration Policy. On behalf of the Committee, I recommend that you endorse both items.

Guy Parsons
Chair of the Remuneration Committee

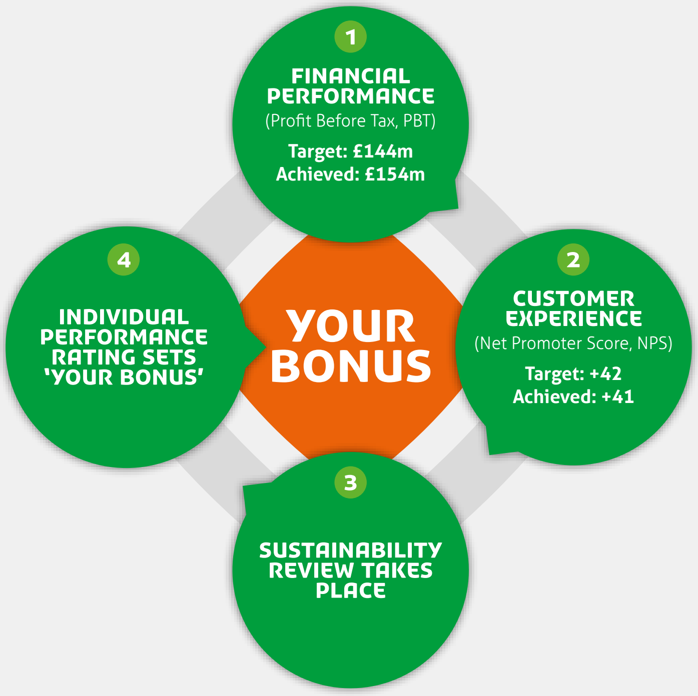
27 February 2019

At a glance summary of executive director outcomes in 2018

The summary below outlines the structure of the Society's current bonus scheme, 'Your Bonus' and the performance measures taken into account to calculate executive directors' bonus awards.

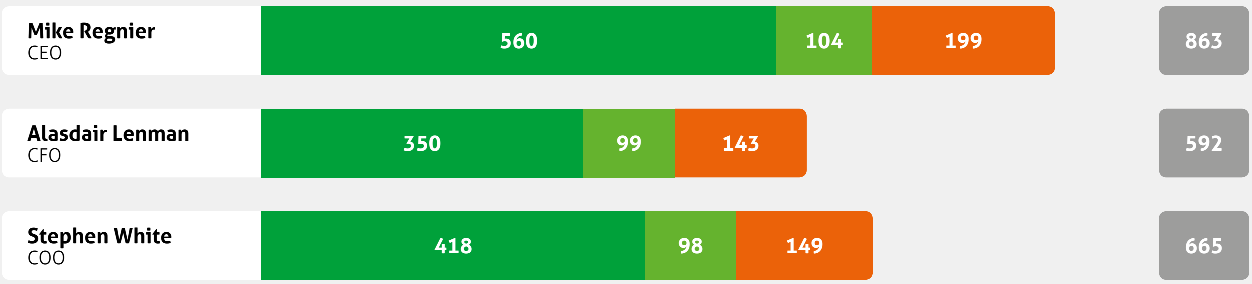
The Group's performance is used for bonus calculations (in line with the remuneration policy approved at the last advisory vote at the 2016 AGM).

*The PBT figure for 'achieved' is different to the figure stated on page 28 of the annual report and accounts. This figure is adjusted to reflect underlying profit and is in line with agreed principles which are outlined on page 73 of this report. The NPS measures how likely customers are to recommend us and is a combination of customer and broker NPS, resulting in an achieved NPS of +41.



How much have our directors earned in 2018?

The summary below confirms Executive Director total earnings for the 2018 performance year.



Key

Base Salary £'000 | Other Fixed Pay £'000* | Bonus £'000 | Total Earnings £'000

* Fixed pay includes pension allowance and any location allowance or additional responsibilities allowance and taxable benefits.

The bonus scheme design is the same for all colleagues, with varying on-target award levels for colleagues and senior managers. Bonus is awarded on the successful achievement of financial and customer performance measures, combined with individual performance. 'On-target' achievement of Group performance and individual performance criteria in line with expectations results in a bonus of 30% of base salary for the executive directors. The maximum bonus available to executive directors is 50% of base salary.

The Committee retains the discretion to make adjustments to the profit figure to ensure that it reflects a true view of the underlying performance of the Group prior to the payment of any bonus. In line with our directors' remuneration policy, the Committee undertakes a risk overlay process (part of the sustainability review) on bonus based on a series of agreed criteria. These are detailed in this report.

The remuneration policy for 2019 and beyond is outlined in this report and is subject to an advisory vote at the 2019 AGM.

Annual Report on Remuneration

Executive directors' remuneration

All remuneration in the 2018 performance year has been awarded in line with the Society's remuneration policy which was last approved by members in 2016. Full details of the Society's remuneration policy are is available at ybs.co.uk/pdf/financial/reward-policy.pdf.

The table below shows the single total figure table of remuneration for the executive directors of the Society for the years ended 31 December 2018 and 2017. **This is audited information.**

Executive Director	Role	Fixed Remuneration			Bonus*	Total Remuneration
		Base Salary	Taxable Benefits	Pension/Pension Allowance		
		£'000	£'000	£'000	£'000	£'000
Year ended 31 December 2018						
Mike Regnier	CEO	560	14	90	199	863
Alasdair Lenman**	CFO	350	43	56	143	592
Stephen White	COO	418	31	67	149	665
Year ended 31 December 2017						
Mike Regnier	CEO	550	15	90	275	930
Alasdair Lenman	CFO	27	3	4	–	34
Stephen White	COO	407	31	65	204	707

*The bonus figures illustrated represent the full amount of bonus awarded in respect of the 2018 performance year. Mike, Alasdair and Stephen will only receive 20% of this in cash in 2019, with the remainder delivered over seven years. Full details regarding how bonuses are paid are available on pages 74 to 75.

**In September 2018, Alasdair assumed the responsibilities of the Chief People Officer and is temporarily receiving an additional non-pensionable supplement of 10% of his salary for this. This uplift is in line with supplements for the wider colleague group.

The following is unaudited information.

Base salary

Executive directors' salaries are reviewed each May as part of the annual pay review. The 2018 increases were in line with those received by the wider colleague group which, for all colleagues, increases ranged from 0.5% to 14.0%. Individual increases are based on performance, relative position to market and affordability, with the aim of retaining talent in a challenging environment. As a result, in 2018, the average pay award for all colleagues was 2.6%, including all executive directors.

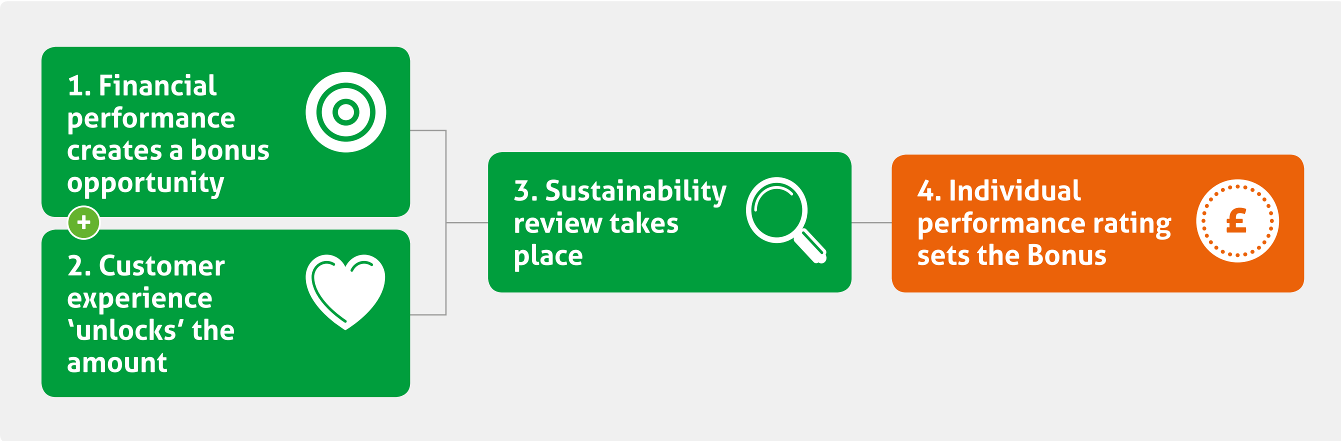
The table below sets out the increases in base pay levels for executive directors following the annual pay review in May 2018.

Executive Director	Base Salary at 1 May 2017	Base Salary at 1 May 2018	Increase
	£'000	£'000	%
Mike Regnier	550	565	2.7%
Alasdair Lenman*	–	350	–
Stephen White	411	422	2.7%

* Alasdair Lenman joined the Group on 4 December 2017 with a salary of £350,000 and his salary was reviewed in May 2018 with no increase given.

Bonus

The Society's bonus scheme, in which executive directors participate, 'Your Bonus' is anchored to the core business objectives of financial performance, customer experience and risk management. The scheme design is the same for all colleagues, with varying on-target awards for all colleagues and senior managers. Bonus is awarded on successful achievement of financial and customer performance measures, combined with individual performance. A risk overlay process is also carried out to ensure the Group hasn't been exposed to unnecessary risk; this forms part of our 'sustainability review'. 'On-target' achievement of Group performance criteria results in a bonus of 30% of base salary for the executive directors. The maximum bonus available to executive directors is 50% of base salary. The payment of bonus is subject to the discretion of the Committee, and all executive director bonuses are subject to the relevant deferral periods.



1. Financial performance

Under the terms of the 'Your Bonus' scheme, scope is given to make adjustments to the calculation of profit underpinning payment of the scheme. The following principles are applied when identifying potential adjustments:

- Where an unexpected or unplanned item arises that is not part of the core, business as usual, running of the Society. For example one-off investments or projects that were not included in the plan profit number against which actual performance is judged.
- Adjustments also include removing both positive and negative impacts from non-core actions that do not reflect management of the underlying Group. For example any unplanned profits (or losses) on the sale of property are not included in the profit before tax (PBT) figure used to calculate bonus outturn.

In line with the above, the overall profit before tax figure was adjusted to produce an achieved position of £154m against a reported figure of £193m. This has performed above target, which was £144m and set the bonus earning potential for the financial element. The PBT calculations used for the bonus outturn have been verified by the Society's internal audit team.

2. Customer experience

The second performance measure is the customer 'Net Promoter Score' (NPS), which unlocks the bonus award. The NPS measures how likely our members and customers are to recommend us and we obtain this through customer and broker surveys. The results are combined, at a ratio of 50% mortgages and 50% savings, to create the 'combined NPS' for 'Your Bonus'. To pay an 'on-target' bonus, the target NPS for the year was +42. On average in 2018 the NPS was at +41.

Contribution from different NPS surveys to the overall combined Group NPS score for Your Bonus	
Mortgages: 50%	
Broker feedback: **25%**	Mortgage customer feedback: **25%**
Savings: 50%	
Savings customer feedback: **45%**	Shareplans customer feedback: **5%**

3. Sustainability review

The following calculations are undertaken and reviewed before any bonus payment is awarded:

1. an assessment of the level of capital held by the Society to ensure it remains sustainable and holds sufficient levels of capital from a regulatory perspective.
2. an assessment of the Society's cost management to ensure that it is managing its costs in line with targets approved by the Board. Payments will be reduced or forfeited if the Society has not delivered in line with these targets.

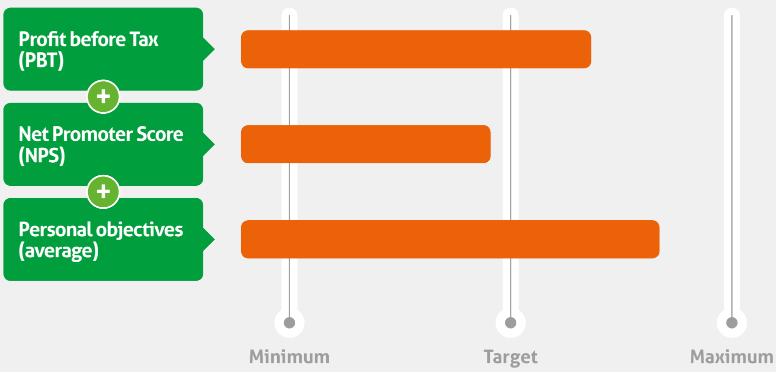
As part of this review, the risk overlay process considers the management of specific business risk appetite measures and payment can be amended where material breaches are identified. Following a rigorous review where business controls processes were assessed, it was deemed that no action was required to adjust the bonus outturn for the 2018 performance year.

4. Individual performance

The Group's performance determines the core bonus award; all three above elements need to be achieved at minimum levels before any bonus will be awarded. Individual performance concludes the percentage of bonus to be awarded.

How bonus is calculated for executive directors

The table below summarises the outcome against the various measures for 'Your Bonus'.



How bonus is awarded for our executive directors

Executive Director	Role	Total Award		Deferral schedule*						
		% of salary	£'000	2019	2020	2021	2022	2023	2024	2025
Mike Regnier	CEO	35.51	199	79	–	–	24	24	24	24
Alasdair Lenman	CFO	39.45	143	56	–	–	17	17	17	17
Stephen White	COO	35.51	149	59	–	–	18	18	18	18

*Bonus deferral is explained below.

For 2018 performance year, 99.7% of eligible colleagues will receive a bonus. On average an eligible executive director achieved 73.6% of their maximum opportunity, with all eligible colleagues on average receiving 50.6% of their maximum opportunity.

Bonuses for executive directors remain subject to malus and clawback, with bonus subject to clawback for up to ten years.

Bonus Deferral and Share Equivalent Instrument (SEI)

In line with the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) remuneration regulations and the Senior Managers and Certification Regime, all bonuses payable to executive directors designated as 'Senior Managers' are subject to deferral. In addition to regulatory requirements, the Society's remuneration policy requires bonuses for all members of the senior management team are subject to an element of deferral. Bonus deferral ensures that the Society delivers variable pay in a manner that prevents undue risk taking whilst achieving a level of sustainable performance.

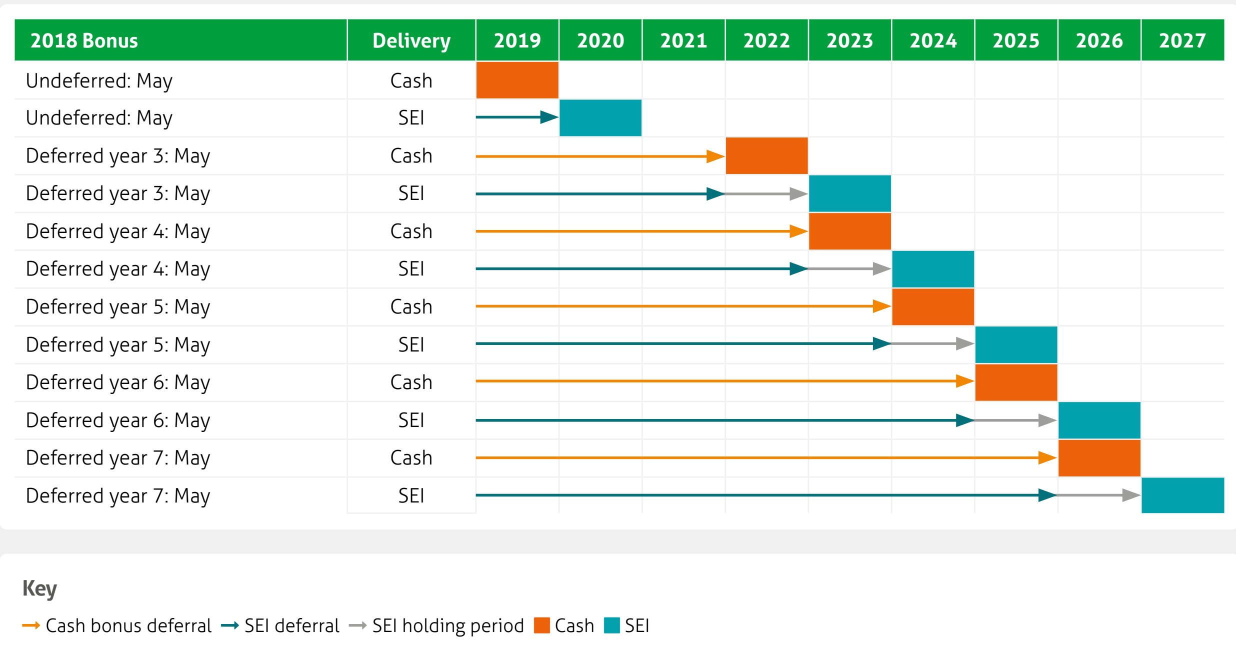
For executive directors whose remuneration is over the 'de-minimis'* limit, bonus awards are required to have a longer deferral period and/or a larger percentage deferred in line with regulations. Where also required by regulation, 50% of each bonus payment will be delivered via an SEI and is subject to a retention period. For the 2018 performance year, an executive director whose remuneration exceeds the de-minimis limit will receive 40% of their bonus in 2019 with the remaining 60% deferred over seven years, with a one year retention period applying to the SEIs received.

(*A de-minimis limit level is set by regulation, in relation to the level of bonus deferral applied, and impacts colleagues whose total remuneration is greater than £500,000 per annum or where variable remuneration is more than 33% of their total remuneration.)

For example:

- **Year 1** – 40% of any bonus earned is paid out in the year following the performance year. Half of this amount is paid in cash and the other half is delivered in a SEI and subject to an additional retention period prior to revaluation and payment.
- **Deferral years** – the remaining 60% is deferred for 7 years and paid equally each year from 3 years after the award. Each year, the award is split in two, with half the amount paid in cash and the second half held in a SEI and subject to an additional retention period prior to revaluation and payment. SEI valuations continue every 12 months until the bonus schedule is complete.

Length of time variable pay is at risk



In a performance year, where executive directors total remuneration falls below the de-minimis limit, the annual bonus awards will be delivered as cash and paid over three years: 50% of any bonus is paid out in the year following the performance year; the remaining 50% is deferred with 25% released after one year and 25% released after two years.

Taxable benefits

The taxable benefits awarded to executive directors are in line with the wider colleague offering, comprising a company car (or equivalent allowance), private medical insurance, permanent health insurance and any location allowances. Executive directors, like all colleagues, can also participate in a concessionary mortgage scheme which is subject to a maximum concessionary amount of £160,000; no executive directors have taken up this mortgage scheme. No significant changes to the construct of the executive directors' benefits entitlement are planned for 2018.

Pensions

From 1 January 2018 all executive directors are members of the Society's defined contribution scheme; a core contribution of up to 16% of base salary is paid for this population. Where prevailing tax restrictions limit pension contributions, the remainder is paid as a cash allowance.

From 1 January 2019 all newly appointed executive directors will be eligible for a core contribution of up to 11% of base salary. This is in line with all other colleagues.

The pension scheme also provides a lump sum of six times' pensionable salary on death in service.

Movement in CEO remuneration relative to the wider colleague population

Mike Regnier received a pay increase of 2.7% in May 2018. The average pay increase in 2018 for all colleagues (including executive directors) was 2.6%.

The overall change in the CEO's pay is 7.2% lower than the same timeframe in 2017.

Payments for loss of office

There were no payments for loss of office in 2018.

Payments to past directors

There were no payments to past directors in 2018 that had not already been disclosed in previous reports..

Chairman and non-executive directors

In line with the annual review of Chairman and non-executive director fees, the fee levels were reviewed in June 2018 and came into effect on 1 July 2018. Non-executive directors' basic fees were increased by 2.2% in July 2018. This change took into account external market data, the skills and the time commitment required for the role as well as wider colleague salary increases. This change was recommended to reflect comparable market data and nearest peer comparators. Non-executive directors fees are agreed by the Society's chairman and executive directors.

The Committee reviews the fees payable to the Society's Chairman. The Chairman is not involved in any decisions relating to his own remuneration. Despite the Chairman being a member of the Committee, he is not involved in decisions relating to his own remuneration.

Non-executive director fees	Fees at 1 July 2017	Fees at 1 July 2018	Uplift
Annual equivalents	£'000	£'000	%
Chairman basic fees	188.6	192.7	2.2
Vice Chairman basic fees	70.5	72.0	2.2
Non-executive director basic fees	49.5	50.6	2.2
Additional fee for:			
Audit Committee – Chair	20.5	21.0	2.2
Audit Committee – Member	8.5	8.7	2.2
Remuneration Committee – Chair	16.7	17.1	2.2
Remuneration Committee – Member	6.1	6.3	2.2
Group Risk Committee – Chair	20.5	21.0	2.2
Group Risk Committee – Member	8.5	8.7	2.2

Single total figure of remuneration for each non-executive director

The non-executive directors' basic and committee fees earned in 2018 are outlined on page 76. Note that the Society's non-executive directors do not receive any benefits. Non-executive directors are reimbursed for any expenses incurred, such as travel and subsistence. Any tax due is the responsibility of individual non-executive directors.

Non-executive Director	2017 Basic Fees	2017 Committee Fees	Total	2018 Basic Fees	2018 Committee Fees	Total
Annual equivalents	£000	£000	£000	£000	£000	£000
John Heaps (Chairman)	187	–	187	191	–	191
Neeta Atkar	33	20	53	50	29	79
Alison Hutchinson	49	14	63	50	15	65
Gordon Ireland	49	14	63	50	17	67
Mark Pain (Vice Chairman)	70	28	98	71	29	100
Guy Parsons	49	17	66	50	17	67

2019 Remuneration Policy

Our reward aims

Our aim is to build a working environment where colleagues feel engaged and committed to the Society's journey, ensuring they feel valued and respected to give their best. Our reward offering is integral to that, with an approach founded in our mutuality and values.

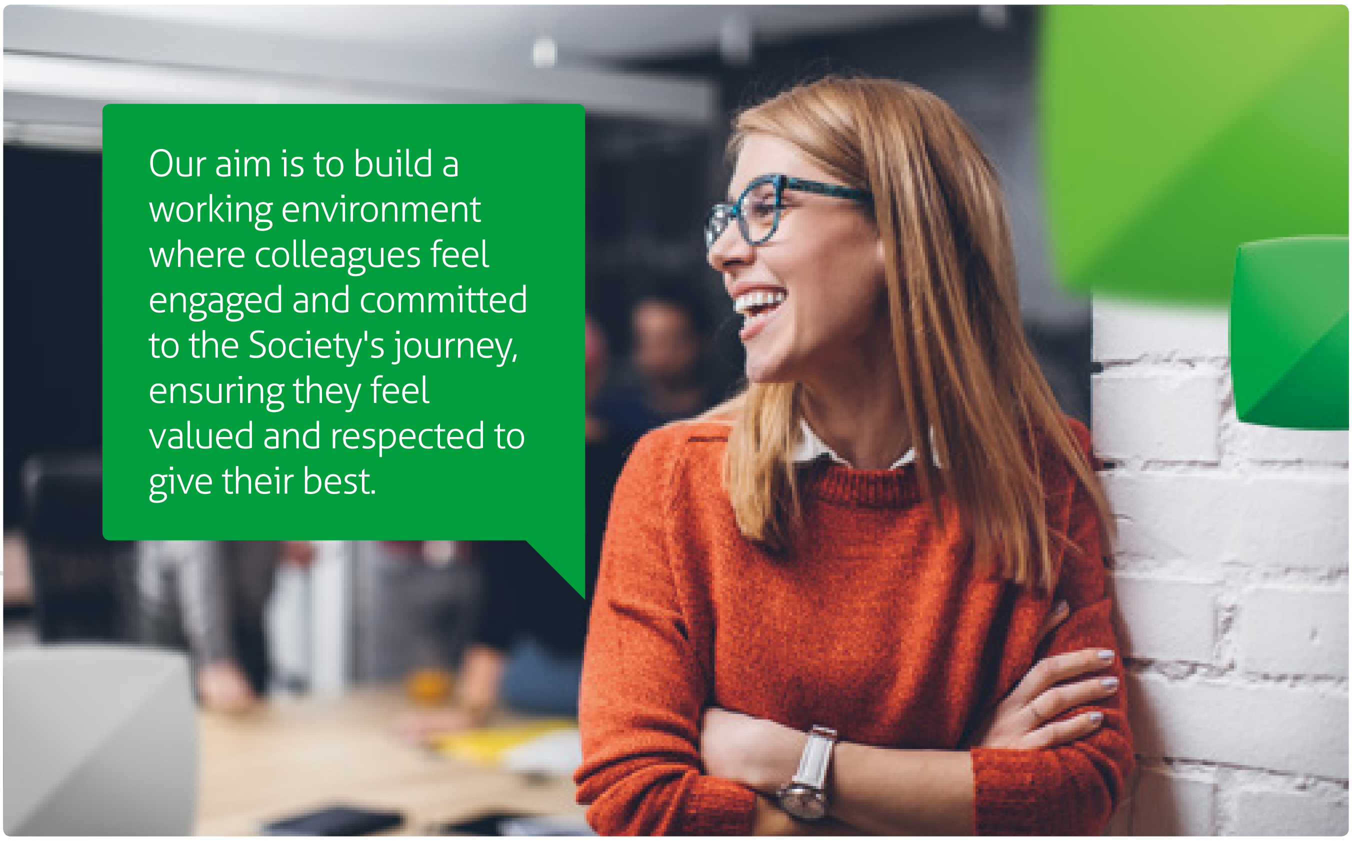
Our remuneration policy is in place to support our colleagues in working together for the benefit of the Society and our members.

Our reward principles

To support us in achieving our aspirations we follow five key principles. These help us know when we are doing the right things and set out what we believe good reward practice for all of our colleagues looks like.

Our five reward principles developed with YBS colleagues' are:

1. Attract and retain talent, aligned to our mutual values and forward thinking to ensure relevance in a changing world.
2. Focused on total reward; recognising that reward is more than just pay, enabling colleagues to make the choices that work for them at different stages in their life.
3. Flexible within a framework to ensure a consistent approach whilst responding to different challenges, supported by education to help managers balance doing the right thing for both the Society and their people.
4. Reward decisions and choices are clear and transparent for colleagues; delivered through effective and open communication.
5. Our reward arrangements are reflective of both team and individual achievements, with the ability to recognise the contribution all colleagues have made to our success.



Our approach to Risk Management and Governance of Reward

Our reward provisions will meet all the requirements of both our internal governance processes and external regulators. Our provision of reward and the associated policies, processes, procedures and practices relating to these will be created in a way which ensures the appropriate level of governance is in place to mitigate any potential risks to the Society, colleagues and customers.

Our Committees

To ensure our reward policies and procedures are robust and assured we have two main Committees in place to support this; the Remuneration Committee (RemCo) and the Performance and Reward Committee. These Committees play different roles in making sure our approach to reward meets our required levels of compliance, as explained below.

Remuneration Committee (RemCo)

This Committee has specific responsibility for making sure we have the right policies and processes in place for our most senior roles and setting the tone for the wider organisation. RemCo is made up of non-executive directors and its purpose is to oversee the remuneration policy in place for the Society, making sure this aligns to our business strategy and any regulatory requirements. Details in relation to the composition and the Terms of Reference of the Remuneration Committee can be found on our website at ybs.co.uk/committees.

Performance & Reward Committee

The Performance & Reward Committee is in place to ensure effective governance and oversight of our reward policy with a focus on regulatory compliance and alignment to our business strategy. The Committee also ensures that any incentive arrangements (such as the Society's bonus) that we offer colleagues drive the right behaviours towards risk taking and safeguard good customer outcomes. The Performance & Reward Committee comprises a number of senior leadership team members within the organisation with representation from the Customer, People, Finance and Risk functions.

Our Regulators

As a financial services provider we are regulated by both the FCA and the PRA. The relationship with our regulators is important to us, and builds trust both inside and outside of the Group. This means that from a reward and benefits perspective we ensure that our pay, bonus and benefits not only meet any necessary obligations of our regulators but are designed and provided in a way which develops a trusted relationship with them.

Remuneration components

The remuneration arrangements applicable to our executive directors are made up of 4 key components:

1. Fixed remuneration – Base pay
2. Short term performance-based remuneration ('variable pay' or 'bonus')
3. Benefits
4. Retirement Benefits

Executive Director Remuneration Policy

This document details the Society's remuneration policy for its executive directors, making comparisons where applicable to the wider colleague group. For executive directors, the remuneration policy is voted on every three years (or sooner if required) and will be shared with members for their approval through an advisory vote at the 2019 AGM.

Fixed Remuneration – Base Pay (also referred to as 'Base Salary')

Purpose and link to strategy

To enable the attraction and retention of the right calibre of Executive by ensuring that they are appropriately rewarded for their role.

The level of base pay awarded serves to reflect the contribution of executive directors in their role as defined by the combination of:

- Skills, knowledge and experience;
- On-going performance;
- Demonstration of the Group's behaviours and values.

Actual base pay levels are also determined by a review of market conditions to ensure that we offer levels of base pay that are appropriate in the market and enable us to attract and retain talent into the organisation.

In practice

Base pay is typically reviewed annually and determined with reference to:

- Role, experience and individual performance.
- Affordability – the economic environment and overall financial position of the Group.
- Comparison to the external market, supported by reference to the Society's grading structure, the Career Framework.
- Internal relativities and wider workforce base pay levels

A consistent set of principles are applied when considering both executive directors' base salaries and those of the wider organisation.

Opportunity

There is no 'maximum' base pay opportunity.

We seek to target a median position in relation to 'total remuneration'. To ensure that this is achieved base pay ranges are developed with reference to the total package including variable pay.

Annual base pay increases will normally be in line with the typical level of increases awarded to the wider workforce and will be a reflection of the individual's performance.

The Remuneration Committee may award increases above this level in certain circumstances.

Short term performance-based remuneration ('variable pay' or 'bonus')

Purpose and link to strategy

To ensure that an executive director's remuneration has a direct link to the success of the Society, motivating delivery of core business metrics in line with our company values.

The Society's 'Building Together' bonus scheme rewards annual performance against challenging financial and customer measures as well as key individual objectives.

Bonus is driven by 3 key factors:

- Financial performance currently measured via Profit Before Tax
- Customer Experience currently measured via the Group's Net Promoter Score
- Individual performance measured with reference to an executive director's performance against key objectives.

In practice

Key measures within the Corporate Plan have to be achieved for 'on target' pay-out, and considerably exceeded for maximum pay-out.

Bonus is achieved in the following way:

1. The development of a bonus pool determined by reference to the Group's financial performance.
2. The bonus pool is moderated up or down as a result of the Customer Experience received by our members and customers.
3. The total individual awards are determined by an executive director's performance against his or her annual objectives.

A minimum level of performance across all 3 metrics is required to activate a bonus payment.

Bonus payments are subject to the operation of a Business Controls Process that considers a range of key metrics to evidence the robust management of the Society e.g. cost indicators, risk indicators.

The profit figures utilised for pay out may be adjusted at the discretion of the Remuneration Committee in line with approved principles to ensure a true and fair view of performance is applied.

Risk Overlay

Bonus payments applicable to Material Risk Takers are subject to a formal risk overlay process where a series of key risk indicators are considered to provide assurance that no inappropriate risk taking behaviours have taken place.

In instances where issues are identified the Remuneration Committee reserve the right to apply a malus adjustment (reduce bonus or lapse deferred elements) and to apply clawback (recover bonus payments already made) as applicable. Awards are subject to clawback for up to a maximum of ten years.

Deferral and Share Equivalent Instrument (SEI)

In line with regulation, all bonus awards for executive directors are subject to deferral. Bonus deferral ensures that the Society delivers variable pay in a manner that prevents undue risk taking and achievement of sustainable performance.

For executive directors designated as 'Senior Managers' under the Senior Manager Regime and over the 'de-Minimis*' limit, a percentage of their bonus awards is deferred for a period of time, subject to regulation.

*De-Minimis limit level is set by regulation, in relation to the level of bonus deferral applied, and impacts colleagues' whose total remuneration is greater than £500,000 per annum and/or where colleagues' variable remuneration is more than 33% of their total remuneration.

Where also required by regulation, 50% of a payment will be delivered as SEI, which is subject to a retention period. For example in the 2019 performance year, 40% of each individual director's award vests in 2020 and the remaining 60% is deferred over seven years.

How this works in practice:

- Year 1 – 40% of any bonus earned is paid out in the year following the performance year. Half of this amount is paid in cash and the other half is delivered in a SEI and subject to an additional retention period prior to revaluation and payment.
- Deferral Years – the remaining 60% is deferred for 7 years and paid equally each year from 3 years after the award. Each year, the award is split in two, with half the amount paid in cash and the second half held in an SEI, subject to an additional retention period prior to revaluation and payment. SEI valuations continue every year until the bonus schedule is complete.

Where executive director remuneration is below the de-minis criteria and they are not defined as 'Senior Manager' within the senior manager regime, the delivery of the annual bonus award will normally be delivered as cash and paid over three years: 50% of any bonus is paid out in the year following the performance year; the remaining 50% is deferred with 25% released in year 2 and 25% released in year 3.

Bonuses for executive directors will be disclosed in the annual report and accounts.

Opportunity

'On-target' achievement of Group performance criteria results in a bonus of 30% of base salary for the executive directors. The maximum bonus available to executive directors is 50% of base salary.

Failure to meet organisational or individual performance thresholds can reduce bonus awards to zero.

All Senior Manager bonuses are subject to deferral.

All of the Society's bonus schemes are underpinned by the same metrics.

Benefits

Purpose and link to strategy

To provide a total reward package (base pay, bonus, pension and benefits) that is in line with market practice and enables the attraction and retention of executive directors of the required calibre.

In practice

Executive directors are eligible to receive a number of benefits, principally consisting of:

- Private medical insurance
- Life assurance (6x salary);
- Concessionary mortgage and savings account;
- Insured sick pay;
- Provision of a company car, or cash equivalent.

Opportunity

There is no 'maximum' level of benefits – the overall value of benefits to the Society's executive directors is determined by the nature of its benefit offering which is subject to change throughout a given year.

Retirement benefits

Purpose and link to strategy

The Society's pension arrangements support the recruitment and retention of executive directors through the provision of competitive retirement benefits.

In practice

The Society operates a single defined contribution pension scheme and all colleagues have the opportunity to participate.

Where contributions exceed the annual or lifetime allowance, or participation in the scheme is tax inefficient, colleagues may be permitted to take a cash supplement instead of contributions to the plan.

Opportunity

Current executive directors receive a contribution (or cash allowance) equal to a maximum of 16% of base salary.

Future executive directors (appointed after 1 January 2019) will receive a contribution in line with the wider colleague group equal to maximum of 11% of salary.

Remuneration arrangements in relation to specific circumstances

New hires

Remuneration package

When agreeing the components of a remuneration package for the appointment of executive directors, the Committee will apply the following principles:

- The packages will be sufficient to recruit individuals of the required calibre to lead the business and effectively execute the strategy for members;
- The Committee will look to align the remuneration package offered with the Society's broader remuneration policy; and,
- The Committee will ensure that the level of pay is necessary but not excessive.

The Committee has discretion within the policy to make remuneration decisions where it considers it appropriate to do so.

In determining remuneration arrangements, the Committee will consider similar positions in the market, the structure of the remuneration package and the experience of the candidate. This ensures that arrangements are in the best interests of both the Society and its members without paying in excess of what is necessary to recruit an executive director of the required calibre.

Buy out arrangements

The Committee may make awards on hiring an external candidate to the Society to compensate them for the forfeiture of any award entered into with a previous employer. In determining any such 'buy out', the Committee will consider all the relevant factors including the likelihood of the awards vesting should the candidate have remained in their previous employment, the form in which they were awarded and the time over which they would have vested.

Bonus buyouts will be liable to forfeiture or 'clawback' in the event of early departure and are executed in line with the Remuneration Code.

Remuneration arrangements in relation to specific circumstances

Leaver arrangements and loss of office

The Committee shall apply the policy in relation to leavers, taking into account performance, conduct and commercial justifications, as summarised below:

Notice period

The standard notice period is 12 months from the Society and 12 months from the executive directors.

In normal circumstances, executive directors will be required to work their notice period. In the event executive directors are not required to fulfil their notice period, they will receive a payment in lieu of notice, or they may be placed on garden leave.

Chief officers and other MRTs have notice periods varying between three months and one year, depending on the role undertaken.

Termination Period

Typically, termination payments will consist of basic pay and other contractual benefits for the notice period, the emphasis being to not reward failure.

Annual bonus – leaver provisions

On termination of office, the leaver provisions as set out below will apply. These are also outlined in the Society's bonus plan rules:

- In the event of retirement or redundancy, ill-health or disability, any bonus will be pro-rated to reflect the time served during the performance period. Any deferred payments due remain subject to future performance conditions and are payable at the end of the corresponding performance periods. There will be no acceleration of payment. They are also subject to the Society's risk overlay process, and therefore subject to the Society's malus and clawback provisions.
- In the case of death, any bonus payments will be pro-rated to reflect the time served during the performance period. Payment of any deferred amounts, including deferred amounts from previous years, is accelerated and payable at the next payment date.
- Subject to Committee discretion, in the event of resignation, any eligibility to participate in the current year's bonus scheme will cease. Leavers under these circumstances will be eligible to receive deferred bonus payments earned in previous years, subject to the Society's risk overlay process.

Subject to Committee discretion and the Society's risk overlay process, executive directors who resign from the Society will retain eligibility to any deferred bonus payments earned in previous years. Malus and clawback provisions continue to apply.

Remuneration Policy in relation to non-executive directors

Non-executive director fees

Purpose and link to strategy

Sole element of remuneration set at a level that reflects market conditions and sufficient to attract individuals with appropriate knowledge and experience to provide a meaningful contribution to the Group.

In practice

Fees are based on the level of fees paid to non-executive directors and chairs serving on boards of comparable organisations, the time commitment, and contribution expected from the role.

- Non-executive director fees are determined and approved by the Board on recommendation from the CEO.
- The Chairman's fees are determined by the Remuneration Committee.
- Both the Chairman's and non- executive directors' fees are reviewed periodically, at least annually.
- The Chairman's and non-executive directors' fees are not subject to any specific performance measures; however, their overall performance is reviewed on a regular basis.

Neither the Chairman nor any of the non-executive directors have any influence over the setting of their own fees.

Opportunity

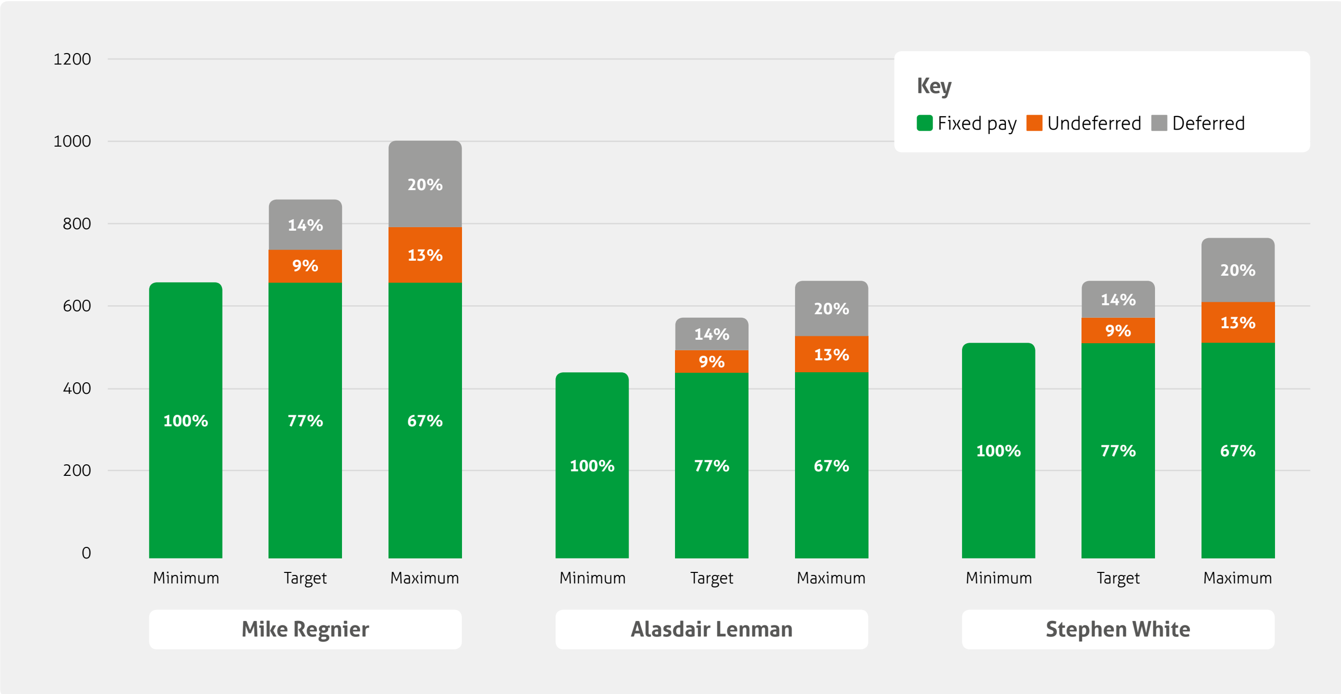
There is no 'maximum' fee opportunity.

Fees are set with reference to the level of fees paid to non-executive directors and chairs serving on boards of comparable organisations, the time commitment, and contribution expected from the role.

Remuneration scenarios in relation to the 2019 Remuneration Policy

The chart on page 82 shows the potential split of remuneration between fixed pay (salary, benefits and pension) and variable pay for the CEO and other executive directors under the following scenarios:

- **Minimum** – under certain performance conditions, bonus can be zero.
- **Target** - represents remuneration (30% of base salary) that would be paid if Group and personal performance measures are achieved in 2019.
- **Maximum** – the maximum bonus (50% of base salary) that could be paid assuming Group and personal performance measures are fully realised.



Remuneration Committee terms of reference

The Committee has specific responsibility for ensuring we have the right policies in place for our most senior roles and setting the tone for the wider organisation. Its purpose is to oversee the remuneration policy in place for the Society, making sure it aligns to the Group's business strategy and any regulatory compliance requirements, with a specific focus on the risks posed by remuneration policies and practices.

The Committee's Terms of Reference were reviewed and updated in January 2019. The full terms of reference are available on the Society's website at ybs.co.uk/committees.

The members of the Remuneration Committee consist of non-executive directors and include a member of the Group's Risk Committee. During the year the Committee members were: Guy Parsons (Chair of the Remuneration Committee), John Heaps and Alison Hutchinson.

The Committee met seven times during the year and covered the following activities:

- Reviewing the Society's remuneration policy for executive directors and the wider colleague group
- A strategic review of the Society's Reward strategy
- Reviewing the Society's bonus scheme structure and targets
- Ongoing work in relation to the Prudential Regulatory Authority's (PRA) Remuneration Code and how it applies to the Group
- Agreeing the approach for executive base salary increases in 2018
- Agreeing the remuneration package for the new Chief Officers

The Committee is supported by the Chief People Officer and the Director of People Performance. Where it is felt to be appropriate, the Chief Executive Officer is invited to attend to provide further background and context to assist the Committee in discharging its duties.

The Committee draws on the advice of independent external consultants to support in performing its duties. During the year, the Committee sought advice on executive director salaries, variable pay structures and regulatory matters from PwC. The Committee is satisfied that the advice received is objective and independent. PwC's fees for advice provided to the Committee in 2018 were £113,400 (including irrecoverable VAT): £113,400 in 2017 (including irrecoverable VAT). During 2018, PwC also provided business consulting services across the Society on matters including IT risk assurance, data assurance, project assurance, operational risk assurance, regulatory compliance monitoring services, internal audit, risk treasury (hedge accounting) support, accounting advisory support and tax advisory support.

As PwC have been appointed as the Society's external auditors, subject to member approval at 2019 AGM, PwC will no longer serve as advisors to the Committee. After a robust selection process, EY have been appointed as Remuneration Committee advisors for 2019 onwards.

Statement of Member Voting

The Society remains committed to ongoing member dialogue and takes an active interest in voting outcomes. The following table sets out the voting results in respect of the resolution to approve the 2018 Directors' Remuneration Report at the Society's Annual General Meeting (AGM) in 2018.

Resolution

To approve the Directors' Remuneration Report

Votes for	Votes against
128,159	14,760
% in favour	**Votes withheld**
89.67	3,240

As noted in the Committee Chair's letter, there will be an advisory vote on the Directors' Remuneration Policy and Directors' Remuneration Report at the 2019 AGM.

On behalf of the Board

Guy Parsons,
Chair of the Remuneration Committee

Aggregate remuneration data (Pillar 3)

In accordance with the Capital Requirements Regulation (CRR) as part of CRD IV, which requires the disclosure of the aggregate remuneration data for senior managers and MRTs, the Group's data is set out as follows:

	Senior Management[1]	Other MRTs	Total
	£'000	£'000	£'000
Aggregate remuneration data			
Fixed pay	6,562	532	7.094
2018 Variable pay (undeferred)	893	39	932
2018 Variable pay (deferred)	1,016	–	1,016
2018 Variable pay due via SEI	309	–	309
Deferred variable pay to be paid 2018	652	–	652
Outstanding deferred variable pay from previous years	1,004	–	1,004
Total	**10,127**	**571**	**10,698**
Aggregate bonus buyout and severance payments			
Bonus buyout payments - 2018	–	–	–
Severance Payments - 2018	1,056	–	1,056
Total	**1,056**	–	**1,056**

	Senior Management	Other MRT	Total
Number of MRT colleagues at 1.1.18	28	9	37
Number of MRT colleagues at 31.12.18	28	6	34

Ratios between fixed and variable pay

The Society's fixed:variable pay ratio is not affected by the CRD IV cap on variable pay as the variable component of total remuneration to the fixed component does not exceed 1:1. The maximum annual bonus award for any colleague is 50% of base pay and therefore variable pay will not exceed the CRD IV cap. The Society's full Pillar 3 disclosure is available at ybs.co.uk/your-society/financial-results.

1 Senior managers and colleagues whose actions have a material impact on the 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.

The main components of Material Risk Taker (MRT) remuneration structures are:

Element & purpose	Operation	Opportunity
Base pay To enable the attraction and retention of the right calibre of individual by ensuring that they are appropriately rewarded for their role.	Typically reviewed annually, in line with the range of increases for all colleagues, and determined with reference to: ▪ Role, experience and individual performance; ▪ Affordability – the economic environment and overall financial state of the Group; ▪ Comparison to the external market, supported by reference to the Group's grading structure, the Career Framework.	n/a
Bonus To ensure that an MRT's remuneration has a direct link to the success of the Society, motivating delivery of core business metrics in line with our company values.	▪ Key measures within the Corporate Plan have to be achieved for 'on target' pay-out, and considerably exceeded for maximum pay-out. ▪ All bonus payments are made in line with regulatory requirements and adhere to the relevant deferral periods. ▪ The Committee reserve the right to apply a malus adjustment (reduce bonus or lapse deferred elements) and to apply clawback (recover bonus payments already made) as applicable. ▪ Awards are subject to clawback for up to a maximum of ten years.	'On-target' achievement of Group performance criteria results in a bonus of 30% of base salary for the majority of MRTs, with a maximum of 50% of base pay. For a small number of MRTs working within the Treasury function, their on-target achievement is 7% of base pay and a maximum of 10% of base pay.
Benefits To provide a total reward package that is in line with market practice and enables the attraction and retention of MRTs of the required calibre.	Benefits include car benefits, healthcare, private medical insurance, life cover and insured sick pay.	All benefits are provided in line with the Group's grading structure, the Career Framework.
Retirement benefits The Group's pension arrangements support the recruitment and retention of executive directors through the provision of competitive retirement benefits.	MRTs are eligible to participate in the Group's defined contribution pension scheme. ▪ Where contributions exceed the annual or lifetime allowance, executive directors may be permitted to take a cash supplement instead of contributions to the plan.	Current executive directors receive a contribution (or cash allowance) equal to a maximum of 16% of base pay. Future executive directors (appointed after 1 January 2019) and all other MRTs will receive a contribution in line with the wider colleague group equal to maximum of 11% of base pay.

Independent Auditor's Report

Independent Auditor's Report to the members of Yorkshire Building Society. Report on the audit of the Financial statements.

Opinion

In our opinion the financial statements of Yorkshire Building Society (the 'Society') and its subsidiaries (the 'Group'):

- give a true and fair view of the state of the Group's and Society's affairs as at 31 December 2018 and of the Group's and the Society's income and expenditure for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- 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.

We have audited the financial statements which comprise:

- the Group and Society income statements.
- the Group and Society statements of comprehensive income.
- the Group and Society balance sheet.
- the Group and Society statements of movements in member's interest and equity.
- the Group and Society cash flow statements.
- the related notes 1 to 43 excluding the capital adequacy disclosures in note 31 calculated in accordance with the Pillar III legislation which are marked as unaudited.

The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the Group and the Society in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the Financial Reporting Council's (the 'FRC's') Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We confirm that the non-audit services prohibited by the FRC's Ethical Standard were not provided to the Group or the Society.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Summary of our audit approach

Key audit matters	The key audit matters that we identified in the current year were: ■ IFRS 9 Financial Instruments – Expected credit loss provisioning. ■ Fair value adjustments. ■ Effective Interest Rate adjustment. ■ Hedge accounting and derivatives. ■ Provision for Mortgage Payment Protection Insurance policies ("MPPI") redress. Within this report, any new key audit matters are identified with ⌃ and any key audit matters which are the same as the prior year are identified with ›
Materiality	The materiality that we used in the Group financial statements was £8.9m which was determined on the basis of 5% of income before tax as per the Consolidated Income Statement.
Scoping	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 99% of the Group's net assets and 99% of the Group's profit before tax. These audits were performed directly by the Group audit team and executed to each of the individual entity materialities which were lower than the Group materiality.
Significant changes in our approach	The key audit matters are consistent with those identified in the prior year with the exception of effective interest rate adjustment. Effective interest rate adjustment was introduced as a new key audit matter as the Group was developing a new enhanced model.

Conclusions relating to going concern, principal risks and viability statement	
Going concern	
We have reviewed the directors' statement on page 42 to the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's and Society's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.	**We confirm that we have nothing material to report, add or draw attention to in respect of these matters.**
We considered as part of our risk assessment the nature of the Group, its business model and related risks including where relevant the impact of Brexit, the requirements of the applicable financial reporting framework and the system of internal control. We evaluated the directors' assessment of the Group's ability to continue as a going concern, including challenging the underlying data and key assumptions used to make the assessment, and evaluated the directors' plans for future actions in relation to their going concern assessment.	**We confirm that we have nothing material to report, add or draw attention to in respect of these matters.**
Principal risks and viability statement	
Based solely on reading the directors' statements and considering whether they were consistent with the knowledge we obtained in the course of the audit, including the knowledge obtained in the evaluation of the directors' assessment of the Group's and the Society's ability to continue as a going concern, we are required to state whether we have anything material to add or draw attention to in relation to: ▪ the disclosures on pages 60 to 68 that describe the principal risks and explain how they are being managed or mitigated. ▪ the directors' confirmation on pages 34 to 35 that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity. ▪ the directors' explanation on pages 34 to 35 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.	

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

IFRS 9 Financial Instruments – Expected Credit Loss provisioning

Key audit matter description	This is a new and complex accounting standard which has required considerable judgement and interpretation in its implementation. These judgements have been key in the development of new models which have been built and implemented to measure the expected credit losses on loans measured at amortised cost. The models developed estimate the expected loss provisions against loans to customers within the Group's residential mortgage book. The Group held £29.1m of impairment provisions against residential mortgages at year-end in accordance with IFRS 9 (2017: £32.5m in accordance with IAS 39) against total loans and advances to customers of £36,702.4m (2017: £35,061.2m). The transition adjustment on adoption of IFRS 9 at 1 January 2018 was a decrease of £3.2m (resulting in a total provision of £29.3m). Estimating these expected losses requires judgement and estimation on assumptions relating to customer default rates, likelihood of repossession, future property values, forced sale discounts and indicators of significant increases in credit risk. These assumptions are informed using historical behaviour and experience as well as credit bureau data. They are also affected by management's consideration of the future economic environment including the potential effect of the withdrawal of the United Kingdom from the European Union. The Group have applied this key accounting estimate through its selection of economic scenarios and weighting allocations as described on pages 165 to 166. The Group identified a population of highly-indebted customers in the loan portfolio that exhibit higher credit risk as described on page 109. Management has separately assessed whether the model appropriately provides against potential losses for such accounts. There is a risk of fraud inherent in estimating the required loan loss provision given the material impact and sensitivity of these judgements on the final figure and therefore profit for the year. We noted that the provision is highly sensitive to the expectation of future house prices and has been materially affected by the expectation of the future economic environment, the effect of which has been disclosed by management on page 165. The Group's loan loss provision balances are detailed within Note 9. Management's associated accounting policies are detailed on pages 105 to 106 with detail about judgements in applying accounting policies and critical accounting estimates on page 109. Management's consideration of the effect of the future economic environment is disclosed on page 109. The Audit Committees' consideration of the matter is described on page 57.
How the scope of our audit responded to the key audit matter	We first obtained an understanding of management's processes for the Group's loan loss provision balances by performing a walkthrough, and evaluated the design, and assessed the implementation of key internal controls in place. We engaged credit risk and accounting specialists to assess the compliance of the modelling approach with the requirements of the standard. We also engaged IT and credit risk specialists to determine whether the documented modelled approach was implemented in practice. We have tested the accuracy of the loss given default, probabilities of default and possession given default parameters applied, comparing the recent historical performance against model forecasts. In addition, we have made an assessment of the collateral valuation techniques used by management to estimate an appropriate provision balance. We recalculated certain components of the provision calculation using underlying data that we tested the completeness and accuracy. We assessed whether the model was appropriately capturing the higher credit risk of highly-indebted customers by checking whether such accounts had been identified as having a significant increase in credit risk, as well as assessing the valuation of associated provisions. We challenged management's consideration of the future economic environment including the potential effect of the withdrawal of the United Kingdom from the European Union by engaging our economic experts to review management's approach as well as comparing modelled assumptions to publicly available data and comparable peer data. We reconciled each book to the general ledger and substantively tested a sample of loans to assess whether the data used in the provision calculation was complete and accurate.
Key observations	Based on the evidence obtained, we found that the assumptions underpinning all the impairment models were determined and applied appropriately and the recognised provision was reasonably stated. We consider that the provisions held are at the conservative end of a reasonable range.

Fair Value Adjustments

Key audit matter description	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 (N&P) and Chelsea Building Society (CBS) in prior years is an area that requires the use of significant judgement. The primary judgement relates to the level of lifetime losses that are expected from the acquired loan books, in particular the level of capital that will be recoverable from the CBS interest only portfolio. The future expected losses are compared with those anticipated at the dates of the mergers with any reduction in the required provision being reflected in the effective interest rate and any additional provision required reflected as an expected credit loss under IFRS 9 where appropriate. There is a risk of fraud inherent in the application of fair value adjustments given the material impact and sensitivity of these judgements on the final figure and therefore profit for the year. The Group's associated accounting policies are detailed on page 106, with detail about judgements in applying accounting policies and critical accounting estimates on page 109. This key audit matter was discussed by the Audit Committee as detailed in the Audit Committee Report on page 57.
How the scope of our audit responded to the key audit matter	We understood Management's fair value adjustments process by undertaking a walk-through to identify the key controls, data flows and input sensitivities. We assessed the design and implementation of the governance review control in respect of key judgements over model inputs. We identified the most significant judgements made by the Group in the calculation as being the estimation of future property values, the estimation of customers that will remain on an interest only product until the term of the loan, and the probability of interest-only customers having a repayment vehicle on maturity of their loan. We benchmarked the key assumptions against internal, external and industry data were available, and calculated an independent range of values. Our acceptable range for the fair value estimate was determined by using reasonably plausible alternative assumptions, in particular around the house price forecasts and the interpretation of responses to a customer contact programme relating to the availability of a repayment vehicle at the maturity of interest-only accounts, as well as publicly available data about interest only customers across the mortgage market. We tested the mechanical accuracy of the related models, engaging our IT and data specialists to independently recalculate the expected lifetime losses from data that was tested for accuracy and completeness.
Key observations	We found the judgements to be appropriate with the fair value adjustment being at the conservative end of a reasonable range, consistent with prior year.

Effective Interest Rate Adjustment

Key audit matter description	The Group uses an Effective Interest Rate (EIR) model to adjust the recognition of fees, commissions and early redemption charges integral to its mortgage balances in line with IFRS 9 – Financial Instruments. The loans and advances to customers of £36.7bn (2017: 35.1bn) presented in the balance sheet include an EIR adjustment, which is released to the income statement in line with the run off profile of the relevant account balances. This was identified as a key audit matter in 2018 as the Group was developing a new enhanced EIR model, which was being run in parallel to the existing model at year-end. We identified a significant audit risk in relation to the mechanical accuracy of the EIR model calculation and populations of data inputs to the model are accurate and complete. The Group's associated accounting policies are detailed on page 104, with detail about judgements made, and critical accounting estimates formed, in applying accounting policies on page 109. This key audit matter was discussed by the Audit Committee as detailed in the Audit Committee Report on page 58.
How the scope of our audit responded to the key audit matter	We understood Management's EIR adjustments process by undertaking a walk-through to identify the key controls, data flows and input sensitivities. We assessed the design and implementation of the governance review control in respect of key judgements and observations from implementation of the model to determine the EIR adjustment accurately. We tested the mechanical accuracy of the related models, by independently recalculating the effective interest rate adjustment from supporting data for a sample of mortgage products. The Group use historic redemption data to estimate the future account behaviour to directly determine the rate at which fees and commissions are released, and early redemption fees accrued, to the income statement. We tested the underlying redemption data and the analysis performed by the Group to determine its run-off curves. We also tested the accuracy and completeness of mortgage balance

Key observations	From our work performed on the effective interest rate model concluded that the deferred fees held in the Balance Sheet were appropriate at year end.

Hedge Accounting and Derivatives

Key audit matter description	The Group holds derivative financial instruments in order to mitigate the risks associated primarily with interest rate and basis risk, and eliminating where possible certain foreign currency exposures. The Group designates such derivatives into hedging relationships to reduce income statement volatility; the hedging relationships designated to reduce volatility relating to the foreign currency exposures involve more complexity because of the nature of the swaps used and varying methodologies used to measure effectiveness. The net fair value of the cross currency derivatives at year-end totals a £452.7m asset (2017: £420.3m asset) as disclosed in the notes to the financial statements on page 142. The hedge accounting requirements are complex and require significant skilled input and oversight by Management, as well as robust systems and controls. The Group's associated accounting policies are detailed on page 105 and was discussed by the Audit Committee as detailed in the Audit Committee Report on page 57.
How the scope of our audit responded to the key audit matter	We performed a walk-through of the Group's treasury and hedge accounting processes to understand Management's process for determining suitable hedging instruments, and the data flows that underpin and inform hedge accounting and valuation decisions. Once we had identified the key controls we performed an assessment of the design and implementation of such controls. We tested the Group's application of hedge accounting which comprised testing hedge documentation for compliance with the requirements of the accounting standards, and independently re-performing a sample of hedge effectiveness tests conducted by Management during the year. We independently calculated the fair value of a sample of the cross currency swaps and the underlying hedged items.
Key observations	We agree that the implementation of hedge accounting requirements and specifically the designation of cross currency derivatives into hedge relationships and the assessment of the effectiveness of hedge relationships are appropriate and in line with supporting documentation. We are satisfied that the valuations of complex derivatives are reasonable.

Provision for Mortgage Payment Protection Insurance policies ("MPPI") redress

Key audit matter description	Significant provisions have been made to reflect customer redress payments relating to the past sales of MPPI. Given the number and volume of the policies sold by the Group historically and the continued public focus on the industry in relation to miss-selling of such policies there is a risk that the Group's provisions are incomplete and do not adequately provide for expected future claims. There is also a risk that there is inadequate disclosure about the related provision. The provision at the year-end totalled £12.6m (2017: £21.3m) as disclosed in the notes to the financial statements on page 134. The Group's associated accounting policies are detailed on page 108 with detail about judgements in applying accounting policies and critical accounting estimates on page 109. This key audit matter was discussed by the Audit Committee as detailed in the Audit Committee Report on page 58.
How the scope of our audit responded to the key audit matter	We understood management's process for calculating the potential exposure and estimated cost of future customer claims including identification of key controls, data flows and input sensitivities. Once we had identified the key controls we performed an assessment of the design and implementation of such controls. We re-performed management's provision calculation and also tested the underlying data used in the calculation for completeness and accuracy. To challenge the Group's estimate we calculated an independent range using historical data and future expectations using our understanding of the sector and benchmarked to other organisations. We have reviewed the disclosures in Note 28 for compliance with IAS 37 Provisions, contingent liabilities and contingent assets.

Key observations	We are satisfied that the basis for the Group's calculation is reasonable and uses all available data to calculate a best estimate. Based on the results of our independent range analysis we believe that the Group's provision is towards the conservative end of a reasonable range.

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.

Based on our professional judgement, we determined materiality for the financial statements as a whole as follows:

	Group financial statements	Society financial statements
Materiality	£8.9m (2017: £8.0m)	£5.3m (2017: £4.7m)
Basis for determining materiality	Group materiality was set at the planning stage of our audit using forecast income before tax and assessed at year end and considered to be appropriate.	Society materiality equates to 2.7% of income before tax (2017: 5%), which is capped at an appropriate level as a proportion of Group materiality based on the Society's contribution of income before tax after removing dividends received from other Group entities.
Rationale for the benchmark applied	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.	The accumulation of profits is critical to maintaining and building capital for regulatory purposes and allowing the Society to invest in activities for its members. We have therefore selected profit before tax as the benchmark for determining materiality.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £190,000 (2017: £190,000) for the Group, 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

All material entities in the Group are within our audit scope and have been audited to a local materiality for the purpose of individual entity reporting resulting in an audit of over 99% of all the balances in the Group. All balances in the Group that are above our materiality threshold have been audited for the purpose of Group reporting. We have performed testing over the consolidation of Group entities. 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 £3.3m to £5.3m (2017: £2.7m to £4.8m).

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

In this context, matters that we are specifically required to report to you as uncorrected material misstatements of the other information include where we conclude that:

- Fair, balanced and understandable – the statement given by the directors that they consider the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for members to assess the Group's and Society's position and performance, business model and strategy, is materially inconsistent with our knowledge obtained in the audit; or
- Audit Committee reporting – the section describing the work of the audit committee does not appropriately address matters communicated by us to the Audit Committee.

We have nothing to report in respect of these matters.

Responsibilities of directors

As explained more fully in the directors' responsibilities statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group's and the Society's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or the Society or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Details of the extent to which the audit was considered capable of detecting irregularities, including fraud are set out below.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Use of our report

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

Extent to which the audit was considered capable of detecting irregularities, including fraud

We identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and then design and perform audit procedures responsive to those risks, including obtaining audit evidence that is sufficient and appropriate to provide a basis for our opinion.

Identifying and assessing potential risks related to irregularities

In identifying and assessing risks of material misstatement in respect of irregularities, including fraud and non-compliance with laws and regulations, our procedures included the following:

- enquiring of management, internal audit and the Audit Committee, including obtaining and reviewing supporting documentation, concerning the Group's policies and procedures relating to:
  - identifying, evaluating and complying with laws and regulations and whether they were aware of any instances of non-compliance;
  - detecting and responding to the risks of fraud and whether they have knowledge of any actual, suspected or alleged fraud;
  - the internal controls established to mitigate risks related to fraud or non-compliance with laws and regulations;

- discussing among the engagement team and involving relevant internal specialists, including tax, financial instrument, pensions, and IT regarding how and where fraud might occur in the financial statements and any potential indicators of fraud. As part of this discussion, we identified potential for fraud in the determination of management's estimates of expected credit loss and fair value adjustments; and
- obtaining an understanding of the legal and regulatory frameworks that the Group operates in, focusing on those laws and regulations that had a direct effect on the financial statements or that had a fundamental effect on the operations of the Group. The key laws and regulations we considered in this context included those set by the Financial Conduct Authority in respect of the misselling of payment protection insurance, as well as the Building Society Act 1986. In addition, we considered the regulation set by the Prudential Regulatory Authority relating to regulatory capital and liquidity requirements which are fundamental to the Group's ability to continue as a going concern.

Audit response to risks identified

As a result of performing the above, we identified IFRS 9 Financial Instruments – Expected Credit Loss provisioning and fair value adjustments as key audit matters. The key audit matters section of our report explains the matters in more detail and also describes the specific procedures we performed in response to those key audit matters.

In addition to the above, our procedures to respond to the risks identified included the following:

- reviewing the financial statement disclosures and testing to supporting documentation to assess compliance with relevant laws and regulations discussed above;
- enquiring of management, the audit committee and in-house legal counsel concerning actual and potential litigation and claims;
- performing analytical procedures to identify any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud;
- reading minutes of meetings of those charged with governance, reviewing internal audit reports and reviewing correspondence with the Prudential Regulation Authority and Financial Conduct Authority;
- in addressing the risk of fraud through management override of controls, testing the appropriateness of journal entries and other adjustments; assessing whether the judgements made in making accounting estimates are indicative of a potential bias; and evaluating the business rationale of any significant transactions that are unusual or outside the normal course of business.

We also communicated relevant identified laws and regulations and potential fraud risks to all engagement team members including internal specialists, and remained alert to any indications of fraud or non-compliance with laws and regulations throughout the audit.

Report on other legal and regulatory requirements

Opinions on other matters prescribed by the Building Societies Act 1986

In our opinion, based on the work undertaken in the course of the audit:

- 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 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.

In the light of the knowledge and understanding of the Group and the Society and their environment obtained in the course of the audit, we have not identified any material misstatements in the directors' report.

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

In our opinion the information given on page 41 for the financial year ended 31 December 2018 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: ▪ adequate accounting records have not been kept by the Society; or ▪ the Society's 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 in respect of these matters.**

Other matters

Auditor tenure

Following the recommendation of the audit committee, we were appointed by the board of directors of the Society on 22 July 2009 to audit the financial statements for the year ending 31 December 2009 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments of the firm is 10 years, covering the years ending 31 December 2009 to 31 December 2018.

Consistency of the audit report with the additional report to the audit committee

Our audit opinion is consistent with the additional report to the audit committee we are required to provide in accordance with ISAs (UK).

Use of our report

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

Peter Birch FCA
(Senior statutory auditor)
For and on behalf of Deloitte LLP
Statutory Auditor
Leeds, United Kingdom

27 February 2019

Income Statements

for the year ended 31 December 2018

		Group		Society	
		2018	2017	**2018**	2017
	Notes	**£m**	£m	**£m**	£m
Interest receivable and similar income	3	**1,018.7**	1,078.2	**963.5**	987.0
Interest payable and similar charges	4	**(547.0)**	(576.1)	**(617.0)**	(642.1)
Net interest income		**471.7**	502.1	**346.5**	344.9
Fees and commissions receivable		**29.1**	30.7	**16.5**	20.2
Fees and commissions payable		**(21.7)**	(24.2)	**(11.6)**	(15.5)
Net fee and commission income		**7.4**	6.5	**4.9**	4.7
(Expense)/income from investments	10	**(0.1)**	3.2	**74.8**	59.9
Net gains from financial instruments held at fair value	5	**20.1**	13.1	**20.6**	14.4
Net realised profits		**8.0**	6.1	**8.0**	6.1
Other operating income	6	**3.1**	4.8	**63.7**	53.4
Total income		**510.2**	535.8	**518.5**	483.4
Administrative expenses	7	**(291.3)**	(308.1)	**(291.3)**	(308.1)
Depreciation and amortisation		**(19.9)**	(31.4)	**(19.8)**	(31.4)
Impairment release/(charge) on financial instruments	9	**0.4**	9.8	**(2.7)**	3.9
Provisions for liabilities and charges	28	**(6.9)**	(40.3)	**(7.0)**	(40.2)
Operating profit and profit before tax		**192.5**	165.8	**197.7**	107.6
Tax expense	11	**(42.7)**	(41.4)	**(33.2)**	(23.9)
Net profit		**149.8**	124.4	**164.5**	83.7

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

The notes on pages 100 to 177 form part of these accounts. Where applicable the 2018 balances are under IFRS 9, and the 2017 balances under IAS 39. The transition tables within Note 1 provide further details of the full impact.

Statements of Comprehensive Income

for the year ended 31 December 2018

		Group		Society	
		2018	2017	**2018**	2017
	Notes	**£m**	£m	**£m**	£m
Net profit		**149.8**	124.4	**164.5**	83.7
Items that may subsequently be reclassified to the income statement:					
Assets measured through other comprehensive income:					
Fair value movements taken to equity		**(3.7)**	11.6	**(3.7)**	11.6
Amounts transferred to income statement	42	**(0.3)**	(8.0)	**(0.3)**	(8.0)
Taxation	11	**1.1**	(0.9)	**1.1**	(0.9)
Cash flow hedges:					
Fair value movements taken to equity		**(0.2)**	2.2	**(0.2)**	2.2
Amounts transferred to income statement	42	**2.7**	3.8	**2.7**	3.8
Taxation	11	**(0.6)**	(1.5)	**(0.6)**	(1.5)
Subtotal		**(1.0)**	7.2	**(1.0)**	7.2
Items that will not be reclassified subsequently to the income statement:					
Remeasurement of net retirement benefit obligations	26	**(19.1)**	49.6	**(19.1)**	49.6
Taxation	11	**5.2**	(13.5)	**5.2**	(13.5)
Effect of change in corporation tax rate	11	**(0.4)**	1.2	**(0.4)**	1.2
Subtotal		**(14.3)**	37.3	**(14.3)**	37.3
Total comprehensive income for the year		**134.5**	168.9	**149.2**	128.2

The notes on pages 100 to 177 form part of these accounts. Where applicable the 2018 balances are under IFRS 9, and the 2017 balances under IAS 39. The transition tables within Note 1 provide further details of the full impact.

Balance Sheets

as at 31 December 2018

		Group		Society	
		2018	2017	**2018**	2017
	Notes	**£m**	£m	**£m**	£m
Assets					
Liquid assets					
Cash and balances with the Bank of England	13	**3,539.8**	4,893.9	**3,539.8**	4,893.9
Loans and advances to credit institutions	14	**294.6**	351.0	**169.1**	126.6
Debt securities	15	**1,670.3**	850.8	**7,083.7**	5,976.2
Loans and advances to customers	16	**36,702.4**	35,061.2	**15,414.6**	16,337.3
Derivative financial instruments	34	**564.4**	591.8	**330.5**	324.1
Investments	10	**6.8**	6.3	**23,594.7**	21,105.4
Intangible assets	17	**40.1**	32.2	**40.1**	32.2
Investment properties	18	**12.0**	12.4	**11.8**	12.2
Property, plant and equipment	19	**110.6**	113.3	**110.2**	112.8
Deferred tax assets	20	**8.3**	8.7	**8.2**	7.3
Retirement benefit surplus	26	**75.9**	95.2	**75.9**	95.2
Other assets	21	**29.5**	30.4	**38.5**	39.7
Total assets		**43,054.7**	42,047.2	**50,417.1**	49,062.9
Liabilities					
Shares	22	**29,558.6**	28,938.0	**29,558.6**	28,938.0
Amounts owed to credit institutions	23	**4,485.1**	4,451.6	**4,485.1**	4,442.9
Other deposits	24	**508.6**	420.2	**8,863.1**	8,468.2
Debt securities in issue	25	**5,145.9**	4,933.3	**4,398.4**	4,192.1
Derivative financial instruments	34	**97.8**	156.9	**124.0**	160.0
Current tax liabilities		**19.9**	19.4	**15.9**	4.6
Deferred tax liabilities	20	**29.7**	29.6	**23.1**	29.2
Other liabilities	27	**54.1**	62.5	**51.6**	55.9
Provisions for liabilities and charges	28	**35.4**	45.8	**35.4**	45.7
Subordinated liabilities	29	**585.1**	593.7	**585.1**	593.7
Subscribed capital	30	**6.1**	6.4	**6.1**	6.4
Total liabilities		**40,526.3**	39,657.4	**48,146.4**	46,936.7
Total members' interests and equity		**2,528.4**	2,389.8	**2,270.7**	2,126.2
Total members' interest, equity and liabilities		**43,054.7**	42,047.2	**50,417.1**	49,062.9

Approved by the Board of directors on 27 February 2019 and signed on its behalf by:

John Heaps — **Chairman**
Mark Pain — **Vice Chairman**
Mike Regnier — **Chief Executive**

The notes on pages 100 to 177 form part of these accounts. Where applicable the 2018 balances are under IFRS 9, and the 2017 balances under IAS 39. The transition tables within Note 1 provide further details of the full impact.

Statements of Changes In Members' Interest And Equity

for the year ended 31 December 2018

	Note	General reserve	Cash flow hedge reserve	Available for sale reserve	Fair value through other comprehensive income	Total reserves
	Note	£m	£m	£m	£m	£m
Group						
At 1 January 2018		**2,382.6**	**(3.6)**	**10.8**	–	**2,389.8**
IFRS 9 transition adjustments	1	**5.8**	**–**	**(10.8)**	**9.1**	**4.1**
Restated balance at 1 January 2018		**2,388.4**	**(3.6)**	**–**	**9.1**	**2,393.9**
Profit for the period		149.8	–	–	–	149.8
Net Remeasurement of defined benefit plan		(14.3)	–	–	–	(14.3)
Net movement in cash flow hedge reserve		–	1.9	–	–	1.9
Net movement in fair value through other comprehensive income reserve		–	–	–	(2.9)	(2.9)
Total comprehensive income		**135.5**	**1.9**	**–**	**(2.9)**	**134.5**
At 31 December 2018		**2,523.9**	**(1.7)**	**–**	**6.2**	**2,528.4**
At 1 January 2017		2,220.9	(8.1)	8.1		2,220.9
Profit for the period		124.4	–	–	–	124.4
Net Remeasurement of defined benefit plan		37.3	–	–	–	37.3
Net movement in cash flow hedge reserve		–	4.5	–	–	4.5
Net movement in available for sale reserve		–	–	2.7	–	2.7
Total comprehensive income		**161.7**	**4.5**	**2.7**	**–**	**168.9**
At 31 December 2017		**2,382.6**	**(3.6)**	**10.8**	**–**	**2,389.8**

The notes on pages 100 to 177 form part of these accounts.

Statements of Changes In Members' Interest And Equity continued

for the year ended 31 December 2018

	Note	General reserve	Cash flow hedge reserve	Available for sale reserve	Fair value through other comprehensive income	Total reserves
	Note	£m	£m	£m	£m	£m
Society						
At 1 January 2018		**2,119.0**	**(3.6)**	**10.8**	**–**	**2,126.2**
IFRS 9 transition adjustments	1	**(3.0)**	**–**	**(10.8)**	**9.1**	**(4.7)**
Restated balance at 1 January 2018		**2,116.0**	**(3.6)**	**–**	**9.1**	**2,121.5**
Profit for the period		164.5	–	–	–	164.5
Net Remeasurement of defined benefit plan		(14.3)	–	–	–	(14.3)
Net movement in cash flow hedge reserve		–	1.9	–	–	1.9
Net movement in fair value through other comprehensive income reserve		–	–	–	(2.9)	(2.9)
Total comprehensive income		**150.2**	**1.9**	**–**	**(2.9)**	**149.2**
At 31 December 2018		**2,266.2**	**(1.7)**	**–**	**6.2**	**2,270.7**
At 1 January 2017		1,998.0	(8.1)	8.1		1,998.0
Profit for the period		83.7	–	–	–	83.7
Net Remeasurement of defined benefit plan		37.3	–	–	–	37.3
Net movement in cash flow hedge reserve		–	4.5	–	–	4.5
Net movement in available for sale reserve		–	–	2.7	–	2.7
Total comprehensive income		**121.0**	**4.5**	**2.7**	**–**	**128.2**
At 31 December 2017		**2,119.0**	**(3.6)**	**10.8**	**–**	**2,126.2**

The notes on pages 100 to 177 form part of these accounts.

Statements of Cash Flows

for the year ended 31 December 2018

		Group		Society	
		2018	2017	**2018**	2017
	Notes	**£m**	£m	**£m**	£m
Cash flows from operating activities:					
Profit before tax		**192.5**	165.8	**197.7**	107.6
Non-cash items included in profit before tax	43	**(23.5)**	51.8	**(16.0)**	54.6
Net increase in operating assets	43	**(1,653.1)**	(1,122.0)	**(1,602.6)**	(2,018.0)
Net increase in operating liabilities	43	**742.5**	1,561.1	**1,057.7**	3,145.7
Taxation paid		**(36.2)**	(28.5)	**(21.5)**	(6.2)
Net cash flows from operating activities		**(777.8)**	628.2	**(384.7)**	1,283.7
Cash flows from investing activities:					
Purchase of property, plant and equipment, investment properties and intangible assets		**(26.3)**	(18.2)	**(26.3)**	(18.2)
Sale of property, plant and equipment		**1.8**	9.3	**1.8**	9.3
Purchase of debt securities		**(1,990.0)**	(1,031.2)	**(4,490.0)**	(3,031.3)
Sale and redemption of debt securities		**1,173.9**	798.2	**3,386.0**	2,290.6
Net cash flows used in investing activities		**(840.6)**	(241.9)	**(1,128.5)**	(749.6)
Cash flows from financing activities:					
Redemption of debt securities in issue		**(1,043.7)**	(213.4)	**(750.0)**	–
Issue of securities		**1,243.5**	726.7	**943.5**	426.7
Redemption of subordinated liabilities		**(5.0)**	(5.0)	**(5.0)**	(5.0)
Issue of subordinated liabilities		**–**	300.0	**–**	300.0
Interest paid on subordinated liabilities and subscribed capital		**(25.7)**	(19.1)	**(25.7)**	(19.1)
Net cash flows from financing activities		**169.1**	789.2	**162.8**	702.6
Net (decrease)/increase in cash and cash equivalents		**(1,449.3)**	1,175.5	**(1,350.4)**	1,236.7
Opening balance		**5,191.7**	4,016.2	**4,967.3**	3,730.6
Total closing cash and cash equivalents		**3,742.4**	5,191.7	**3,616.9**	4,967.3
Cash and cash equivalents:					
Cash and balances with the Bank of England		**3,447.8**	4,840.7	**3,447.8**	4,840.7
Loans and advances to credit institutions	14	**294.6**	351.0	**169.1**	126.6
		3,742.4	5,191.7	**3,616.9**	4,967.3

The Statements of Cash Flows has been prepared in compliance with IAS 7 'Statements 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 100 to 177 form part of these accounts.

Notes to the Accounts

1. Statement of Accounting Policies

Basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations (IFRICs) in issue, that have been endorsed by the European Union (EU), and are effective at 31 December 2018, 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 certain financial instruments measured at fair value at the end of each reporting period. The financial statements are presented in Sterling, which is the functional currency of the Group, and the separate financial statements of the Society are presented alongside the Group financial statements.

The financial statements have been prepared on the going concern basis as discussed in the Strategic Report on pages 34 to 35, under the heading, 'Viability and going concern'. The accounting policies have been consistently applied, except where a new accounting standard has been introduced.

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 – IFRS 9

IFRS 9 'Financial Instruments' was published in July 2014 and was effective for periods beginning on or after 1 January 2018. This replaced IAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting. The Group has adopted IFRS 9 and the impact on transition is shown in the following tables and the revised accounting policies are contained within the Significant Accounting Policies below.

Balance Sheet

	31 December 2017 As originally presented	Reclassification	Remeasurement	1 January 2018 Restated
	£m	£m	£m	£m
Group				
Financial assets at fair value through other comprehensive income	–	847.0	–	**847.0**
Financial assets at fair value through profit or loss	595.6	6.3	–	**601.9**
Financial assets at amortised cost	40,306.1	–	4.4	**40,310.5**
Available for sale financial assets	853.3	(853.3)	–	**–**
Deferred tax assets	8.7	–	1.6	**10.3**
Assets not impacted by changes arising from IFRS 9	283.5	–	–	**283.5**
Total assets	**42,047.2**	**–**	**6.0**	**42,053.2**
Deferred tax liabilities	29.6	–	1.9	**31.5**
Liabilities not impacted by changes arising from IFRS 9	39,627.8	–	–	**39,627.8**
Total liabilities	**39,657.4**	**–**	**1.9**	**39,659.3**
Available for sale reserve	10.8	(10.8)	–	**–**
Fair value through other comprehensive income reserve	–	9.1	–	**9.1**
General reserves	2,382.6	1.7	4.1	**2,388.4**
Reserves not impacted by changes arising from IFRS 9	(3.6)	–	–	**(3.6)**
Total members' interest, equity and liabilities	**42,047.2**	**–**	**6.0**	**42,053.2**

1. Statement of Accounting Policies continued...

	31 December 2017 As originally presented	Reclassification	Remeasurement	1 January 2018 Restated
	£m	£m	£m	£m
Society				
Financial assets at fair value through other comprehensive income	–	847.0	–	847.0
Financial assets at fair value through profit or loss	327.9	6.3	–	334.2
Financial assets at amortised cost	47,477.1	–	(6.2)	47,470.9
Available for sale financial assets	853.3	(853.3)	–	–
Deferred tax assets	7.3	–	1.5	8.8
Assets not impacted by changes arising from IFRS 9	397.3	–	–	397.3
Total assets	**49,062.9**	**–**	**(4.7)**	**49,058.2**
Total liabilities	**46,936.7**	**–**	**–**	**46,936.7**
Available for sale reserve	10.8	(10.8)	–	–
Fair value through other comprehensive income reserve	-	9.1	–	9.1
General reserves	2,119.0	1.7	(4.7)	2,116.0
Reserves not impacted by changes arising from IFRS 9	(3.6)	–	–	(3.6)
Total members' interest, equity and liabilities	**49,062.9**	**–**	**(4.7)**	**49,058.2**

Statement of Changes in Members' Interest and equity

The total impact on the equity reserves as at 1 January 2018 was as follows:

	General reserve	Cash flow hedge reserve	Available for sale reserve	Fair value through other comprehensive income	Total reserves
	£m	£m	£m	£m	£m
Group					
Closing balances at 31 December 2017 – IAS 39	2,382.6	(3.6)	10.8	–	2,389.8
Reclassify investments from available for sale to fair value through profit or loss	1.7	–	(1.7)	–	–
Reclassify debt securities from available for sale to fair value through other comprehensive income	–	–	(9.1)	9.1	–
Remeasurement of financial assets at amortised cost (including provision for credit losses)	4.4	–	–	–	4.4
Remeasurement of deferred tax balances	(0.3)	–	–	–	(0.3)
Opening equity attributable to members – IFRS 9	**2,388.4**	**(3.6)**	**–**	**9.1**	**2,393.9**

Notes to the Accounts continued

1. Statement of Accounting Policies continued...

Statement of Changes in Members' Interest and equity continued...

	General reserve	Cash flow hedge reserve	Available for sale reserve	Fair value through other comprehensive income	Total reserves
	£m	£m	£m	£m	£m
Society					
Closing balances at 31 December 2017 – IAS 39	2,119.0	(3.6)	10.8	–	2,126.2
Reclassify investments from available for sale to fair value through profit or loss	1.7	–	(1.7)	–	–
Reclassify debt securities available for sale to fair value through other comprehensive income	–	–	(9.1)	9.1	–
Remeasurement of financial assets at amortised cost (including provision for credit losses)	(6.2)	–	–	–	(6.2)
Remeasurement of deferred tax balances	1.5	–	–	–	1.5
Opening equity attributable to members – IFRS 9	**2,116.0**	**(3.6)**	**–**	**9.1**	**2,121.5**

Classification and measurement

The impact of IFRS 9 on the classification and measurement of assets is detailed below. There were no changes in the classification of financial liabilities.

IAS 39 classification and measurement	IFRS 9 classification and measurement	Group		Society	
		31 December 2017	1 January 2018	31 December 2017	1 January 2018
		£m	£m	£m	£m
Cash in hand & balances with the Bank of England					
Loans and receivables at amortised cost	Financial assets at amortised cost	4,893.9	4,893.9	4,893.9	4,893.9
Loans and advances to credit institutions					
Loans and receivables at amortised cost	Financial assets at amortised cost	351.0	351.0	126.6	126.6
Debt Securities					
Available for sale – debt	Fair value through other comprehensive income	847.0	847.0	847.0	847.0
Held to maturity	Financial assets at amortised cost	–	–	5,125.4	5,125.4
Held for trading	Fair value through profit or loss	3.8	3.8	3.8	3.8
Loans and advances to customers					
Loans and receivables at amortised cost	Financial assets at amortised cost	35,061.2	35,065.6	16,337.3	16,331.1
Investments					
Available for sale – equity	Fair value through profit or loss	6.3	6.3	6.3	6.3
Loans and receivables at amortised cost	Financial assets at amortised cost	–	–	20,993.9	20,993.9

1. Statement of Accounting Policies continued...

Reconciliation of the impairment provision from IAS 39 to IFRS 9

The following table reconciles the impairment provision in accordance with the IAS 39 incurred loss model to that measured in accordance with the IFRS 9 expected loss model as at 1 January 2018:

	Loan loss provision under IAS 39	Remeasurement	Loan loss provision under IFRS 9
	£m	£m	£m
Group	32.5	(3.2)	29.3
Society	3.2	7.4	10.6

The Society loan loss provisions have increased on loans acquired during business combinations. This is as a result of applying a more forward looking view of expected loss required by IFRS 9. At the Group level the provision release at IFRS 9 inception primarily relates to Accord, where the significant investment in the IFRS 9 calculation approach has led to a more precise modelling of expected credit loss for individual accounts as required by IFRS 9.

Accounting developments – IFRS 16

IFRS 16 'Leases' was issued in 2016 and is effective for periods beginning on or after 1 January 2019. This replaces IAS 17, IFRIC 4, SIC-15 and SIC-27. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases. IFRS 16 eliminates the distinction between operating and finance leases that exists under IAS 17, with all leases being recognised on balance sheet. Under IAS 17, the cost of operating leases were recorded within administrative expenses, whereas from 2019 the income statement entries relating to leases will be the depreciation on right-of-use assets and interest on the associated lease liabilities.

For leases previously classified as operating leases the Group will recognise a lease liability at the date of initial application measured at the present value of the remaining lease payments, discounted using an incremental borrowing rate at the date of initial application. The right-of-use asset will be recognised as an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the balance sheet immediately before the date of initial application.

The Group will elect to use the modified retrospective transition approach and as a result no prior period balances will be restated. On transition the Group will recognise the cumulative effect of initially applying this standard as an adjustment to the opening balance of reserves. The gross impact on the balance sheet on transition is expected to be the recognition of the right-of-use assets of £50.6m and lease liabilities of £54.0m. The net impact recorded within general reserves is expected to be a credit of £0.5m.

The difference between the operating lease commitments at 31 December 2018, per Note 32, and the IFRS 16 lease liability on transition is due to lease commitments only being for minimum lease commitments, and the lease liability is measured using the expected lease payments even if a break clause exists. The lease liability will also be measured using discounted future cash flows, whereas the operating lease commitments are not discounted.

The Group will elect to use the exemptions available for short term leases, where the lease term is less than or equal to 12 months, and for low value assets. The Group has also taken the option to deem intangibles as not in the scope of IFRS 16. There will be no change in the accounting treatment on transition and the cost of these leases will continue to be recorded within administrative expenses on a straight line basis.

Accounting developments – Other

In the current year, the Group has applied a number of amendments to IFRSs issued by the International Accounting Standards Board (IASB) that were mandatorily effective. Their adoption has not had any material impact on the disclosures or on the amounts reported in these financial statements.

- IFRS 15 'Revenue from Contracts with Customers' is effective for periods beginning on or after 1 January 2018. 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'.
- IFRIC 22 'Foreign currency transactions and advance consideration', provides guidance on considerations denominated in a foreign currency.
- Amendments to IFRS 2 'Classification and Measurement of Share-based Payment Transactions', IAS 40 'Transfers of Investment Property', and 'Annual Improvements to IFRSs 2014-2016 Cycle' December 2016.

The following standards, which have not been adopted in these financial statements, were in issue but not yet effective for the 2018 year end. The adoption of these standards is not expected to have material impact on the financial statements.

- IAS 19 'Employee Benefits – Defined Benefit (DB) Pension Schemes'. This amendment is effective for reporting periods that commence on or after 1 January 2019 and applies to where settlements, curtailments or amendments occur for the pension plan. This amendment clarifies the treatment of past service cost, current service cost and net interest.
- IFRS 17 'Insurance Contracts' is effective for periods beginning on or after 1 January 2022 and is the comprehensive IFRS establishing specific accounting requirements for insurance contracts. This replaces IFRS 4 for which entities were permitted to account for insurance contracts differently across jurisdictions.
- IFRIC 23 'Uncertainty of Income Tax Treatments', and Annual Improvements to IFRSs 2015-2017 Cycle: IAS 12 'Income Taxes', IAS 23 'Borrowing Costs', IFRS 3 'Business Combinations', and IFRS 11 'Joint Arrangements'.

Notes to the Accounts continued

1. Statement of Accounting Policies continued...

Significant Accounting Policies

Basis of consolidation

The Group financial statements consolidate the financial statements of the Society and entities controlled by the Society (its subsidiary undertakings). 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. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between members of the Group are eliminated upon consolidation.

Investments in subsidiary undertakings are stated in the Society accounts at cost less any provisions for impairment.

Dividend income

Dividend income from investments is recognised when the shareholders' rights to receive the payment have been established.

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 income and expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash flows (excluding credit losses) through the expected life of the instrument to the net carrying amount on initial recognition. 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 historical 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 and origination of funding are accounted for on an effective interest rate basis. Other fees and commissions are recognised on an accruals basis as the relevant service is provided or at a point in time if the service or product provided relates to a one-off action. Insurance and Sharesave income are recognised over the period the service is provided.

Classification of financial instruments – 2018 Accounting Policy

Financial assets and liabilities are recognised in the Group's balance sheet when the Group becomes a party to the contractual provisions of the instrument. Financial assets and liabilities are initially measured at fair value.

The Group initially records all of its financial instruments at fair value less directly attributable transaction costs, and subsequently remeasures them as detailed in the paragraph below, except for derivative financial instruments and where an adjustment is made as part of a fair value hedging arrangement.

Under IFRS 9, financial assets are classified as amortised cost, fair value through other comprehensive income, or fair value through profit or loss, depending on the entity's business model and the contractual cash flow characteristics of the instruments.

The financial assets at fair value through other comprehensive income are debt securities held for liquidity and investment purposes. These are recorded at fair value with changes in fair value taken to reserves. Where the asset is disposed of, the cumulative gain or loss previously recognised in reserves is reclassified to the income statement.

Financial assets at fair value through profit and loss comprise equity instruments that have been classified as such at inception and derivative financial instruments. All gains and losses on these financial instruments are recognised in the income statement.

Classification of financial instruments – 2017 Accounting Policy

Financial assets and liabilities are recognised in the Group's Balance Sheet when the Group becomes a party to the contractual provisions of the instrument. Financial assets and liabilities are initially measured at fair value.

The Group initially 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.

Financial assets are classified into the following specified categories: financial assets 'at fair value through profit or loss', 'held to maturity' investments, 'available for sale' financial assets and 'loans and receivables'. The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

Loans and receivables are predominantly mortgage loans to customers and money market advances held for liquidity purposes. They are initially recorded at fair value adjusted for any attributable costs or 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 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. Gains and losses arising from changes in fair value are recognised in the income statement. Interest income arising from financial assets measured at fair value through profit and loss is recognised on an effective interest rate basis.

Held to maturity investments 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 the Group have the intention and ability to hold to maturity. They are initially recorded at fair value adjusted for any attributable costs or 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 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

1. Statement of Accounting Policies continued...

changes in value being taken to reserves. Interest is recognised on an effective interest rate basis. Where the asset is disposed of the cumulative gain or loss previously recognised in reserves is reclassified to the income statement.

Derivative financial instruments and embedded derivatives

The Group enters into a variety of derivative financial instruments to manage its risk exposure to interest rate, foreign exchange and equity prices. Fair values of derivatives are measured using valuation techniques including discounted cash flow models. Further details of derivative financial instruments are disclosed in Note 34.

Certain derivatives are embedded in other financial instruments. Under IAS 39 these are treated as separate derivatives where the economic characteristics and risks are not closely related to the host instrument and the host instrument was not measured at fair value. These embedded derivatives are measured at fair value with movements in value being recognised in the Income Statement. Where the Group is unable to value the embedded derivative separately, the entire instrument is measured at fair value with changes in value being taken to the income statement.

Hedging

The IFRS 9 hedge accounting requirements aim to simplify hedge accounting and permit application to a wider population of economic hedge relationships. IFRS 9 does not explicitly address macro hedge accounting strategies, which are particularly important for banks and building societies. As a result, IFRS 9 includes an accounting policy choice to continue applying the IAS 39 hedge accounting requirements, which the Group continued to do as at 1 January 2018.

Adoption of the IFRS 9 hedge accounting requirements has the potential to reduce fair value volatility for the Group in future periods as changes in the valuation of cross currency swaps from movements in foreign currency basis may be recorded in other comprehensive income rather than the income statement. The Group currently has no committed plans to adopt the IFRS 9 hedge accounting requirements but will continue to monitor the adoption decision.

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 applied when the specific rules and conditions in IAS 39 are fulfilled. The Group has designated the majority of its derivatives as either fair value or cash flow hedges in order to reduce volatility in the income statement.

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 the related 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.

Where a derivative financial instrument is designated as a cash flow hedge, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity reserves 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 of financial assets – 2018 Accounting policy

At each reporting date the Group assesses individual financial assets for impairment. Under IFRS 9, this assessment is based on a more forward looking expected credit loss (ECL) approach for financial assets classified as amortised cost and fair value through other comprehensive income, rather than the incurred loss approach applied under IAS 39.

At initial recognition, financial assets are categorised as 'stage 1' and an impairment provision is required for expected credit losses resulting from default events projected within the next 12 months ('12-month ECL'). Subsequently, financial assets are considered to be in 'stage 2' when their credit risk has increased significantly since initial recognition so it is appropriate to recognise lifetime ECL. The Group assesses loans to be in stage 2 when the accounts are more than 30 days past due or there has been a significant relative increase in the lifetime probability of default (PD) compared to initial recognition, and where the PD for retail mortgages is derived based on the customer's credit quality, including analysis of behaviour score and other account characteristics.

The threshold applied to assess whether a significant relative increase has occurred will depend on the credit quality at initial recognition, with a lower percentage change in PD being required for higher risk accounts. For non-retail portfolios, the Group assess a significant increase in credit risk using a combination of individual and collective information, including monitoring through the watch list process.

Financial assets are included in 'stage 3' when there is objective evidence that the loan is credit impaired, with expected credit losses still calculated on a lifetime basis. The objective evidence that is used to determine whether a loan is impaired is whether they are more than 90 days past due, have been renegotiated for credit risk reasons, or otherwise considered to be in default (including possession, insolvency and assets beyond term expiry). The Group's use of forbearance tools remains consistent with 2017 and is detailed on page 168. Arrears arrangements, payment holiday, term extension, transfers to interest only and interest capitalisation are factored into the criteria for identifying stage 3 accounts. The impairment provision is determined using the same calculation as stage 2 accounts, but with the PD set to 100%.

ECLs are calculated at the individual loan level using three main components, PD, a loss given default ('LGD') and the exposure at default ('EAD'). The LGD represents losses expected on default, taking into account the mitigating effect of collateral, its expected value when realised and the time value of money. The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default.

The Group have based the ECL calculations for retail portfolios on those used to calculate Basel III expected losses ('EL's) given the similarities in the calculations. However, the IFRS 9 approach has been further developed to meet IFRS 9 requirements, including:

Notes to the Accounts continued

1. Statement of Accounting Policies continued...

- Calculation of a separate PD, EAD and LGD for every month that a financial assets is due to be outstanding.
- PD is based on a point in time calculation based on current conditions and adjusted to take into account estimates of future conditions that will impact PD. A default backstop of 90+ days past due has also been applied.
- EAD has been modelled based on expected payments over the term and is not floored at the current balance.
- LGD is based on an estimate of loss given default including the expected impact of future economic conditions, such as changes in value of collateral, and does not include any floors. Only costs associated with obtaining/selling collateral are included.
- Discounting of the expected cash flows is performed using the effective interest rate of the loan.

In addition, the IFRS 9 PD and LGD estimates have to be flexed to capture the effects of forward looking macroeconomic variables (including interest rates, unemployment, house prices and inflation). The Group has used existing stress testing models to measure these effects, with the calculated provision having a significant sensitivity to these macroeconomic variables and with the associated probability weightings applied.

Financial assets that are considered credit impaired on initial recognition are required to have ECLs measured on a lifetime basis, and cannot be transferred to stage 1 or 2 even if the credit quality of these assets improves. The Group as at the transition date had £683.9m of loans acquired as part of the Chelsea and Norwich & Peterborough mergers which are considered credit impaired on initial recognition, as at 31 December 2018 this balance had decreased to £617.1m. This includes commercial loans, interest only mortgages and mortgage lending in Spain & Gibraltar. The ECL modelling for the acquired credit impaired assets is performed outside of the model used for originated mortgages as these have very different risk characteristics that could not be robustly forecast within this model. The ECL calculations are based on consistent principles with those described for the core mortgage model with the assumptions and inputs tailored to meet the characteristics of these portfolios. Note 2 also considers the estimation uncertainty on interest only mortgages acquired as a result of the merger with Chelsea Building Society.

A committee, supported by Finance, Credit Risk, Balance Sheet Management and economic experts has been established to consider and approve the forward looking macroeconomic assumptions with the objective of developing internally coherent economic scenarios. This committee is charged with ensuring that ECL allowance meets the IFRS 9 measurement principle for unbiased and probability weighted amounts derived by evaluating a range of possible outcomes and assumptions.

Loans are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security.

Impairment of financial assets – 2017 Accounting Policy

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 future 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 reporting date.

Individual assessments are made of all loans and advances on properties which are in possession or in arrears by three months or more. All other loans and advances are grouped according to their credit characteristics and a collective review is undertaken of any evidence of impairment. In all cases, future cash flows are estimated on grouped credit characteristics. The collective impairment provision includes an allowance against the risk of customer indebtedness 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 reporting 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 historical default experience, past and current loss emergence periods, the effect of changes in house prices, credit bureau data 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 three months in arrears is treated as individually impaired. Debt which is less than three 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 has no realistic prospect of recovery, 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.

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 when 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. Collateralised borrowing is recognised for the proceeds received. Financial liabilities are only derecognised when the obligation is discharged, cancelled, or has expired.

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 note is consistent with that which is presented to the Board. No segmental information is presented on geographical lines due to substantially all of the Group's activities being in the United Kingdom.

1. Statement of Accounting Policies continued...

Business combinations between mutual organisations

Identifiable assets and liabilities were measured at fair value on merger. Intangible assets are amortised through the Income Statement over their estimated useful lives, being between one and 10 years.

Cash and cash equivalents

For the purposes of the Statements 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.

Investment properties, property, plant and equipment

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 any recognised impairment loss.

Buildings, major alterations to office premises, fixtures and fittings, equipment and other tangible fixed assets are stated at cost less accumulated depreciation and any recognised impairment loss. 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 is recognised so as to write off the cost (other than land) less the 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

Freehold land is stated at cost less accumulated impairment losses and is not depreciated.

The carrying values of investment properties and property, plant and equipment are reviewed for impairment where there is an indication that events or circumstances may mean that the carrying amount is not recoverable. Where the recoverable amount of the asset is estimated to be less than the carrying amount, the carrying amount is written down immediately to the recoverable amount.

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

Intangible assets

Computer software includes development costs, purchased software and internally generated assets.

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 using the straight line method 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 recognised in the Income Statement as it arises.

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.

Retirement benefit costs

Payments to defined contribution pension schemes are recognised as an expense when employees have rendered service entitling them to the contributions.

The asset or liability recognised in respect of the defined benefit pension scheme is the present value of the defined benefit obligation at the reporting date less the fair value of plan assets, together with adjustments for unrecognised past service costs. An asset is only recognised 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 are amortised on a straight line basis over the average period until the benefits become vested.

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 the Statement of Comprehensive Income.

Current tax is the expected tax payable on the taxable profits for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised for temporary differences arising 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 reporting 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 the reversal of temporary differences and it is probable they will not reverse in the foreseeable future.

Notes to the Accounts continued

1. Statement of Accounting Policies continued...

Deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available, against which a temporary difference can be utilised. The carrying amount of the deferred tax asset is reviewed at the reporting date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

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 in the balance sheet 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 recorded by the Group to write off the cost over the estimated useful economic life of the asset. Rent payable on finance leases is apportioned between the finance element, charged to the Income Statement, and the reduction of 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.

Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that the Group will be required to settle that obligation and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the reporting 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 (when the effect of the time value of money is material).

A restructuring provision is recognised when the Group has developed a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement the plan through announcing its main features to those affected by it.

Present obligations arising under onerous contracts are recognised and measured as provisions. An onerous contract is considered to exist where the Group has a contract under which the unavoidable costs of meeting its contractual obligations exceed the economic benefits expected to be received under it.

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.

2. Critical Accounting Judgements and Key Sources of Estimation Uncertainty

The Group makes judgements in applying its accounting policies that have a significant impact on the amounts recognised in the financial statements. In addition estimates and assumptions are used which could affect the reported amounts of assets and liabilities in the next financial year.

The estimates and underlying assumptions are reviewed on an ongoing basis. As explained on pages 57 to 58, the Audit Committee has confirmed that the accounting judgements and estimates applied are considered to be appropriate.

Critical judgements

The following are the critical judgements, apart from those involving estimations (which are dealt with separately below), that the directors have made in the process of applying the Group's accounting policies.

Pensions

International Financial Reporting Interpretations Committee statement 14 (IFRIC 14) requires that a net defined benefit asset should only be recognised to the extent that an entity has the ability to access the pension scheme surplus in the form of a refund or reduction in future contributions. This requires judgement to be made around the legal rights to which the scheme trustees could unilaterally act in order to restrict the ability of the entity to seek a refund or reduction in future contributions. The Group operates a defined benefit pension scheme for which it has received a legal opinion that it can recover in full any surplus of the scheme. The Group has recognised an asset in respect of the surplus as at both December 2017 and 2018. Whilst the Group is unable to release funds from the scheme and the asset would not be crystallised in full if the pension obligations were settled immediately, the asset has been recognised based on the obligations being settled as they fall due and the surplus being used to reduce future contributions or be repaid after all settlements have occurred. This includes an assessment that the pension scheme trustees are unable to act, without the Society's support, to amend the scheme rules and ultimately prevent the Society accessing the surplus.

2. Critical Accounting Judgements and Key Sources of Estimation Uncertainty continued...

Effective interest rate

IFRS 9 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 income or expense using the effective interest rate method. This includes the cash flows for arrangement fees, introducer fees, incentive arrangements and early repayment charges.

Key sources of estimation uncertainty

The key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date that may have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year, are discussed below.

Impairment of loans and advances to customers

The calculation of impairment provisions for a portfolio of mortgage loans is inherently uncertain. Provisions are calculated using historical default and loss experience but require judgement to be exercised in predicting future economic conditions (e.g. interest rates and house prices) and customer behaviour (e.g. default rates). The most critical sources of estimation uncertainty are:

- The economic scenarios and associated probability weightings, further details of which can be found in Note 39. The committee established to set the forward looking macroeconomic assumptions has assessed the uncertainty associated with the UK's expected withdrawal from the EU, and determined that applying a combined 40% weighting to downside and stress scenarios as at the balance sheet date represents the best estimate of there being a significant impact on the UK economy. The Group has applied a 20% weighting to upside, 40% to core, 25% to downside and 15% to stress. The Group considered alternative sets of weightings in reaching these results. The most severe applied a 5% movement from downside to stress scenario weightings, which would give rise to a £4.4m increase in provisions, the least severe applied a 5% movement from stress to upside, which would give rise to a £7.3m decrease in provisions.
- The threshold applied to assess whether a significant relative increase in credit risk has occurred. If 10% of the accounts in stage 1 were to be transferred to stage 2 and subject to a calculation of full lifetime expected credit losses, this would result in a £6.2m increase in the provision.
- The calculation of the probability of default (PD) for accounts in stage 2 and the probability of possession (PP) for accounts in stage 3. A 10% relative increase or decrease in these probabilities would give rise to a £4.7m increase or decrease in the provision, respectively.
- The assessment of staging for customers who are currently in arrears on their unsecured lending with other lenders but allocated to stage 1. The majority of these accounts were originated at high credit risk, so whilst there has been an increase in credit risk this has not been sufficiently high to breach the transfer criteria for classification as stage 2. For these accounts, if this was treated as a hard indicator of increased credit risk and these loans were transferred to stage 2, there would be a £11.8m increase in provisions.

The factors above apply to all loans underwritten by the Group. There is additional uncertainty associated with the PD and LGD for certain interest only mortgages acquired from Chelsea Building Society. The Group has only been able to substantiate the existence of an appropriate repayment vehicle for 26% of these customers and there is a risk that the Group will be unable to collect the full amount due at maturity (average maturity being 2028). The Group applies a model to estimate the probability that accounts will reach the end of the term without being recovered, with the average probability across these accounts being 10.4%, generating expected credit losses of £18.0m. The Group uses two alternative PDs dependent on whether we have been unable to contact the customer or whether they have been contacted and it has been confirmed that they do not have an appropriate repayment vehicle in place. If we assumed that all customers with whom we have been unable to make contact do not have an appropriate repayment vehicle, expected credit losses would increase by £9.8m.

During 2018, the Group has refined the expected loss calculation for this portfolio following improvements in how these interest only accounts are identified. Based on a smaller population, the model has been redeveloped and the key assumptions reassessed, giving rise to differences when compared to the assumptions applied in 2017. Overall this change led to a £0.4m decrease in the expected credit losses.

Pensions

Significant estimation uncertainty (on areas such as future interest, salary escalation and mortality rates) have to be exercised in estimating the value of the assets and liabilities of the defined benefit scheme, and hence of its net surplus/deficit. These are outlined in Note 26. The impact of a 1.0% absolute decrease in the rate used to discount the future value of the asset and liabilities (from 2.7% to 1.7%) would be to increase the surplus by £36.5m. The impact of a 0.75% increase in the salary escalation rate would be to decrease the surplus by £8.0m. The percentage changes used to calculate these sensitivities have been set based on analysis of previous annual movements in these inputs. The impact of a one year increase in each of the quoted life expectancies at age 60 would be to decrease the surplus by £20.7m.

Regulatory and other provisions

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligations at the reporting date, taking into account the risks and uncertainties surrounding the obligations. Note 28 provides details of regulatory and other provisions which include amounts provided in relation to customer redress claims related to past sales of Payment Protection Insurance (PPI) totalling £12.6m (2017: £21.3m). This provision is calculated using management's best estimate of the complaint volumes, average redress payments, referral rates to the Financial Ombudsman Service, complaint handling costs and other costs. The provision and the principal uncertainty around complaint volumes continue to reduce as the deadline of August 2019 for customers to make a complaint approaches. Whilst this provision is materially expected to be utilised during 2019, if further regulatory guidance is issued or there are legal challenges to the industry approach in settling PPI claims this could give rise to payments extending beyond the August 2019 deadline.

Notes to the Accounts continued

3. Interest receivable and similar income

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Loans secured on residential property	**883.0**	957.6	**418.8**	475.1
Loans to connected undertakings	**–**	–	**360.1**	374.5
Other loans	**22.5**	19.4	**22.5**	19.4
Liquid assets	**24.2**	11.3	**23.7**	11.2
On debt securities	**17.0**	6.8	**69.9**	47.3
Derivatives in hedge relationships	**36.4**	45.3	**31.1**	21.7
Derivatives not included in hedge relationships	**35.4**	37.8	**37.2**	37.8
Investments held at fair value	**0.2**	–	**0.2**	–
Total interest receivable	**1,018.7**	1,078.2	**963.5**	987.0

4. Interest payable and similar charges

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Shares held by individuals	**316.1**	286.7	**316.1**	286.7
Deposits from banks	**49.5**	25.8	**49.5**	25.8
Deposits from connected undertakings	**–**	–	**82.7**	71.5
Other deposits	**0.9**	0.3	**0.9**	0.3
Debt securities in issue	**70.7**	90.0	**62.0**	83.7
Subordinated liabilities	**25.4**	18.8	**25.4**	18.8
Subscribed capital	**0.3**	0.3	**0.3**	0.3
Derivatives in hedge relationships	**62.9**	108.0	**54.8**	104.9
Derivatives not included in hedge relationships	**21.2**	46.2	**25.3**	50.1
Total interest payable	**547.0**	576.1	**617.0**	642.1

5. Net gains from financial instruments held at fair value

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Investments held at fair value	**1.7**	–	**1.7**	–
Embedded derivatives	**6.9**	5.7	**6.9**	5.7
Hedge accounting ineffectiveness	**(0.2)**	(3.2)	**3.2**	(5.0)
Derivatives not included in hedge relationships	**11.7**	10.6	**8.8**	13.7
Net gains from financial instruments held at fair value	**20.1**	13.1	**20.6**	14.4

6. Other operating income

Other operating income primarily comprises income from fixed assets; specifically profits on disposal, rental income from investment property and software licensing income. Also included is the payment and recharge of administrative expenses from subsidiaries.

7. Administrative expenses

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Staff costs				
Salaries and wages	**127.5**	136.1	**127.5**	136.1
Social security costs	**12.9**	13.8	**12.9**	13.8
Pension costs – defined benefit plans	**1.7**	0.4	**1.7**	0.4
Pension costs – defined contribution plans	**10.7**	12.0	**10.7**	12.0
Other staff costs	**1.3**	1.8	**1.3**	1.8
Operating lease rentals	**7.8**	8.9	**8.0**	9.1
Professional consultancy costs	**24.1**	24.6	**24.1**	24.6
Other expenses	**105.3**	110.5	**105.1**	110.3
	291.3	308.1	**291.3**	308.1

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 in the table 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	
	2018	2017	**2018**	2017
	£000	£000	**£000**	£000
Audit Fees for the Group and Society statutory audit	**499**	553	**499**	553
Fees payable for other services:				
Audit of Group Subsidiaries	**72**	70	**–**	–
Audit related assurance services	**172**	153	**172**	153
Total audit and audit related assurance services	**743**	776	**671**	706
Other non-audit services	**4**	–	**4**	–
	747	776	**675**	706

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 page 59.

Notes to the Accounts continued

7. Administrative expenses continued...

Staff numbers

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

	2018		2017	
	Full time	**Part time**	Full time	Part time
Central administration	**2,300**	**525**	2,359	558
Branches	**591**	**490**	782	521
	2,891	**1,015**	3,141	1,079

8. Remuneration of and transactions with directors

Full details of directors' remuneration, bonuses and pensions are given in the Directors' Remuneration Report on pages 69 to 84. In addition, past directors' pensions in respect of services as directors (closed scheme) amounted to £20,240 (2017: £20,000).

None of the directors had any interest in the shareholdings or debentures of any connected undertaking 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 containing the details for 2018 will be available for inspection at the principal office by members for a period of 15 days up to and including the Annual General Meeting.

9. Impairment

	Group		**Society**	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
At 1 January	**29.3**	45.0	**10.6**	6.2
Amounts written off during the year	**(3.0)**	(4.7)	**(0.2)**	(0.1)
Reduction in discounting	**1.6**	–	**1.3**	–
Impairment adjustment for the year	**1.2**	(7.8)	**3.3**	(2.9)
At 31 December	**29.1**	32.5	**15.0**	3.2
The charge for the year comprises:				
Impairment adjustment	**1.2**	(7.8)	**3.3**	(2.9)
Recoveries relating to amounts previously written off	**(1.6)**	(2.0)	**(0.6)**	(1.0)
Net provision (release)/charge for the year	**(0.4)**	(9.8)	**2.7**	(3.9)

Income on impaired assets is calculated using the effective interest rate method based on the amortised cost of the asset after adjusting for expected credit losses, and not the gross carrying value. This gives rise to a reduction in the interest income recorded on impaired assets, but also an offsetting reduction in the impairment charge for the year due to the reduction in discounting on the future credit losses (as shown in the table above). In 2017 this was immaterial.

The Group's opening provision for 2018 is £3.2m lower than the closing provision for 2017, whereas the Society's position is £7.4m higher. These differences are due to the transition from IAS 39 to IFRS 9 as set out in Note 1. Detailed analysis of provision movements by stage are included in Note 39. The table above includes treasury impairments of £0.2m that are excluded from Note 39.

Where applicable the 2018 balances are under IFRS 9, and the 2017 balances under IAS 39. The transition tables within Note 1 provide further details of the full impact.

10. Investments

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
(Expense)/income from investments				
Income from subsidiary undertakings	**–**	–	**74.9**	56.7
Other	**(0.1)**	3.2	**(0.1)**	3.2
	(0.1)	3.2	**74.8**	59.9

During 2018, Accord made a dividend payment of £75.0m to the Society (2017: £50.0m).

Other income in 2018 relates to the revaluation of the Visa shareholding to reflect the change of share price throughout the year. In 2017 other income related to cash consideration received from the sale of the majority shareholding in VocaLink Holdings Limited (VocaLink) to Mastercard.

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Investments				
Equities	**6.8**	6.3	**6.8**	6.3
Joint ventures	**–**	–	**–**	0.3
Subsidiaries	**–**	–	**23,587.9**	21,098.8
	6.8	6.3	**23,594.7**	21,105.4

Investment in equities

The Group holds equity investments relating to participation in banking and credit card service operations. The investments are held at fair value through profit or loss and the valuation technique is detailed in Note 40.

This includes shares received as part of the consideration from the sale of Visa Europe to Visa Inc. where the Group had a small percentage holding as a result of being a member of Visa Europe through our trading activities, and a residual shareholding of VocaLink shares.

Investment in joint venture

The Society had a 50% interest in a joint venture, MutualPlus Ltd, a branch sharing company incorporated in the United Kingdom and registered in England and Wales. The company was dissolved on 22 September 2018.

Notes to the Accounts continued

10. Investments continued...

Investment in subsidiaries
Society

	Shares	Loans	Total
	£m	£m	£m
Cost			
At 1 January 2018	**105.4**	**20,994.2**	**21,099.6**
Additions	**0.1**	**3,475.8**	**3,475.9**
Repayments	**(0.1)**	**(986.7)**	**(986.8)**
At 31 December 2018	**105.4**	**23,483.3**	**23,588.7**
Impairment losses			
At 1 January 2018 and 31 December 2018	**(0.5)**	**(0.3)**	**(0.8)**
Net book value			
At 31 December 2018	**104.9**	**23,483.0**	**23,587.9**
Cost			
At 1 January 2017	105.5	17,849.2	17,954.7
Additions	–	3,366.5	3,366.5
Repayments	(0.1)	(221.5)	(221.6)
At 31 December 2017	105.4	20,994.2	21,099.6
Impairment losses			
At 1 January 2017 and 31 December 2017	(0.5)	(0.3)	(0.8)
Net book value			
At 31 December 2017	104.9	20,993.9	21,098.8

All shares held are equity shares. All loans are charged interest which is included within net interest income.

10. Investments continued...

The Society directly or indirectly holds 100% of the ordinary share capital for each of the following subsidiary undertakings, all of which are audited and consolidated.

Subsidiary	Principal activity
Accord Mortgages Limited	Mortgage lending
YBS Properties (Edinburgh) Limited	Property holding
Yorkshire Building Society Covered Bonds LLP	Mortgage acquisition and guarantor of covered bonds
Brass No.4 PLC	Funding vehicle
Brass No.4 Mortgage Holdings Limited	Holding company
Brass No.5 PLC	Funding vehicle
Brass No.5 Mortgage Holdings Limited	Holding company
Brass No.6 PLC	Funding vehicle
Brass No.6 Mortgage Holdings Limited	Holding company
Brass No.7 PLC	Funding vehicle
Brass No.7 Mortgage Holdings Limited	Holding company
Norwich and Peterborough Insurance Brokers Limited.	Non-trading
Norwich and Peterborough (LBS) Limited	Mortgage finance
Tombac No.2 PLC	Funding vehicle
Tombac No.2 Mortgage Holdings Limited	Holding company

For certain subsidiaries, the Group has taken advantage of the audit exemptions available for small and dormant subsidiaries under Sections 479 and 480 of the Companies Act 2006. The Group has adopted such audit exemptions for the following subsidiary undertakings which are largely non-trading for the year ended 31 December 2018:

BCS Loans and Mortgages Limited
Brass No.2 PLC *
Brass No.2 Mortgage Holdings Limited *
Brass No.3 PLC
Brass No.3 Mortgage Holdings Limited
Chelsea Mortgage Services Ltd
Tombac No.1 PLC
Tombac No.1 Mortgage Holdings Limited
YBS Ltd
YBS Covered Bonds Finance (Holdings) Limited
YBS Covered Bonds Finance Limited
YBS Group Ltd
YBS Pension Trustees Limited **
Yorkshire Direct Ltd
Yorkshire Group Ltd
Yorkshire Guernsey Ltd *
Yorkshire Key Services Limited
Yorkshire Life Assurance Services Ltd
Yorkshire Mortgage Services Ltd
Yorkshire Personal Financial Services Ltd
Yorkshire Property Services Ltd
Yorkshire Services Ltd

All subsidiaries have an accounting period of the 31 December. All the companies are registered in England and operate in the United Kingdom, and the registered office of all the wholly owned subsidiary companies is Yorkshire Drive, Bradford, BD5 8LJ, except Yorkshire Guernsey Ltd which is registered in Guernsey and is non-trading.

All the entities are wholly owned except for Yorkshire Building Society Covered Bonds LLP (registered office Yorkshire Drive, Bradford, BD5 8LJ), YBS Covered Bonds Finance (Holdings) Limited, YBS Covered Bonds Finance Limited, Brass No. 2 PLC (in liquidation), Brass No. 2 Mortgage Holdings Limited (in liquidation), Brass No. 3 PLC, Brass No. 3 Mortgage Holdings Limited, Brass No. 4 PLC, Brass No. 4 Mortgage Holdings Limited, Brass No. 5 PLC, Brass No. 5 Mortgage Holdings Limited, Brass No. 6 PLC, Brass No. 6 Mortgage Holdings Limited, Brass No.7 PLC, Brass No.7 Mortgage Holdings Ltd, Tombac No. 1 PLC, Tombac No. 1 Mortgage Holdings Limited, Tombac No. 2 PLC and Tombac No. 2 Mortgage Holdings Limited (where the registered office is Third Floor, 1 King's Arms Yard, London, EC2R 7AF). 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.

* In liquidation
** Incorporated 21 December 2018.

Notes to the Accounts continued

11. Tax expense

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Current tax:				
UK corporation tax at 19.00% (2017: 19.25%)	**40.0**	40.5	**36.0**	25.6
Corporation tax – adjustment in respect of prior periods	**(2.1)**	0.2	**(1.9)**	0.2
Total current tax	**37.9**	40.7	**34.1**	25.8
Deferred tax (Note 20):				
Current year	**5.4**	1.1	**(0.3)**	(1.5)
Adjustment in respect of prior periods	**(0.6)**	(0.4)	**(0.6)**	(0.4)
Total tax expense in Income Statement	**42.7**	41.4	**33.2**	23.9

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	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Profit before tax	**192.5**	165.8	**197.7**	107.6
Tax calculated at a tax rate of 19.00% (2017: 19.25%)	**36.6**	31.9	**37.5**	20.7
Effects of:				
Income not subject to tax	**(0.7)**	(0.3)	**(15.5)**	(11.2)
Expenses not deductible for tax purposes	**0.7**	4.8	**4.5**	8.7
Banking surcharge	**9.2**	5.6	**9.2**	5.6
Adjustment to tax charge in respect of previous periods	**(2.7)**	(0.2)	**(2.5)**	(0.2)
Change in tax rate	**(0.4)**	(0.4)	**–**	0.3
Total tax expense in Income Statement	**42.7**	41.4	**33.2**	23.9
Tax (credit)/expense recognised directly in equity:				
Tax on financial instruments held at fair value through other comprehensive income	**(1.1)**	–	**(1.1)**	–
Effect of change in tax rate	**–**	–	**–**	–
Tax on available for sale securities*	**–**	1.0	**–**	1.0
Effect of change in tax rate	**–**	(0.1)	**–**	(0.1)
Tax on remeasurement of net retirement benefit obligations	**(5.2)**	13.5	**(5.2)**	13.5
Effect of change in tax rate	**0.4**	(1.2)	**0.4**	(1.2)
Deferred tax on cash flow hedges	**0.6**	1.6	**0.6**	1.6
Effect of change in tax rate	**–**	(0.1)	**–**	(0.1)
	(5.3)	14.7	**(5.3)**	14.7

* Available for Sale Securities have been reclassified as Financial Instruments held at Fair Value through Other Comprehensive Income ("FVTOCI") or Financial Instruments held at Fair Value through P&L ("FVTPL") under IFRS 9, as described at Note 1.

11. Tax expense continued...

The main rate of corporation tax reduced to 19% on 1 April 2017. It will reduce to 17% from 1 April 2020.

These rate changes are reflected in the financial statements resulting in a credit of £0.4m (2017: £0.4m credit) to the Income Statement and a debit of £0.4m (2017: £1.4m credit) to Other Comprehensive Income in the period, giving no overall movement (2017: £1.8m credit) in respect of the Group's net deferred tax liability.

The effective tax rate for the year is 22.18% (2017: 24.97%) which is higher than the statutory corporation tax rate of 19.00% (2017: 19.25%). The effective tax rate is increased due to a charge of £9.2m (2017: £5.6m) in respect of the banking surcharge which is charged at a rate of 8.00% (2017: 8.00%) on the Society's taxable profits above £25m. The rate for the year is also affected by the prior year adjustment of £2.7m. This credit is mainly attributable to adjustments to prior year tax computations in respect of the tax treatment of certain customer redress provisions that arose on merger with the Chelsea Building Society and Norwich and Peterborough Building Society.

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:

Segment	Description	Basis of aggregation
Retail	Prime residential owner occupied lending, prime intermediary lending and non-owner occupied lending. Traditional member savings, non-traditional savings and sale of general insurance, protection and investment products provided by third parties.	These are the core activities and focus of the Group.
Non-retail	Prime commercial lending portfolio (including social housing).	These ongoing parts of the business support the Group's financial stability and primary businesses but are not considered core and have a non-retail customer base.
Secondary	Non-prime residential owner occupied lending, consumer banking, personal lending, non-prime commercial lending and non-owner occupied lending acquired through mergers.	These elements, originated and acquired through merger, are closed to new business and are historical areas in which the Group no longer operates.
Central	Supporting business units, the Treasury function and other head office Group functions which have not been apportioned across the aforementioned segments.	These operations are not directly customer related.

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 internal funds transfer pricing methodology, which includes the cost of raising external funds.

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

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

Notes to the Accounts continued

12. Segmental reporting continued...

2018	Notes	Retail	Non-retail	Secondary	Central	Total
		£m	£m	£m	£m	£m
Net interest income		**319.9**	**22.8**	**21.5**	**107.5**	**471.7**
Non-interest income (net)	a	**15.7**	**–**	**–**	**(5.3)**	**10.4**
Net realised profits and fair value		**–**	**–**	**–**	**28.1**	**28.1**
Management expenses	b	**(183.5)**	**(2.4)**	**(1.4)**	**(123.9)**	**(311.2)**
Operating profit before provisions		**152.1**	**20.4**	**20.1**	**6.4**	**199.0**
Impairment and other provisions		**0.5**	**0.3**	**0.6**	**(7.9)**	**(6.5)**
Profit/(loss) before tax		**152.6**	**20.7**	**20.7**	**(1.5)**	**192.5**
Total assets		**34,930.3**	**1,168.9**	**621.2**	**6,334.3**	**43,054.7**
Total liabilities		**29,914.4**	**–**	**–**	**10,611.9**	**40,526.3**
Equity		**–**	**–**	**–**	**2,528.4**	**2,528.4**

2017	Notes	Retail	Non-retail	Secondary	Central	Total
		£m	£m	£m	£m	£m
Net interest income		365.2	20.6	22.7	93.6	502.1
Non-interest income (net)	a	19.0	–	–	(4.5)	14.5
Net realised profits and fair value		–	–	–	19.2	19.2
Management expenses	b	(197.3)	(2.5)	(1.8)	(137.9)	(339.5)
Operating profit/(loss) before provisions		186.9	18.1	20.9	(29.6)	196.3
Impairment and other provisions		5.9	–	(0.6)	(35.8)	(30.5)
Profit/(loss) before tax		192.8	18.1	20.3	(65.4)	165.8
Total assets		33,336.9	1,037.1	708.5	6,964.7	42,047.2
Total liabilities		29,405.2	–	–	10,252.2	39,657.4
Equity		–	–	–	2,389.8	2,389.8

Notes

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

b Management expenses include administrative expenses, depreciation and amortisation.

12. Segmental reporting continued...

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

2018	Retail	Non-retail	Secondary	Central	Total
	£m	£m	£m	£m	£m
External income	**527.4**	**43.5**	**31.5**	**(120.2)**	**482.2**
Income from other segments	**(191.8)**	**(20.7)**	**(10.0)**	**222.5**	**–**
Total income	**335.6**	**22.8**	**21.5**	**102.3**	**482.2**

2017	Retail	Non-retail	Secondary	Central	Total
	£m	£m	£m	£m	£m
External income	633.6	36.4	33.8	(187.2)	516.6
Income from other segments	(249.4)	(15.8)	(11.1)	276.3	–
Total income	384.2	20.6	22.7	89.1	516.6

13. Cash and balances with the Bank of England

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Cash in hand	**9.8**	10.1	**9.8**	10.1
Cash ratio deposit with the Bank of England	**92.0**	53.1	**92.0**	53.1
Other deposits with the Bank of England	**3,438.0**	4,830.7	**3,438.0**	4,830.7
	3,539.8	4,893.9	**3,539.8**	4,893.9

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

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. The cash collateral placed related to swap agreements of £186.7m is subject to legally enforceable netting agreements. The cash collateral and derivative fair value are presented gross in the balance sheet as the requirements for offset in IAS 32 are not met.

15. Debt securities

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Debt securities issued by:				
Public bodies	**820.0**	724.2	**820.0**	724.2
Other borrowers	**850.3**	126.6	**850.3**	126.6
Group companies	**–**	–	**5,413.4**	5,125.4
	1,670.3	850.8	**7,083.7**	5,976.2

Notes to the Accounts continued

15. Debt securities continued...

Debt securities issued by Group companies comprise retained investments in the Group's Brass and Tombac securitisation vehicles.

Group	Held at fair value	Embedded derivatives	Fair value through Other Comprehensive Income	Amortised cost	Total
	£m	£m	£m	£m	£m
Movements in debt securities during the year were:					
At 1 January 2018	**3.8**	**–**	**847.0**	**–**	**850.8**
Additions	**136.3**	**–**	**1,853.7**	**–**	**1,990.0**
Disposals and repayments	**(6.7)**	**–**	**(1,174.3)**	**–**	**(1,181.0)**
Other changes in value	**9.7**	**–**	**0.8**	**–**	**10.5**
At 31 December 2018	**143.1**	**–**	**1,527.2**	**–**	**1,670.3**
Movements in debt securities during the year were:					
At 1 January 2017	7.6	(8.9)	609.4	–	608.1
Additions	–	–	1,031.2	–	1,031.2
Disposals and repayments	(3.0)	8.9	(802.8)	–	(796.9)
Other changes in value	(0.8)	–	9.2	–	8.4
At 31 December 2017	3.8	–	847.0	–	850.8

Society	Held at fair value	Embedded derivatives	Fair value through Other Comprehensive Income	Amortised cost	Total
	£m	£m	£m	£m	£m
Movements in debt securities during the year were:					
At 1 January 2018	**3.8**	**–**	**847.0**	**5,125.4**	**5,976.2**
Additions	**136.3**	**–**	**1,853.7**	**2,500.0**	**4,490.0**
Disposals and repayments	**(6.7)**	**–**	**(1,174.3)**	**(2,220.0)**	**(3,401.0)**
Other changes in value	**9.7**	**–**	**0.8**	**8.0**	**18.5**
At 31 December 2018	**143.1**	**–**	**1,527.2**	**5,413.4**	**7,083.7**
Movements in debt securities during the year were:					
At 1 January 2017	7.6	(8.9)	609.4	4,617.9	5,226.0
Additions	–	–	1,031.2	2,000.0	3,031.2
Disposals and repayments	(3.0)	8.9	(802.8)	(1,494.9)	(2,291.8)
Other changes in value	(0.8)	–	9.2	2.4	10.8
At 31 December 2017	3.8	–	847.0	5,125.4	5,976.2

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

A number of debt securities were structured so that they could pay a return over and above their regular coupon. This feature is regarded as an embedded derivative. A synthetic collateralised debt obligation matured during 2017, which contained an embedded derivative. This embedded derivative was separated from the host instrument and held at fair value with movements in fair value taken to the Income Statement.

16. Loans and advances to customers

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Loans and advances to customers comprise:				
Loans secured on residential property				
Loans fully secured on residential property	**36,169.7**	34,579.2	**14,875.6**	15,836.1
Other loans secured on residential property	**12.8**	26.4	**5.0**	16.3
Loans secured on commercial property	**566.8**	509.3	**566.8**	509.3
Fair value hedging adjustments	**(18.0)**	(21.2)	**(18.0)**	(21.2)
Impairment provisions	**(28.9)**	(32.5)	**(14.8)**	(3.2)
	36,702.4	35,061.2	**15,414.6**	16,337.3

Fair value hedging adjustments of £18.0m (2017: £21.2m) have been made to certain fixed rate mortgages that are in fair value hedging relationships.

Where applicable the 2018 balances are under IFRS 9, and the 2017 balances under IAS 39. The transition tables within Note 1 provide further details of the full impact on the gross loan balances and impairment provision.

Notes to the Accounts continued

17. Intangible assets

	Development costs	Purchased software	Internally generated assets	Other	Total
	£m	£m	£m	£m	£m
Group					
Cost					
At 1 January 2018	**7.3**	**38.5**	**25.6**	**18.5**	**89.9**
Additions	**14.5**	**2.5**	**–**	**–**	**17.0**
Disposals	**(0.3)**	**(1.7)**	**(1.0)**	**–**	**(3.0)**
At 31 December 2018	**21.5**	**39.3**	**24.6**	**18.5**	**103.9**
Amortisation					
At 1 January 2018	**1.1**	**26.1**	**13.2**	**17.3**	**57.7**
Charged in year	**–**	**3.0**	**5.3**	**0.5**	**8.8**
Disposals	**–**	**(2.7)**	**–**	**–**	**(2.7)**
At 31 December 2018	**1.1**	**26.4**	**18.5**	**17.8**	**63.8**
Net book value					
At 31 December 2018	**20.4**	**12.9**	**6.1**	**0.7**	**40.1**
Cost					
At 1 January 2017	6.2	31.5	23.4	18.5	79.6
Additions	4.8	7.4	–	–	12.2
Disposals	–	(0.9)	(1.0)	–	(1.9)
Transfers	(3.7)	0.5	3.2	–	–
At 31 December 2017	7.3	38.5	25.6	18.5	89.9
Amortisation					
At 1 January 2017	1.1	21.3	11.1	12.0	45.5
Charged in year	–	5.0	3.1	1.3	9.4
Impairment	–	0.6	–	4.0	4.6
Disposals	–	(0.8)	(1.0)	–	(1.8)
At 31 December 2017	1.1	26.1	13.2	17.3	57.7
Net book value					
At 31 December 2017	6.2	12.4	12.4	1.2	32.2

The Group's purchased software cost carried forward and depreciation carried forward include £1.0m which relates to Yorkshire Key Services Limited software licence. This is not included in the Society accounts.

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

Transfers relate to the reclassification of assets from development costs to purchased software and internally generated assets.

The additions under development costs relate mainly to the Society's investment in a new mortgage processing systems with market leading technology required to meet the future needs of the business. To the extent that these new systems are not yet ready for use by the business, no amortisation has been charged.

18. Investment properties

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Cost				
At 1 January	**16.4**	19.4	**16.2**	19.2
Additions	**0.3**	0.3	**0.3**	0.3
Disposals	**(0.4)**	(3.3)	**(0.4)**	(3.3)
Transfers	**(0.3)**	–	**(0.3)**	–
At 31 December	**16.0**	16.4	**15.8**	16.2
Depreciation				
At 1 January	**4.0**	4.4	**4.0**	4.4
Charged in year	**0.3**	0.2	**0.3**	0.2
Impairment	**–**	0.1	**–**	0.1
Disposals	**(0.3)**	(0.7)	**(0.3)**	(0.7)
Transfers	**–**	–	**–**	–
At 31 December	**4.0**	4.0	**4.0**	4.0
Net book value				
At 31 December	**12.0**	12.4	**11.8**	12.2
Fair value				
At 31 December	**17.3**	17.7	**16.9**	16.9

Investment properties are generally flats and offices ancillary to branch premises and not used by the Group. Rental income of £1.5m on investment properties has been included within other operating income (2017: £1.7m).

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

The fair value of the Group's investment properties at 31 December 2018 has been arrived at predominantly on the basis of external valuations provided by Gerald Eve surveyors, the remaining properties have been valued internally by the Group's Estates Manager, an appropriately qualified surveyor.

Notes to the Accounts continued

19. Property, plant and equipment

	Land and buildings	Equipment, fixtures, fittings and vehicles	Total
	£m	£m	£m
Group			
Cost			
At 1 January 2018	**124.3**	**75.4**	**199.7**
Additions	**4.1**	**4.9**	**9.0**
Disposals	**(2.1)**	**(3.6)**	**(5.7)**
Transfers	**0.3**	**–**	**0.3**
At 31 December 2018	**126.6**	**76.7**	**203.3**
Depreciation			
At 1 January 2018	**34.8**	**51.6**	**86.4**
Charged in year	**4.0**	**6.8**	**10.8**
Disposals	**(1.0)**	**(3.5)**	**(4.5)**
At 31 December 2018	**37.8**	**54.9**	**92.7**
Net book value			
At 31 December 2018	**88.8**	**21.8**	**110.6**
Cost			
At 1 January 2017	129.1	77.5	206.6
Additions	2.5	3.2	5.7
Disposals	(7.3)	(5.3)	(12.6)
At 31 December 2017	124.3	75.4	199.7
Depreciation			
At 1 January 2017	30.6	46.7	77.3
Charged in year	5.9	8.6	14.5
Impairment	1.8	0.6	2.4
Disposals	(3.5)	(4.3)	(7.8)
At 31 December 2017	34.8	51.6	86.4
Net book value			
At 31 December 2017	89.5	23.8	113.3

19. Property, plant and equipment continued...

	Land and buildings	Equipment, fixtures, fittings and vehicles	Total
	£m	£m	£m
Society			
Cost			
At 1 January 2018	**118.2**	**75.3**	**193.5**
Additions	**4.1**	**4.9**	**9.0**
Disposals	**(2.1)**	**(3.6)**	**(5.7)**
Transfers	**0.3**	**–**	**0.3**
At 31 December 2018	**120.5**	**76.6**	**197.1**
Depreciation			
At 1 January 2018	**29.4**	**51.3**	**80.7**
Charged in year	**3.9**	**6.8**	**10.7**
Impairment	**–**	**–**	**–**
Disposals	**(1.0)**	**(3.5)**	**(4.5)**
At 31 December 2018	**32.3**	**54.6**	**86.9**
Net book value			
At 31 December 2018	**88.2**	**22.0**	**110.2**
Cost			
At 1 January 2017	123.0	77.4	200.4
Additions	2.5	3.2	5.7
Disposals	(7.3)	(5.3)	(12.6)
At 31 December 2017	118.2	75.3	193.5
Depreciation			
At 1 January 2017	25.1	46.4	71.5
Charged in year	6.0	8.6	14.6
Impairment	1.8	0.6	2.4
Disposals	(3.5)	(4.3)	(7.8)
At 31 December 2017	29.4	51.3	80.7
Net book value			
At 31 December 2017	88.8	24.0	112.8

Notes to the Accounts continued

20. Deferred tax assets and liabilities

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
The movement on the net deferred tax (liability)/asset is as follows:				
At 1 January as originally presented	**(20.9)**	0.1	**(21.9)**	(3.5)
Remeasurement due to IFRS 9	**(0.3)**	–	**1.5**	–
At 1 January under IFRS 9	**(21.2)**	0.1	**(20.4)**	(3.5)
Income Statement (expense)/credit (Note 11)	**(4.8)**	(0.7)	**0.9**	1.9
Tax credit/(expense) recognised directly in equity	**4.6**	(20.3)	**4.6**	(20.3)
At 31 December	**(21.4)**	(20.9)	**(14.9)**	(21.9)
Deferred tax assets and liabilities are attributable to the following items:				
Deferred tax assets				
Depreciation in excess of capital allowances	**2.9**	3.0	**2.9**	3.0
Other temporary differences	**0.4**	1.2	**0.3**	0.4
Implementation of IAS 39 – mortgages and hedging	**0.6**	0.6	**0.6**	0.6
Deferred remuneration	**0.9**	0.9	**0.9**	0.9
Cash flow hedging	**0.6**	1.2	**0.6**	1.2
Fair value volatility on financial instruments in securitisation entities	**–**	0.6	**–**	–
Restructuring costs	**1.5**	1.2	**1.5**	1.2
Transitional adjustment arising following implementation of IFRS 9*	**1.4**	–	**1.4**	–
	8.3	8.7	**8.2**	7.3
Deferred tax liabilities				
Pensions and other post-retirement benefits	**19.0**	23.8	**19.0**	23.8
Other temporary differences	**1.1**	1.8	**1.0**	1.8
Fair value volatility on financial instruments in securitisation entities	**4.8**	0.4	**–**	–
Available for sale securities**	**–**	3.6	**–**	3.6
Financial Instruments held at fair value through profit and loss**	**1.0**	–	**1.0**	–
Financial Instruments held at fair value through other comprehensive income**	**2.1**	–	**2.1**	–
Transitional adjustment arising following implementation of IFRS 9*	**1.7**	–	**–**	–
	29.7	29.6	**23.1**	29.2

The deferred tax assets have not been discounted. The Group considers that sufficient future taxable trading profits will be available to utilise the Group's trading deferred tax assets and the Group has therefore recognised such deferred tax assets where they have arisen.

* As described at Note 1, IFRS 9 took effect as at 1 January 2018 and gave rise to changes in the methodology of calculation of impairment of financial assets. A deferred tax asset of £1.6m and deferred tax liability of £1.9m were created on transition as a result of this change.

** Available for Sale Securities have been reclassified as Financial Instruments held at Fair Value through Other Comprehensive Income ("FVTOCI") or Financial Instruments held at Fair Value through P&L ("FVTPL") under IFRS 9. The £3.6m deferred tax liability in respect of Available for Sale Securities at 31 December 2017, is reclassified on transition as a £0.6m deferred tax liability relating to financial instruments held at FVTPL, and a £3.0m deferred tax liability in relation to financial instruments held at FVTOCI.

20. Deferred tax assets and liabilities continued...

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

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Pensions and other post-retirement benefits	**(0.5)**	(0.1)	**(0.5)**	(0.1)
Depreciation in excess of capital allowances	**0.1**	(0.8)	**0.1**	(0.8)
Other temporary differences	**0.2**	0.1	**(0.6)**	0.1
Implementation of IAS 39 – mortgages and hedging	**–**	0.3	**–**	0.3
Deferred remuneration	**–**	(0.3)	**–**	(0.3)
Fair value volatility on financial instruments in securitisation entities	**5.0**	2.6	**–**	–
Financial instruments held at fair value through profit and loss**	**0.4**	–	**0.4**	–
Restructuring costs	**(0.4)**	(1.1)	**(0.4)**	(1.1)
Transitional adjustment arising following implementation of IFRS 9*	**–**	–	**0.1**	–
	4.8	0.7	**(0.9)**	(1.9)

21. Other assets

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Prepayments and accrued income	**22.7**	18.1	**22.7**	18.1
Due from subsidiary undertakings	**–**	–	**10.4**	10.9
Other assets	**6.8**	12.3	**5.4**	10.7
	29.5	30.4	**38.5**	39.7

22. Shares

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Shares comprising balances held by individuals	**29,590.8**	28,985.1	**29,590.8**	28,985.1
Fair value adjustments	**(32.2)**	(47.1)	**(32.2)**	(47.1)
	29,558.6	28,938.0	**29,558.6**	28,938.0

* As described at Note 1, IFRS 9 took effect as at 1 January 2018 and gave rise to changes in the methodology of calculation of impairment of financial assets. A deferred tax asset of £1.6m and deferred tax liability of £1.9m were created on transition as a result of this change.

** Available for Sale Securities have been reclassified as Financial Instruments held at Fair Value through Other Comprehensive Income ("FVTOCI") or Financial Instruments held at Fair Value through P&L ("FVTPL") under IFRS 9. The £3.6m deferred tax liability in respect of Available for Sale Securities at 31 December 2017, is reclassified on transition as a £0.6m deferred tax liability relating to financial instruments held at FVTPL, and a £3.0m deferred tax liability in relation to financial instruments held at FVTOCI.

Notes to the Accounts continued

23. Amounts owed to credit institutions

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

24. Other deposits

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Amounts owed to:				
Subsidiary undertakings	**–**	–	**8,667.7**	8,332.4
Other customers	**508.6**	420.2	**195.4**	135.8
	508.6	420.2	**8,863.1**	8,468.2

25. Debt securities in issue

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Covered bonds	**2,309.0**	2,521.1	**2,309.0**	2,521.1
Medium term notes	**2,089.4**	1,671.0	**2,089.4**	1,671.0
Residential mortgage backed securities	**747.5**	741.2	**–**	–
	5,145.9	4,933.3	**4,398.4**	4,192.1

Debt securities in issue include amounts secured on certain loans and advances to customers – Group £3.1bn (2017: £3.3bn) and Society £2.3bn (2017: £2.5bn).

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.

In addition, the Group operates unfunded defined benefit pension schemes for certain current and former members of staff. The present value at 31 December 2018 of the defined benefit obligation (DBO) in relation to these schemes was £8.9m (2017: £9.6m) and the relevant disclosures have been aggregated with those of the main employee benefits scheme.

Net defined benefit asset

As at 31 December 2018 the defined benefit asset is £75.9m, this is a decrease of £19.3m from 31 December 2017. This includes the £25m reduction in assets as a result of the pensioner buy in.

Pensioner buy-in

In mid-November the Scheme entered into a pensioner buy-in with Pension Insurance Corporation (PIC) a UK insurer. The premium of c.£248m was paid for out of the Scheme's assets, with no additional funding required from the Society. The asset loss from the buy-in was approximately £25m on the accounting basis. The transaction covered around £250m of the Scheme's pensioner liabilities, based on the Technical Provisions basis. As such, some pensioners remain uninsured and not covered by the buy-in. At 31 December 2018, we have valued the YBS Scheme 9 January 2019 insurance contract with PIC to be equal to the corresponding IAS 19 DBO in respect of the insured members. This was calculated by rolling forward the assessed value of the liabilities at the point of the transaction, and adjusting for changes in assumptions.

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. This includes a section which covers auto-enrolled employees. The total expense recognised for these defined contribution benefits is £10.7m (2017: £12.0m). This excludes the additional contributions made by the Society as a result of the salary sacrifice scheme.

26. Retirement benefit obligations continued...

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 from, with the exception of N&P Section members 1 April 2010, are based on career average revalued earnings. N&P Section members' benefits are based on their Final Pensionable Salary (following the removal of the 31 March 2010 freeze). The defined benefit section was closed to new employees in 2000 and to future accrual on 31 December 2015. 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 of the Scheme has a weighted average maturity of around 20 years. This weighted average duration of a pension scheme is the average discounted term until benefit payments are due, weighted by the size of the payment. A breakdown of the scheme liabilities by members is included below.

	31 Dec 2018
	£m
Active liability	166.5
Deferred liability	236.6
Pensioner liability	411.1
GMP Equalisation cost	1.7
Total Liabilities	**815.9**

GMP equalisation

On 26 October 2018, the High Court ruled that the Lloyds schemes had to equalise pension scheme benefits between males and females for the effects Guaranteed Minimum Pension (GMP) and identified acceptable methods as to how this can be achieved. As a result the Group has now included GMP equalisation in the determination of the defined benefit obligation. The estimated impact of GMP equalisation at 31 December 2018 is £1.7m, which has been treated as a past service cost, increasing the defined benefit obligation.

Scheme specific risks

The ultimate cost of the Scheme 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 Society and a lower surplus 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:

i. The investment return on the Scheme's assets being lower than assumed, resulting in an 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.

ii. 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.

iii. 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.

iv. 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 (at the date of implementation in October 2012, the strategy hedged around 70% of the Scheme's interest rate and inflation rate risk).

Notes to the Accounts continued

26. Retirement benefit obligations continued...

	31 Dec 2018	31 Dec 2017
	%	%
Disaggregation of assets		
Equities	**9**	15
Index-linked bonds	**32**	58
Corporate and other bonds	**20**	8
Cash and other	**6**	7
Swaps	**8**	12
Pensioner buy-in insurance contract	**25**	–
	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 and 'Buy in'.

Scheme investment strategy

The Trustees set the investment strategy for the Defined Benefit ('DB') Section taking into account considerations such as the strength of the employer covenant, the long-term liabilities of the DB Section and the funding agreed with the Employer.

The Scheme's investment strategy has been to seek to reduce investment risk over time, within an agreed 'journey plan' that anticipates a managed transition to assets that carry lower risk albeit with expectations of lower investment returns. This transition would occur when the funding level met pre-agreed de-risking levels. The investment objective of the DB Section was to maintain a portfolio of suitable assets of appropriate liquidity which will generate investment returns to meet, together with future contributions, the benefits of the DB Section payable under the Trust Deed and Rules as they fall due.

During 2018, the Trustees agreed to implement a long term, lower risk portfolio targeting a return of gilts + 1% pa. It was agreed that this portfolio should incorporate Secure Income Assets, Diversified Return Seeking Assets and Long Term Credit. The Trustees also agreed to implement a buy-in policy, the size of which was carefully considered and positioned in the context of the Scheme's investment objective. Over the year, the Trustees have made some progress towards implementing the long term strategic asset allocation. These are as follows:

- A portion of the equity portfolio was disinvested in order to fund the investment in the Diversified Return Seeking Assets.
- A portion of the equity portfolio was disinvested, together with an adjustment to the Liability Driven Investment (LDI) portfolio, to fund the continuing investment in the Secure Income Assets.
- The buy-in policy was funded by raising cash from within the LDI portfolio and the hedging was adjusted to remove the exposures provided by the buy-in.
- A manager for the Long Term Credit portfolio was selected and the portfolio is due to be implemented in the first half of 2019.

As part of these changes the Trustees agreed that the investment objectives for the DB Section should be:

- To achieve a return on the Scheme's assets that is consistent with the long-term assumptions of the Scheme Actuary in determining the funding of the Scheme, whilst at the same time balancing risk.
- To aim for the assets to exceed the liabilities as determined in the event of the Scheme winding up on the basis of cash equivalent transfer values.
- To minimise the requirement for the Society to make further deficit recovery plan contributions.

The investment strategy is set out in its Statement of Investment Principles. The new strategy is to hold:

- A range of instruments that provide a better match both to changes in liability values and expected cash flows, including (but not limited to) gilts, corporate bonds, derivatives, secure income assets and insurance policies.
- A diversified range of return-seeking assets, including (but not limited to) equities, corporate bonds, emerging market equities and debt, reinsurance and secure income assets, which may be provided through a multi-asset diversified growth fund.
- Passive and actively managed portfolios as appropriate, following consideration of efficiency, liquidity and level of transaction costs likely to prevail within each market as well as the impact of the investment managers' fees on future expected returns.

26. Retirement benefit obligations continued...

Summary of assumptions	31 Dec 2018	31 Dec 2017
	%	%
Retail Prices index (RPI) Inflation	**3.4**	3.4
Consumer price index (CPI) inflation	**2.4**	2.4
Discount rate	**2.7**	2.4
Rate of increase in pay	**3.7**	3.7
Rate of increase of pensions in payment*		
in line with RPI, subject to a min of 3% and a max of 5% pa	**3.8**	3.8
in line with RPI, subject to a min of 0% and a max of 5% pa	**3.1**	3.1
in line with RPI, subject to a min of 0% and a max of 2.5% pa	**2.0**	2.0
in line with CPI, subject to a min of 0% and a max of 3% pa	**2.0**	2.0
Rate of increase for deferred pensions*		
in line with CPI, subject to a min of 0% and a max of 5% pa	**2.4**	2.4
in line with CPI, subject to a min of 0% and a max of 2.5% pa	**2.4**	2.4

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

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:

	2018	2017
	Years	Years
For a current 60 year old male	**28.4**	28.6
For a current 60 year old female	**29.7**	29.9
For a current 45 year old male	**29.9**	30.0
For a current 45 year old female	**31.3**	31.3

Reconciliation of funded status	31 Dec 2018	31 Dec 2017
	£m	£m
Present value of defined benefit obligation	**(815.9)**	(899.1)
Assets at fair value	**891.8**	994.3
Funded status/defined benefit asset	**75.9**	95.2

Statement of Comprehensive Income (SCI)	2018	2017
	£m	£m
Cumulative actuarial gains recognised at 1 January	**41.5**	(8.3)
Gain/(loss) due to change in financial assumptions	**48.4**	(6.6)
Gain/(loss) due to demographic assumptions	**5.7**	(3.1)
(Loss)/gain due to experience	**(1.8)**	40.4
(Loss)/gain due to investment return different from return implied by discount rate	**(71.4)**	19.1
Total actuarial (loss)/gain recognised in SCI	**(19.1)**	49.6
Cumulative actuarial gains recognised at 31 December	**22.4**	41.5

Notes to the Accounts continued

26. Retirement benefit obligations continued...

The experience loss of £1.8m has arisen as a result of pension increases, deferred revaluation and Career Average Revalued Earning ("CARE") revaluation being higher than assumed.

Components of pension expense as shown in the Income Statement	2018	2017
	£m	£m
Past Service cost – plan amendments*	**1.7**	–
Administrative expenses	**2.3**	1.7
Interest on net defined benefit surplus	**(2.3)**	(1.0)
Total pension expense	**1.7**	0.7

*Past service cost is in relation to GMP equalisation.

Reconciliation of present value of defined benefit obligation	2018	2017
	£m	£m
Present value of defined benefit obligation at 1 January	**899.1**	949.3
Past service cost – plan amendments for GMP	**1.7**	–
Administrative expenses	**2.3**	1.7
Interest cost	**20.9**	23.8
Actuarial (gain)	**(52.3)**	(30.7)
Defined benefit actual benefits paid	**(55.8)**	(45.0)
Present value of defined benefit obligation at 31 December	**815.9**	899.1

Movement in defined benefit fair value of assets	2018	2017
	£m	£m
Fair value of assets at 1 January	**994.3**	991.3
Interest income on scheme assets	**23.2**	24.8
Return on plan assets (less) / greater than discount rate	**(71.4)**	19.1
Defined benefit actual Society contributions	**1.5**	4.0
Defined benefit actual benefits and costs paid	**(55.8)**	(44.9)
Fair value of plan assets at 31 December	**891.8**	994.3

Asset returns have been lower than assumed, this includes an accounting loss in relation to the pensioner buy-in of c.£25m. The impact of this has been offset to some extent by the reduction in DBO through transfers out of £34.9m, changes in demographic assumption (where we adopted the latest mortality improvements table) and an increase in discount rate.

Defined benefit actual contributions paid wholly relate to contributions made by the Society. Contributions for the period ending 31 December 2019 will be £2.5m as per the Schedule of Contributions and Recovery Plan. However this plan includes an assessment of the value associated with the prior year's transfer-out experience, which may then lead to a potential adjustment of Recovery Plan payment. This adjustment may result in the Recovery Plan payment being either increased (but within an overall payment cap of £3.5m) or reduced (potentially to £nil).

Sensitivities

The IAS 19 liability measurement 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 expectation. 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 Scheme assets to changes in these assumptions. The final assumptions are chosen by the Society.

26. Retirement benefit obligations continued...

Principal Sensitivity Illustrations	Defined benefit obligation	Assets	Net effect
	£m	£m	£m
Total as at 31 December 2018	(815.9)	891.8	75.9
Change in defined benefit obligation/assets given the following change of assumption:			
Discount Rate[1]: 1.00% decrease	(180.5)	217.0	36.5
Salary Escalation: 0.75% increase	(8.0)	–	(8.0)
Inflation[2]: 0.50% increase	(40.9)	49.2	8.3
Life Expectancy: 1 year average increase	(28.6)	7.9	(20.7)

The asset liability matching strategy implemented for the Scheme means that a change in discount rate or inflation assumption has a broadly similar impact on the liabilities and the assets, reducing the volatility of the net impact. It should be noted that this strategy is based on liabilities on the self-sufficiency basis, i.e. higher liabilities than on an accounting basis. As such, on an accounting basis, for the sensitivities above, the assets increase by more than the liabilities, resulting in an improvement in the accounting balance sheet position.

27. Other liabilities

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Accruals and deferred income	**44.1**	48.0	**41.6**	45.7
Other	**10.0**	14.5	**10.0**	10.2
At 31 December 2018	**54.1**	62.5	**51.6**	55.9

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 sensitivity illustrations above are calculated changing each assumption in isolation, keeping all other assumptions constant. In practice this is unrealistic as it ignores the impact from correlation between assumptions.

Notes to the Accounts continued

28. Provisions for liabilities and charges

Movements in provisions during the year were as follows:

	Customer redress	Restructuring	Property related provision	FSCS levy	Other	Total
	£m	£m	£m	£m	£m	£m
Group						
At 1 January 2018	**24.9**	**9.2**	**8.1**	**2.5**	**1.1**	**45.8**
Amounts utilised during the year	**(8.7)**	**(5.8)**	**(1.6)**	**(1.1)**	**(0.1)**	**(17.3)**
Provision (release)/charge during the year	**(1.3)**	**10.5**	**(1.2)**	**(0.9)**	**(0.2)**	**6.9**
At 31 December 2018	**14.9**	**13.9**	**5.3**	**0.5**	**0.8**	**35.4**
At 1 January 2017	17.9	–	4.9	5.2	1.1	29.1
Amounts utilised during the year	(12.7)	(4.4)	(1.3)	(5.2)	–	(23.6)
Provision charge during the year	19.7	13.6	4.5	2.5	–	40.3
At 31 December 2017	24.9	9.2	8.1	2.5	1.1	45.8

	Customer redress	Restructuring	Property related provision	FSCS levy	Other	Total
	£m	£m	£m	£m	£m	£m
Society						
At 1 January 2018	**24.8**	**9.2**	**8.1**	**2.5**	**1.1**	**45.7**
Amounts utilised during the year	**(8.7)**	**(5.8)**	**(1.6)**	**(1.1)**	**(0.1)**	**(17.3)**
Provision (release) / charge during the year	**(1.2)**	**10.5**	**(1.2)**	**(0.9)**	**(0.2)**	**7.0**
At 31 December 2018	**14.9**	**13.9**	**5.3**	**0.5**	**0.8**	**35.4**
At 1 January 2017	17.8	–	4.9	5.2	1.1	29.0
Amounts utilised during the year	(12.6)	(4.4)	(1.3)	(5.2)	–	(23.5)
Provision charge during the year	19.6	13.6	4.5	2.5	–	40.2
At 31 December 2017	24.8	9.2	8.1	2.5	1.1	45.7

Customer redress

Provisions have been made in respect of various potential customer claims and represent management's best estimate of the likely costs. The largest provision of £12.6m (2017: £21.3m) 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. The provision reflects the Financial Conduct Authority's (FCA) finalised guidance (CP18/33) on how firms should handle complaints about regular premium payment protection insurance (PPI) in light of recurring non-disclosure(s) of the existence of, or level of, commission and/or profit share.

Restructuring

A restructuring provision of £13.9m (2017: £9.2m) is held in relation to business and organisational changes announced during 2018 and earlier periods. The majority of the restructuring costs are due to be paid in 2019.

Property related provision

A property related provision of £5.3m (2017: £8.1m) is held in respect of onerous leases for branch premises that are no longer in use. This will be utilised over the remaining term of the unoccupied leasehold branches.

29. Subordinated liabilities

	2018	2017
	£m	£m
Group and Society		
Floating Subordinated Bonds 2018	**–**	5.0
6⅜% Subordinated Bonds 2024	**4.1**	4.1
4⅛% Subordinated Bonds 2024	**250.6**	250.0
13½% Convertible Tier 2 Capital Notes 2025	**26.3**	26.1
3⅜% Subordinated Bonds 2028	**300.3**	300.0
Fair value hedging adjustments	**3.8**	8.5
	585.1	593.7

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 PRA under the following conditions:

- Redemption of all (but not some only) of the 4⅛% Notes at par on 20 November 2019 after giving not less than 30 nor more than 60 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%.
- Redemption of all (but not some only) of the 3⅜% Notes at par on 13 September 2027 after giving not less than 30 nor more than 60 days' notice to the holders. In the event the Society does not redeem the notes on 13 September 2027 the fixed rate of interest will become the sum of the six month mid-swap rate plus 2.3175%.
- 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

	2018	2017
	£m	£m
Group and Society		
5.649% Permanent Interest Bearing Shares	**6.1**	6.1
Fair value hedging adjustments	**–**	0.3
	6.1	6.4

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 PRA. 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.

Notes to the Accounts continued

31. Capital management (Unaudited)

The Society is subject to regulatory capital requirements enforced in the United Kingdom (UK) by the Prudential Regulation Authority (PRA). Regulatory capital resources include general reserves, fair value through other comprehensive income reserves, permanent interest-bearing shares (PIBS) and subordinated liabilities; these are subject to regulatory adjustments and IFRS9 transitional arrangements. The Society has complied with the PRA's regulatory capital requirements during the year, further details of the Society's capital position can be found in the 2018 Pillar 3 Disclosures.

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

	2018	2017
	£m	£m
Tier 1		
Common Equity Tier 1 (CET1)		
General reserve	**2,518.5**	2,377.2
Fair value through other comprehensive income reserve	**6.2**	10.8
Cash flow hedge reserve	**(1.8)**	(3.6)
Common Equity Tier 1 prior to regulatory adjustments	**2,522.9**	2,384.4
Common Equity Tier 1 regulatory adjustments		
IFRS 9 transitional arrangements[1]	**0.4**	–
Pension fund adjustments[2]	**(56.9)**	(71.4)
Intangible fixed assets[3]	**(39.8)**	(31.3)
Prudent valuation adjustment[4]	**(2.3)**	(1.6)
Cash flow hedge reserve[5]	**1.8**	3.6
Low rated securitisations[6]	**(3.2)**	–
Total Common Equity Tier 1 capital	**2,422.9**	2,283.7
Additional Tier 1 Capital (AT1)		
Subscribed Capital[7]	**2.5**	3.2
Total Tier 1 Capital	**2,425.4**	2,286.9

1 Following the implementation of IFRS 9, any increase in impairment provisions may be added back to CET1 capital resources on a reducing basis, over five years. As at December 2018, 95% of the increase in provisions is added back to CET1.
2 CRD IV requires a pension fund surplus, net of any associated deferred tax liabilities, to be deducted from CET1 capital. CRD IV does not permit a pension fund deficit to be added back to regulatory capital.
3 CRD IV requires intangible fixed assets, net of any associated deferred tax liabilities, to be deducted from CET1.
4 A regulatory deduction applied to CET1 capital as calculated in accordance with Article 105 of the CRR. The purpose of the Prudential Valuation Adjustment is to ensure that the valuation of financial instruments for capital reporting is at the more conservative end of any range of plausible valuations.
5 The cash flow hedge reserve does not form part of regulatory capital, net of associated deferred tax.
6 Under CRD IV, low rated securitisations can either be deducted from CET1 resources, or risk weighted at 1,250%.
7 Under CRD IV, subscribed capital is being phased out as qualifying for regulatory Tier 1 capital over a ten year period. Currently 40% of the subscribed capital balance sheet carrying value qualifies as additional Tier 1 capital.

31. Capital management (Unaudited) continued...

	2018	2017
	£m	£m
Tier 2		
Subordinated liabilities[8]	**585.1**	589.2
Collective allowances for impairment[9]	**–**	24.5
Total Tier 2 Capital	**585.1**	613.7
Total capital	**3,010.5**	2,900.6
Risk weighted assets	**14,841.3**	14,449.4
Common Equity Tier 1 capital ratio	**16.3%**	15.8%
Tier 1 ratio	**16.3%**	15.8%
Total capital ratio	**20.3%**	20.1%
CRR Leverage ratio	**5.4%**	5.1%
UK Leverage ratio (excluding claims on central banks)[10]	**5.8%**	5.7%

The Executive Risk Committee reviews the Society's capital position and regulatory developments under CRD IV.

For a detailed analysis of the Society's capital position and disclosures please refer to the Pillar 3 Disclosure for 2018 which can be found on our website ybs.co.uk

8 Subordinated liabilities with less than five years to maturity are adjusted for amortisation in the regulatory capital value of instruments.
9 Following the implementation of IFRS 9, there are no longer collective allowances for impairment.
10 This ratio is based on the calculation as stipulated in PS21/17. Currently, this calculation does not apply to the Group, although this will be reviewed in due course by the PRA.

Notes to the Accounts continued

32. Financial commitments

	Group and Society	
	2018	2017
	£m	£m
Committed undrawn standby facilities	**383.1**	197.8

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 subsidiaries, in the event that these subsidiaries are unable to discharge them out of their own assets. In addition, the Society guarantees certain Accord mortgage buyback obligations regarding the Group's securitisation entities (discussed in Note 35) in the event that Accord is unable to discharge these obligations.

The Society accounts for these guarantees in accordance with IFRS 4 'Insurance Contracts'.

Future minimum lease payments under non-cancellable operating leases are as follows:

	2018		2017	
	Land and buildings	**IT Equipment**	Land and buildings	IT Equipment
	£m	**£m**	£m	£m
Group and Society				
Within one year	**5.0**	**0.4**	6.7	0.4
Between one and five years	**15.9**	**0.1**	19.3	0.5
Over five years	**4.6**	**–**	6.5	–
	25.5	**0.5**	32.5	0.9

The Group leases various offices and branches under non-cancellable operating lease arrangements. These leases have various terms, escalation clauses and renewal rights. In January 2019 the new leases standard, IFRS 16, became effective. Note 1 details the impact of the new standard and leads to a lease liability of £54.0m for leased properties that were previously held via operating leases. This is a higher balance than the information presented above as IFRS 16 includes future rental payments until the end of the lease, unless the break clause has been activated, whereas the financial commitment information above only includes the minimum lease payments on operating leases. As a result leases that have a break clause will have a larger IFRS 16 liability than the related minimum financial commitment.

33. Financial instruments

The table below summarises the main non-derivative 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	Cash balances and statutory deposits with variable and non-interest bearing interest rates	Amortised cost
Loans and advances to credit institutions	Fixed and variable interest rates	Amortised cost
Debt securities	Fixed, variable and indexed linked interest rates	Generally held at fair value through other comprehensive income. Certain investments are held at fair value through profit and loss. Detail is given in Note 15.
Loans and advances to customers	Primarily mortgage products offering a variety of fixed and variable interest rates	Amortised cost*
Intercompany deposit from Covered Bond Limited Liability Partnerships	Fixed and variable interest rates	Amortised cost
Investments	Share and loan investments in subsidiary companies Investments in equities	Cost/Amortised cost Fair value through profit and loss
Shares	Deposits made by individuals with a variety of fixed and variable interest rates	Amortised cost
Amounts owed to credit institutions	Primarily Time Deposits Fixed and variable interest rates	Amortised cost
Debt securities in issue	Fixed and variable interest rates	Amortised cost*
Subordinated liabilities	Fixed interest rates	Amortised cost*
Subscribed capital	Fixed interest rates	Amortised cost*

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

Notes to the Accounts continued

34. Derivative financial instruments

Instruments used for the management of market risk include derivative financial instruments (derivatives) which are contracts or agreements whose value is derived from one or more underlying price, rate or index inherent in the contract or agreement, such as interest rates, exchange rates or stock market indices.

Derivatives are only used by the Group in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and 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 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 after considering any offsetting risk from other activities.

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 debt issuance	Sensitivity to changes in interest rates	Interest rate swaps
Fixed rate mortgage lending	Sensitivity to changes in interest rates	Interest rate swaps
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 basis	Interest rate swaps
Equity linked investment products	Sensitivity to changes in equity indices	Equity linked interest rate swaps
Management of foreign currency risk arising from investment and funding	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.

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 hedge accounting requirements of IAS 39. The Group only designates accounting hedges where a high degree of effectiveness can be achieved.

The following table shows the balance sheet categories covered by hedge accounting relationships:

Hedge Relationship	Balance Sheet Line Item
Fair value hedge for interest rate risk	
Fixed rate mortgages Fixed rate debt securities held Fixed rate debt securities issued	Loans and advances to customers Liquid assets – Debt securities Debt securities in issue
Fair value hedge for interest rate and FX risk	
Fixed rate debt securities issued	Debt securities in issue
Cash flow hedge for interest rate risk	
Floating rate liquid assets Floating rate deposits	Liquid assets – Loans and advances to credit institutions Amounts owed to credit institutions

Interest rate risk on fixed rate mortgages and purchased debt securities (fair value hedge)

The Group holds portfolios of long-term fixed rate mortgages and debt securities. These portfolios expose the Group to changes in fair value due to movements in market interest rates. The Group manages this risk exposure by entering into pay fixed/receive floating interest rate swaps.

Only the interest rate risk element is hedged and therefore other risks, such as credit risk, are managed but not hedged by the Group. The interest rate risk component is determined as the change in fair value of the long-term fixed rate mortgages arising solely from changes in SONIA (the benchmark rate of interest). Such changes are usually the largest component of the overall change in fair value. This strategy is designated as a fair value hedge and its effectiveness is assessed by comparing changes in the fair value of the hedged item attributable to changes in the benchmark rate of interest with changes in the fair value of the interest rate swaps.

34. Derivative financial instruments continued...

Possible sources of ineffectiveness are as follows:

(i) differences between the expected and actual volume of prepayments for mortgage portfolios, as the Group hedges to the expected repayment date taking into account expected prepayments based on past experience;

(ii) difference in timing of cash flows between the mortgage loans and the hedging interest rate swaps;

(iii) difference in the designated coupon rate % of the hedged asset and the hedging derivative; and

(iv) hedging derivatives with a non-zero fair value at the date of initial designation as a hedging instrument.

The exposure from the mortgage portfolio frequently changes due to new loans being originated, contractual repayments and early prepayments made by customers in each period. As a result, the Group adopts a portfolio hedging strategy to hedge the exposure by closing and entering into new swap agreements. The Group uses the portfolio fair value hedge of interest rate risk to recognise fair value changes related to changes in interest rate risk in the mortgage portfolio, and therefore reduce the profit or loss volatility that would otherwise arise from changes in the fair value of the interest rate swaps alone. This hedge relationship is updated on a monthly basis for changes in the portfolio.

Foreign Exchange and Interest rate risk on fixed rate debt issuance (fair value hedge)

The Group accesses international markets in order to obtain effective sources of funding. As part of this process, the Group issues fixed rate debt in both GBP and EUR. The foreign currency and interest rate risk associated with the EUR debt is mitigated by the use of cross currency swaps, which exchange fixed interest payments in the foreign currency for floating interest payments in GBP. The interest rate risk associated with the GBP debt is mitigated by the use of interest rate swaps which exchange fixed interest payments with variable payments. These instruments are entered into to match the maturity profile of the Group's debt instruments.

The foreign currency risk component is determined as the change in cash flows of the foreign currency debt arising solely from changes in the relevant foreign currency exchange rate. The interest rate risk component is determined as the change in fair value of the debt arising solely from changes in the benchmark rate of interest. Such changes are usually the largest component of the overall change in fair value. This strategy is designated as a fair value hedge and its effectiveness is assessed by comparing changes in the fair value of the debt attributable to changes in the hedged risk(s) with changes in the fair value of the hedging derivatives.

Possible sources of ineffectiveness are as follows:

(i) differences in discounting approach between the hedged item and hedging instrument, including the cross currency basis spread applied in the valuation of cross currency swaps;

(ii) hedging derivatives with a non-zero fair value at the date of initial designation as a hedging instrument;

(iii) difference in the designated coupon rate % of the hedged liability and the hedging derivative; and

(iv) counterparty credit risk which impacts the value of uncollateralised cross currency swaps but not the hedged items.

Interest rate risk on floating rate deposits and investments (cash flow hedge)

The Group transacts interest rate swaps to mitigate the interest rate risk between its fixed rate assets and liabilities and those which pay or receive a floating rate of interest. Cash flow hedges are designated where interest rate swaps are used to convert the interest rate variability on floating rate financial instruments into fixed rates.

Only the interest rate risk element is hedged and therefore other risks, such as credit risk, are managed but not hedged by the Group. The interest rate risk component is determined as the change in fair value of the hedged item arising solely from changes in the benchmark rate of interest. Such changes are usually the largest component of the overall change in fair value. This strategy is designated as a cash flow hedge and its effectiveness is assessed by comparing changes in the fair value of the hedged item attributable to changes in the benchmark rate of interest with changes in the fair value of the interest rate swaps, using the hypothetical derivative method.

Possible sources of ineffectiveness are as follows:

(i) differences in the floating rate basis of interest between the hedged item and hedging instrument;

(ii) hedging derivatives with a non-zero fair value at the date of initial designation as a hedging instrument; and

(iii) difference in the designated fixed coupon rate % of the hedged item and the hedging derivative.

All ineffectiveness is recorded in the income statement classification titled 'Net gains from financial instruments held at fair value'. The following table shows the ineffectiveness in relation to the hedging relationships designated by the Group.

Notes to the Accounts continued

34. Derivative financial instruments continued...

	Group 2018	Group 2017	Society 2018	Society 2017
	£m	£m	**£m**	£m
Fair value hedges				
Fixed rate mortgages	**(4.8)**	5.7	**(4.8)**	5.7
Fixed rate debt securities held	**3.2**	0.5	**3.2**	0.5
Fixed rate debt securities issued	**0.7**	(9.2)	**4.1**	(11.0)
Cash flow hedges				
Floating rate debt securities issued	**0.7**	1.1	**0.7**	1.1
Floating rate loans	**–**	(1.3)	**–**	(1.3)
Total	**(0.2)**	(3.2)	**3.2**	(5.0)

The following tables summarise the notional and fair value of all derivative financial instruments and the hedging designations in place at that date. The change in fair value used for calculating ineffectiveness is based on all derivatives held during the year.

	Contract/ Notional amount	Fair values		Change in fair value used for calculating ineffectiveness
		Assets	Liabilities	
	£m	£m	£m	£m
Group				
At 31 December 2018				
Interest rate swaps designated as fair value hedges	**21,996.0**	**68.3**	**55.7**	**(25.0)**
Interest rate swaps designated as cash flow hedges	**45.0**	**–**	**3.2**	**3.2**
Cross currency interest rate swaps designated as fair value hedges	**3,446.3**	**452.7**	**–**	**11.3**
Derivatives not designated as hedges:				
Interest rate swaps	**9,953.0**	**35.8**	**38.7**	**n/a**
Equity linked interest rate swaps	**34.2**	**7.6**	**–**	**n/a**
Foreign exchange	**28.7**	**–**	**0.2**	**n/a**
Total derivative financial instruments	**35,503.2**	**564.4**	**97.8**	**(10.5)**
Society				
At 31 December 2018				
Interest rate swaps designated as fair value hedges	**21,996.0**	**68.3**	**55.7**	**(25.0)**
Interest rate swaps designated as cash flow hedges	**45.0**	**–**	**3.2**	**3.2**
Cross currency interest rate swaps designated as fair value hedges	**1,656.0**	**192.5**	**–**	**11.6**
Derivatives not designated as hedges:				
Interest rate swaps	**23,045.8**	**62.1**	**64.9**	**n/a**
Equity linked interest rate swaps	**34.2**	**7.6**	**–**	**n/a**
Foreign exchange	**28.7**	**–**	**0.2**	**n/a**
Total derivative financial instruments	**46,805.7**	**330.5**	**124.0**	**(10.2)**

The Society table above includes transactions between Group subsidiaries which are eliminated in the Group accounts.

34. Derivative financial instruments continued...

For collateralised derivatives, the expected future cash flows have been discounted using the Overnight Indexed Swap (OIS) curve, and for non-collateralised derivatives the LIBOR curve has been used for discounting. Credit Valuation Adjustments (CVA) and Debit Valuation Adjustments (DVA) are incorporated into the fair value of derivative valuations to reflect the impact of counterparty credit risk and the Group's own credit quality respectively for uncollateralised derivatives.

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, it is included as an asset in loans and advances to credit institutions. Credit risk is also mitigated by the use of central counterparties (CCPs) for eligible derivatives.

	Contract/ Notional amount	Fair values		Change in fair value used for calculating ineffectiveness
		Assets	Liabilities	
	£m	£m	£m	£m
Group				
At 31 December 2017				
Interest rate swaps designated as fair value hedges	21,537.0	125.8	97.1	126.4
Interest rate swaps designated as cash flow hedges	241.3	2.7	12.4	5.9
Cross currency interest rate swaps designated as fair value hedges	2,972.6	420.3	–	(37.4)
Derivatives not designated as hedges:				
Interest rate swaps	12,004.0	17.1	47.4	n/a
Equity linked interest rate swaps	122.5	25.8	–	n/a
Foreign exchange	9.5	0.1	–	n/a
Total derivatives held for hedging	**36,886.9**	**591.8**	**156.9**	**94.9**
Society				
At 31 December 2017				
Interest rate swaps designated as fair value hedges	20,787.0	94.9	97.1	126.4
Interest rate swaps designated as cash flow hedges	241.3	2.7	12.4	5.9
Cross currency interest rate swaps designated as fair value hedges	1,197.9	181.0	–	(0.3)
Derivatives not designated as hedges:				
Interest rate swaps	20,879.5	19.6	50.5	n/a
Equity linked interest rate swaps	122.5	25.8	–	n/a
Foreign exchange	9.5	0.1	–	n/a
Total derivatives held for hedging	**43,237.7**	**324.1**	**160.0**	**132.0**

Notes to the Accounts continued

34. Derivative financial instruments continued...

The following tables show the maturity profile of the hedging instruments designated in hedge relationships by notional used in the Group's hedging strategies:

	Repayable up to three years	In more than three years but not more than five years	Over five years	Total
	£m	£m	£m	£m
Group				
As at 31 December 2018				
Interest rate swaps (pay fixed)	**13,325.0**	**5,559.7**	**1,058.1**	**19,942.8**
Interest rate swaps (receive fixed)	**500.1**	**447.5**	**1,105.6**	**2,053.2**
Cross currency interest rate swaps	**1,432.2**	**2,014.1**	**–**	**3,446.3**
Total Fair value hedges	**15,257.3**	**8,021.3**	**2,163.7**	**25,442.3**
Interest rate swaps (pay fixed)	**–**	**–**	**45.0**	**45.0**
Interest rate swaps (receive fixed)	**–**	**–**	**–**	**–**
Total Cash flow hedges	**–**	**–**	**45.0**	**45.0**

The notional for cross currency interest rate swaps in the table above is greater than the exposure detailed in the hedged item table as for certain hedged items multiple swaps are transacted in order to separately mitigate different components of the risk. The Society hedge relationships are consistent with above except for cross currency interest rate swaps where there is an additional £1.8bn of swap notional (2017: £1.8bn).

	Repayable up to three years	In more than three years but not more than five years	Over five years	Total
	£m	£m	£m	£m
Group				
As at 31 December 2017				
Interest rate swaps (pay fixed)	14,495.5	3,413.1	856.2	18,764.8
Interest rate swaps (receive fixed)	1,256.2	406.5	1,109.5	2,772.2
Cross currency interest rate swaps	976.1	1,552.8	443.7	2,972.6
Total Fair value hedges	**16,727.8**	**5,372.4**	**2,409.4**	**24,509.6**
Interest rate swaps (pay fixed)	150.0	6.7	64.6	221.3
Interest rate swaps (receive fixed)	–	–	20.0	20.0
Total Cash flow hedges	**150.0**	**6.7**	**84.6**	**241.3**

34. Derivative financial instruments continued...

The following table shows the average price/rate (%) of the hedging instruments by maturity used in the Group's hedging strategies:

	2018			2017		
	Repayable up to three years	**In more than three years but not more than five years**	**Over five years**	Repayable up to three years	In more than three years but not more than five years	Over five years
Group and Society						
Average fixed interest rate – Fair value hedges						
Interest rate swaps (pay fixed)	**0.69**	**0.91**	**1.20**	0.63	0.74	1.06
Interest rate swaps (receive fixed)	**1.80**	**0.88**	**1.81**	3.50	2.06	1.68
Cross currency interest rate swaps	**1.34**	**0.72**	**–**	1.39	1.11	0.38
Average fixed interest rate – Cash flow hedges						
Interest rate swaps (pay fixed)	**–**	**–**	**2.18**	1.78	3.75	2.40
Interest rate swaps (receive fixed)	**–**	**–**	**–**	–	–	2.60
Average EUR:GBP FX rate – Fair value hedges						
Cross currency interest rate swaps	**1.26**	**1.28**	**–**	1.27	1.35	1.17

The following tables show the fair value hedge exposures covered by the Group's hedging strategies. The change in fair value of the hedged item for calculating ineffectiveness is based on all hedge relationships designated during the year.

	Carrying amount of hedged item		Accumulated fair value adjustments on the hedged item		Change in fair value of the hedged item for calculating ineffectiveness
	Assets	Liabilities	Assets	Liabilities	
	£m	£m	£m	£m	£m
Group					
At 31 December 2018					
Fixed rate mortgages (interest rate risk)	**18,957.3**	**–**	**(18.0)**	**–**	**2.5**
Fixed rate debt securities held (interest rate risk)	**1,185.3**	**–**	**8.7**	**–**	**10.5**
Fixed rate debt securities issued (interest rate risk)	**–**	**969.7**	**–**	**(1.8)**	**9.4**
Fixed rate debt securities issued (interest rate and FX risk)	**–**	**3,471.0**	**–**	**(24.8)**	**(9.6)**
Society					
At 31 December 2018					
Fixed rate mortgages (interest rate risk)	**18,957.3**	**–**	**(18.0)**	**–**	**2.5**
Fixed rate debt securities held (interest rate risk)	**1,185.3**	**–**	**8.7**	**–**	**10.5**
Fixed rate debt securities issued (interest rate risk)	**–**	**969.7**	**–**	**(1.8)**	**9.4**
Fixed rate debt securities issued (interest rate and FX risk)	**–**	**1,674.7**	**–**	**(10.0)**	**(6.5)**

Notes to the Accounts continued

34. Derivative financial instruments continued...

	Carrying amount of hedged item		Accumulated fair value adjustments on the hedged item		Change in fair value of the hedged item for calculating ineffectiveness
	Assets	Liabilities	Assets	Liabilities	
	£m	£m	£m	£m	£m
Group					
At 31 December 2017					
Fixed rate mortgages (interest rate risk)	18,650.9	–	(21.2)	–	(139.0)
Fixed rate debt securities held (interest rate risk)	734.8	–	(1.8)	–	(8.0)
Fixed rate debt securities issued (interest rate risk)	–	1,755.6	–	(7.8)	25.1
Fixed rate debt securities issued (interest rate and FX risk)	–	2,994.0	–	(18.6)	29.8
Society					
At 31 December 2017					
Fixed rate mortgages (interest rate risk)	18,650.9	–	(21.2)	–	(139.0)
Fixed rate debt securities held (interest rate risk)	734.8	–	(1.8)	–	(8.0)
Fixed rate debt securities issued (interest rate risk)	–	979.9	–	(9.3)	2.1
Fixed rate debt securities issued (interest rate and FX risk)	–	1,213.4	–	(8.3)	13.9

The accumulated amount of fair value hedge adjustments remaining in the balance sheet for hedged items that have ceased to be adjusted for hedging gains and losses is (£35.3m) (2017: £13.3m).

The following tables show the cash flow hedge exposures (gross of tax) covered by the Group's hedging strategies:

	Assets	Liabilities	Change in fair value of hedged item used for calculating ineffectiveness	Cash flow hedge reserve	
				Continuing hedges	Discontinued hedges
	£m	£m	£m	£m	£m
Group and Society					
At 31 December 2018					
Floating rate debt securities issued	**–**	**45.0**	**(2.5)**	**0.9**	**1.5**
Floating rate loans	**–**	**–**	**–**	**–**	**–**
Group and Society					
At 31 December 2017					
Floating rate debt securities issued	–	221.3	(6.7)	5.5	1.7
Floating rate loans	20.0	–	0.6	(2.2)	(0.2)

34. Derivative financial instruments continued...

The following table shows the movements in the cash flow hedge reserve during the year:

	2018	2017
	£m	£m
Group and Society		
At 1 January	**(3.6)**	(8.1)
Effective portion of changes in fair value of interest rate swaps		
– Floating rate debt securities issued	**(0.2)**	2.2
– Floating rate loans	**–**	–
Amounts reclassified from reserves to Income Statement		
– Floating rate debt securities issued	**2.7**	4.5
– Floating rate loans	**–**	(0.7)
Taxation	**(0.6)**	(1.5)
At 31 December	**(1.7)**	(3.6)

Gains/(losses) reclassified into P&L are either recorded within interest receivable or interest payable dependent on the nature of the hedged item. During 2017 & 2018, no amounts have been reclassified to the P&L as a result of a re-assessment of whether hedged future cash flows are no longer expected to occur.

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:

- At the highest level, the Group manages its liquidity levels to ensure compliance with the Overall Liquidity Adequacy Rule, as set out by the PRA in Chapter 2 of the Internal Liquidity Adequacy Assessment part of the PRA Rulebook (ILAA rules).
- Limits are established by the Board that govern the quantity, quality and marketability of and returns from the Group's portfolio of liquidity investments. The portfolio is managed by the Treasury function, monitored by the first and second line risk functions 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. These scenarios are updated and approved by the Board annually through the Internal Liquidity Adequacy Assessment Process (ILAAP).
- The Group also manages liquidity in line with prevailing regulatory requirements, which has been the Liquidity Coverage Ratio (LCR) as prescribed under the European Capital Requirements Directive IV (CRD IV) as part of the Capital Requirements Regulation (CRR) element, since 1 October 2015. The LCR measures the quantity of High Quality Liquid Assets (HQLA) against net liquidity outflows over a 30 day period. YBS currently reports to the PRA on a monthly basis at a Group and Society only level, with the lower of the two being reported as 159.30% for December 2018 month end. For comparison, the lowest as at 31 December 2017 was 165.02%.
- The Group has also implemented internal backstop limits for liquidity, to mitigate the potential risk of liquidity levels under a risk-based approach being able to be reduced to below what is considered a minimum appropriate level for the Group. These are linked to balance sheet size, and also take account of sources of contingent liquidity, including the ability of the Group to access funding through the various Bank of England facilities.
- The liquidity position of the Group is forecast across the next two years and measured against forecasts of the requirements on both a regulatory and internal basis. This is to ensure that the short-term plans of the Group do not lead to liquidity limits being breached and the financial sustainability of the organisation being threatened.

Notes to the Accounts continued

35. Liquidity risk continued...

The above metrics are the key elements of the suite of measures by which the Group actively seeks to manage its liquidity position, along with other complimentary metrics which are included within the Group's risk appetite framework.

Liquidity risk in subsidiary companies, with the exception of other deposits, is mitigated by the use of appropriate intercompany loans and deposits.

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 this is for up to three months and for 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 are as follows:

	Carrying amounts of encumbered assets	Carrying amounts of unencumbered assets	Total
	£m	£m	£m
2018			
Liquid assets	**1,144.2**	**4,360.5**	**5,504.7**
Loans and advances to customers	**9,127.8**	**27,574.6**	**36,702.4**
Other assets	**–**	**847.6**	**847.6**
Total assets	**10,272.0**	**32,782.7**	**43,054.7**

	Carrying amounts of encumbered assets	Carrying amounts of unencumbered assets	Total
	£m	£m	£m
2017			
Liquid assets	1,563.5	4,532.2	6,095.7
Loans and advances to customers	8,577.5	26,483.7	35,061.2
Other assets	–	890.3	890.3
Total assets	10,141.0	31,906.2	42,047.2

All of the assets pledged as security are shown in the Balance Sheet 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. As at 31 December 2018 the Society had in issue £500m and €2,000m of covered bonds.

The Group established its first securitisation programme in 2011. This year the latest securitisation structure, Brass No.7 PLC was established and in September 2018 issued £2,800m of listed debt securities secured against certain loans of Accord Mortgages Ltd. Of these debt securities, £2,500m were retained by the Group to be used as collateral for use in sale and repurchase agreements or central bank operations. As at 31 December 2018, the Group had in issue £6,146m of securitisation notes, of which £5,398m were retained.

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

The tables below provide an analysis of gross contractual cash flows. The sum of the balances depicted in the analysis do not reconcile with the carrying value of the liabilities as disclosed in the consolidated balance sheet. This is because they include estimated future interest payments calculated using balances outstanding at the balance sheet date. Amounts are allocated to the relevant maturity band based on the timing of individual contractual cash flows.

35. Liquidity risk continued...

	Repayable on demand and up to three months	In more than three months but not more than one year	In more than one year but not more than five years	Over five years	Total
	£m	£m	£m	£m	£m
Group					
As at 31 December 2018					
Shares	**17,769.7**	**7,300.7**	**4,518.2**	**0.4**	**29,589.0**
Amounts owed to credit institutions	**997.5**	**598.4**	**2,943.5**	**–**	**4,539.4**
Other deposits					
Society	**125.7**	**70.1**	**–**	**–**	**195.8**
Subsidiaries	**312.9**	**–**	**–**	**–**	**312.9**
Debt securities in issue	**565.4**	**123.2**	**4,259.1**	**442.0**	**5,389.7**
Subordinated liabilities	**–**	**24.1**	**96.6**	**647.6**	**768.3**
Subscribed capital*	**0.2**	**0.2**	**1.3**	**1.7**	**3.4**
Operating lease payments	**–**	**5.4**	**16.0**	**4.6**	**26.0**
Derivative financial liabilities	**15.5**	**34.5**	**104.2**	**2.9**	**157.1**
Total	**19,786.9**	**8,156.6**	**11,938.9**	**1,099.2**	**40,981.6**
Group					
As at 31 December 2017					
Shares	18,517.4	6,965.3	3,568.4	1.6	29,052.7
Amounts owed to credit institutions	1,727.5	961.3	1,768.5	–	4,457.3
Other deposits					
Society	134.1	0.4	–	–	134.5
Subsidiaries	284.1	–	–	–	284.1
Debt securities in issue	21.8	917.7	3,337.6	901.3	5,178.4
Subordinated liabilities	–	29.2	96.6	670.0	795.8
Subscribed capital*	0.2	0.2	1.4	1.7	3.5
Operating lease payments	0.2	6.5	19.8	6.5	33.0
Derivative financial liabilities	28.6	54.1	103.1	11.6	197.4
Total	20,713.9	8,934.7	8,895.4	1,592.7	40,136.7

* The table includes interest payments on subscribed capital for 10 years.

Notes to the Accounts continued

35. Liquidity risk continued...

The table below analyses the Group's financial assets and liabilities into relevant maturity groupings, based on the remaining period between the date of the Balance Sheet and the contractual maturity date.

	Repayable on demand	Less than three months	In more than three months but not more than one year	In more than one year but not more than five years	Over five years	Total
	£m	£m	£m	£m	£m	£m
Group						
As at 31 December 2018						
Financial assets						
Cash in hand and balances with the Bank of England	3,539.8	–	–	–	–	3,539.8
Loans and advances to credit institutions	294.6	–	–	–	–	294.6
Debt securities	–	–	–	642.1	1,028.2	1,670.3
Loans and advances to customers	–	42.3	77.6	1,055.3	35,527.2	36,702.4
Derivatives financial instruments	–	55.8	13.2	483.6	11.8	564.4
Investments	–	–	–	–	6.8	6.8
Total financial assets	3,834.4	98.1	90.8	2,181.0	36,574.0	42,778.3
Financial liabilities						
Shares	16,146.8	1,592.5	7,300.7	4,518.2	0.4	29,558.6
Amounts owed to credit institutions	206.4	793.0	580.3	2,905.4	–	4,485.1
Other deposits	321.9	116.9	69.8	–	–	508.6
Debt securities in issue	–	547.3	–	3,443.3	1,155.3	5,145.9
Derivative financial liabilities	–	6.9	1.7	59.6	29.6	97.8
Subordinated liabilities	–	–	–	–	585.1	585.1
Subscribed capital	–	–	–	–	6.1	6.1
Total financial liabilities	16,675.1	3,056.6	7,952.5	10,926.5	1,776.5	40,387.2

35. Liquidity risk continued...

	Repayable on demand	Less than three months	In more than three months but not more than one year	In more than one year but not more than five years	Over five years	Total
	£m	£m	£m	£m	£m	£m
Group						
As at 31 December 2017						
Financial assets						
Cash in hand and balances with the Bank of England	4,893.9	–	–	–	–	4,893.9
Loans and advances to credit institutions	351.0	–	–	–	–	351.0
Debt securities	–	–	–	40.3	810.5	850.8
Loans and advances to customers	1.0	218.8	112.8	1,057.9	33,670.7	35,061.2
Derivatives financial instruments	–	3.2	55.1	503.2	30.3	591.8
Investments	–	–	–	–	21,105.4	21,105.4
Total financial assets	5,245.9	222.0	167.9	1,601.4	55,616.9	62,854.1
Financial liabilities						
Shares	16,815.3	1,694.6	6,904.5	3,522.1	1.5	28,938.0
Amounts owed to credit institutions	199.1	1,532.3	977.6	1,742.6	–	4,451.6
Other deposits	329.1	88.7	2.4	–	–	420.2
Debt securities in issue	–	–	880.1	3,206.5	846.7	4,933.3
Derivative financial liabilities	–	8.5	21.9	93.7	32.8	156.9
Subordinated liabilities	–	–	5.0	–	588.7	593.7
Subscribed capital	–	–	–	–	6.4	6.4
Total financial liabilities	17,343.5	3,324.1	8,791.5	8,564.9	1,476.1	39,500.1

Notes to the Accounts continued

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 Statements 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 252 days and incorporates underlying risk factors based on historical 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 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:

1. Historical data is not necessarily a good guide to future events.
2. The model, by definition, does not capture potential losses outside the 99% confidence level, i.e. those events that are extreme in nature.
3. 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 Treasury positions.

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 Rate, SONIA and LIBOR. The effect of LIBOR and SONIA mismatches within the Balance Sheet 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%). A one basis sensitivity measure is an industry standard approach to quantify the quantum and direction of the interest rate exposure within the Group.

Basis Point value (BP) sensitivity

These measures calculate the change in value of the assets and liabilities resulting from both a one basis point (PV01) and 250 basis points (PV250) parallel upward shift in interest rates. This is calculated and reported on a daily basis separately for each currency and at the full Balance Sheet level on a monthly basis. The previously used PV200 measure has been removed and replaced with PV250 to align with the latest BCBS standards.

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 the Group.

	Year end	Average	Maximum	Minimum
	£000	**£000**	**£000**	**£000**
2018				
LIBOR basis	**54**	**33**	**54**	**1**
SONIA basis	**1,484**	**1,413**	**1,527**	**1,258**
PV01 sensitivity	**140**	**(85)**	**140**	**(263)**
PV250 sensitivity	**33,150**	**(20,087)**	**33,150**	**(61,879)**
Treasury VaR	**2,980**	**4,633**	**8,559**	**1,499**

	Greater than one year	Greater than five years	Greater than 10 years
	£m	**£m**	**£m**
Repricing gap	**407**	**(108)**	**(2)**

	Year end	Average	Maximum	Minimum
	£000	**£000**	**£000**	**£000**
2017				
LIBOR basis	7	57	89	7
SONIA basis	1,286	1,378	1,446	1,286
PV01 sensitivity	(170)	(169)	(4)	(339)
PV250 sensitivity	(40,369)	(39,521)	(106)	(79,861)
Treasury VaR	5,112	10,159	19,645	4,493

	Greater than one year	Greater than five years	Greater than 10 years
	£m	**£m**	**£m**
Repricing gap	1,440	(23)	4

Detail of how the Group manages its interest rate risk is included in the Risk Management Report on pages 60 to 68.

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. In particular the Group's non-Sterling investments and debt securities issued are hedged via derivatives. The maximum exposures throughout the year represented less than 0.01% of total assets.

Actual exposures were:

	2018	2017
	£m	£m
Year end	**1.6**	0.6
Maximum	**1.6**	1.4

Notes to the Accounts continued

38. Wholesale Credit Risk

The Group's wholesale credit risk arises principally from assets held for liquidity purposes. The risk is that counterparties fail to repay those investments when they fall due. The Group, through the Treasury 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 limits designed to prevent over-exposure to a given country.

The Group uses an internal credit ratings process to identify potential risks and wholesale related credit risks are reported and discussed monthly at the Executive Risk Committee.

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. A diversified range of counterparties is in place to meet business and regulatory requirements in order to meet the Board approved strategies with no credit risk exposures being undertaken by Treasury to counterparties that have not been through an internal approvals process including a formal second LoD function.

The following tables break down Wholesale Group exposures[1] by type using average external ratings.

	Aaa-Aa3	A1-A3	Baa1-Baa3	Ba1-B3	Caa1-C3	Unrated	Total
	£m	£m	£m	£m	£m	£m	£m
2018							
Central Bank and Sovereigns	**6,412.4**	**–**	**–**	**–**	**–**	**–**	**6,412.4**
Financial Institutions	**629.2**	**558.4**	**6.8**	**–**	**–**	**–**	**1,194.4**
Multilateral & Government Development Banks	**414.2**	**–**	**–**	**–**	**–**	**–**	**414.2**
Structured	**0.4**	**–**	**–**	**–**	**3.1**	**–**	**3.5**
Other	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Total	**7,456.2**	**558.4**	**6.8**	**–**	**3.1**	**–**	**8,024.5**

	Aaa-Aa3	A1-A3	Baa1-Baa3	Ba1-B3	Caa1-C3	Unrated	Total
	£m	£m	£m	£m	£m	£m	£m
2017							
Central Bank and Sovereigns	8,226.2	–	–	–	–	–	8,226.2
Financial Institutions	322.0	516.9	13.6	–	–	–	852.5
Multilateral & Government Development Banks	119.2	–	–	–	–	–	119.2
Structured	–	–	3.8	–	–	–	3.8
Other	–	–	–	–	–	3.4	3.4
Total	**8,667.4**	**516.9**	**17.4**	**–**	**–**	**3.4**	**9,205.1**

[1] Exposures are measured and reported equivalent to those under CRR 575/2013: Part Four.

38. Wholesale Credit Risk continued...

The Group has a low risk appetite to exposures[1] outside the UK. This is reflected in the country exposures[1] by type shown in the tables below.

2018	Central Banks and Sovereigns £m	Financial Institutions £m	Multilateral & Government Development Banks £m	Structured £m	Other £m	Total £m
United Kingdom	**6,412.4**	**995.6**	–	–	–	**7,408.0**
France	–	**123.1**	–	–	–	**123.1**
United States	–	**45.2**	–	–	–	**45.2**
Germany	–	–	**219.4**	–	–	**219.4**
International	–	–	**194.8**	–	–	**194.8**
Switzerland	–	**2.0**	–	–	–	**2.0**
Canada	–	**20.0**	–	–	–	**20.0**
Australia	–	**0.1**	–	–	–	**0.1**
Netherlands	–	–	–	**0.4**	–	**0.4**
Denmark	–	–	–	–	–	–
Spain	–	–	–	–	–	–
Belgium	–	**8.4**	–	–	–	**8.4**
Cayman Islands	–	–	–	**3.1**	–	**3.1**
Total	**6,412.4**	**1,194.4**	**414.2**	**3.5**	–	**8,024.5**

2017	Central Banks and Sovereigns £m	Financial Institutions £m	Multilateral & Government Development Banks £m	Structured £m	Other £m	Total £m
United Kingdom	8,226.2	595.0	–	–	3.4	8,824.6
France	–	124.0	–	–	–	124.0
United States	–	107.6	–	–	–	107.6
Germany	–	0.2	80.3	–	–	80.5
International	–	–	38.9	–	–	38.9
Switzerland	–	10.2	–	–	–	10.2
Canada	–	7.6	–	–	–	7.6
Australia	–	6.5	–	–	–	6.5
Netherlands	–	–	–	3.8	–	3.8
Denmark	–	1.0	–	–	–	1.0
Spain	–	0.2	–	–	–	0.2
Belgium	–	0.2	–	–	–	0.2
Cayman Islands	–	–	–	–	–	–
Total	**8,226.2**	**852.5**	**119.2**	**3.8**	**3.4**	**9,205.1**

[1] Country risk exposures for structured and RMBS are based on the country of origination for the asset.

Notes to the Accounts continued

38. Wholesale Credit Risk continued...

The Group's Sovereign exposure is to the UK which had an average external rating of 'AA'. At the 2018 year end, the UK Sovereign exposure was £5,592.4m (2017: £7,502.0m) to the Bank of England and £820.0m (2017: £724.2m) in UK Government bonds.

The largest exposure to a single institution (other than the UK Government) was £299m (2017: £307m) in both instances to a UK clearing bank.

None of the wholesale exposures are 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 105 to 106.

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.

Wholesale credit risk is recorded in the following Balance Sheet captions:

	2018	2017
	£m	£m
Cash in hand and balances with the Bank of England	**3,539.8**	4,893.9
Loans and advances to credit institutions	**294.6**	351.0
Debt securities	**1,670.3**	850.8
Derivative financial instruments	**564.4**	591.8
Total wholesale credit risk	**6,069.1**	6,687.5

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

UK Government securities	**820.0**	724.2
Financial institutions	**846.8**	119.2
Structured	**3.5**	3.8
Other	**–**	3.6
	1,670.3	850.8

39. Credit risk on loans and advances to customers

Where applicable the 2018 balances are under IFRS 9, and the 2017 balances under IAS 39. The transition tables within Note 1 provide further details of the full impact.

The Group's exposure to credit risk on loans and advances to customers can be broken down as follows:

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Retail mortgages	**35,650.0**	34,171.0	**14,401.4**	15,467.1
Commercial lending	**1,183.0**	1,053.4	**1,180.9**	1,050.9
Unsecured lending	**1.1**	2.0	**1.1**	2.0
Total gross exposure (contractual amounts)	**36,834.1**	35,226.4	**15,583.4**	16,520.0
Impairment, fair value, EIR and hedging adjustments	**(131.7)**	(165.2)	**(168.8)**	(182.7)
Total net exposure	**36,702.4**	35,061.2	**15,414.6**	16,337.3

Lending by type	**2018**	2017
	%	%
Residential Prime	**85.2**	84.5
Residential Sub-Prime/Self-Cert	**1.4**	1.8
Retail Buy-To-Let	**10.2**	10.7
Social Housing	**0.7**	0.7
Commercial lending (exc. Social Housing)	**2.5**	2.3
	100.0	100.0

Credit risk management

The Retail and Commercial Credit Risk section of the Risk Management Report describes how the Group manages credit risk via a robust risk appetite, credit risk framework, governance framework and through stress testing.

The Group's exposure to mortgage related credit risk is monitored closely by the Customer and Commercial Risk team. Reporting on risk exposures is provided regularly to the Group's risk committees and includes analysis of mortgages in arrears as well as monitoring of the characteristics of the loan portfolios (e.g. geographic location and loan-to-value).

Arrears Status	2018		2017	
	Retail	**Commercial**	Retail	Commercial
	%	**%**	%	%
No arrears	**97.7**	**98.8**	97.4	99.2
Less than three months	**2.0**	**1.1**	2.1	0.5
Equal to or more than three months, less than six months	**0.2**	**–**	0.3	0.2
Equal to or more than six months, less than twelve months	**0.1**	**–**	0.1	–
Twelve months or more	**–**	**–**	0.1	–
In possession/collections	**–**	**0.1**	–	0.1
Total gross exposure (contractual amounts)	**100.0**	**100.0**	100.0	100.0
Number of properties in possession at the year end	**85**	**5**	73	4

Notes to the Accounts continued

39. Credit risk on loans and advances to customers continued...

The percentage of retail mortgages with arrears of three months or more (as a % of outstanding balances, including possessions) has fallen during 2018 from 0.46% to 0.38%. The UK Finance industry average ratio for mortgage arrears is measured using the number of accounts (including possessions). On this basis, the Group's retail mortgage arrears ratio of 0.50% (2017: 0.58%) is below the comparable UK Finance ratio 0.80% (2017: 0.84%). Arrears on more recent lending are minimal, reflecting the Group's credit risk appetite. The arrears are also lower for the buy-to-let portfolio within retail with an arrears ratio of 0.12% (2017: 0.08%).

Society Retail Arrears Status	Society	
	2018	2017
	%	%
No arrears	**97.3**	97.1
Less than three months	**2.3**	2.4
Equal to or more than three months, less than six months	**0.3**	0.3
Equal to or more than six months, less than twelve months	**0.1**	0.1
Twelve months or more	**–**	0.1
Property in possession	**–**	–
	100.0	100.0
Number of properties in possession at the year end	**54**	45

Retail Mortgage lending

The Group's retail mortgage exposure can be broken down by customer type and geographical region as follows:

Retail Mortgage Customer Type	Book		New Lending	
	2018	2017	**2018**	2017
	%	%	**%**	%
First time buyer	**18.4**	18.9	**16.8**	19.2
Other buyers e.g. movers	**37.9**	38.7	**33.1**	40.0
Remortgage	**33.1**	31.3	**41.5**	30.4
Buy-to-let	**10.6**	11.0	**8.6**	10.3
Other	**–**	0.1	**–**	0.1
	100.0	100.0	**100.0**	100.0

Note: The customer type distribution for new lending is based on year end balances.

39. Credit risk on loans and advances to customers continued...

Retail Mortgage Geographical Distribution	Book	
	2018	2017
	%	%
Group		
Scotland	**6.6**	6.6
North East	**3.0**	3.1
Yorkshire & Humberside	**8.9**	9.0
North West	**9.8**	9.6
Midlands	**12.4**	12.1
East	**11.0**	10.9
South West	**7.1**	6.9
Greater London	**19.9**	20.6
South East	**17.6**	17.4
Wales & Northern Ireland	**3.6**	3.7
Non-UK	**0.1**	0.1
	100.0	100.0

The Group's retail mortgages are secured on property. The value of these properties is updated on a quarterly basis using the ONS regional property price indices which comprise relative house price movements across the UK. These indexed valuations provide senior management with a view of the value and risk of the properties on which retail mortgages are secured.

Loan-to-value distribution of retail mortgages (including split for new lending)	Book		New Lending	
	2018	2017	**2018**	2017
	%	%	**%**	%
100% or greater	**0.1**	0.2	**–**	–
95 to 100%	**0.2**	0.3	**–**	–
90 to 95%	**1.8**	1.4	**5.9**	5.4
85 to 90%	**4.8**	3.9	**15.9**	15.9
80 to 85%	**7.6**	6.6	**16.8**	17.8
75 to 80%	**8.1**	6.8	**10.6**	13.0
70 to 75%	**8.9**	7.9	**13.7**	13.6
60 to 70%	**18.1**	18.7	**15.5**	16.3
Less than 60%	**50.4**	54.2	**21.6**	18.0
	100.0	100.0	**100.0**	100.0
Average LTV (all retail)	**48.4**	48.2	**69.9**	71.6
Average LTV (buy-to-let)	**57.0**	57.2	**63.9**	62.4

Note: For new lending, the origination loan to value is used, and the distribution is based on year end balances.

Notes to the Accounts continued

39. Credit risk on loans and advances to customers continued...

Loan-to-value distribution of retail mortgages (including split for whether impaired)	2018		2017	
	Not impaired	Impaired	Not impaired	Impaired
	%	%	%	%
100% or greater	**0.1**	**0.0**	0.2	–
95 to 100%	**0.2**	**0.0**	0.2	–
90 to 95%	**1.7**	**0.1**	1.4	–
85 to 90%	**4.7**	**0.1**	3.9	–
80 to 85%	**7.5**	**0.1**	6.5	–
75 to 80%	**7.9**	**0.2**	6.8	0.1
70 to 75%	**8.7**	**0.2**	7.9	0.1
60 to 70%	**17.6**	**0.5**	18.6	0.1
Less than 60%	**49.0**	**1.4**	54.0	0.2
	97.4	**2.6**	99.5	0.5

The increase in impaired balances during 2018 is due to a change to the definition of default under IFRS 9. The new definition of default includes accounts that are 90 days past due, interest only accounts past term end, certain forbearance measures and other unlikely to pay indicators. IFRS 9 requires that, for accounts considered to be credit impaired at the time of business combinations that these loans will continue to be classed as impaired until derecognition. These balances represent 1.7% of the 2.6%.

Commercial lending

The Group originates commercial lending via its N&P brand, providing loans to commercial owner occupiers and corporate entity landlords of commercial and residential property. The majority of loans are advanced against commercial properties using a vacant possession valuation to mitigate future losses. Loans against specialist properties are strictly limited and no lending is given against land only.

The valuations of commercial properties are updated on a quarterly basis using the company MSCI's commercial property price indices based on region and property type. Residential valuations are indexed using the regional ONS house price indices. The indexed valuations are 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.

	2018	2017
Average Loan to Value (%)	**48.6**	52.4
Average loan size (£m)	**0.3**	0.3
Value of Security held (£m)	**2,067**	1,721
Balance of loans >100% LTV (£m)	**3.9**	8.0
Largest exposure to a single counterparty (£m)	**11.8**	12.1

39. Credit risk on loans and advances to customers continued...

Only 0.16% of N&P commercial accounts were more than three months in arrears (as a % of outstanding balances, including repossessions) as at the year end (2017 0.26%). While arrears and losses to date have been low, as part of the merger, all acquired N&P commercial loans are subject to a fair value adjustment to reflect likely future losses on the portfolio.

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 or reporting trading losses. Loans on the watch list total £5.1m (2017: £7.3m). Our appetite and approach to the provision of commercial lending is to provide amortising term loans, typically over 10 – 25 years. Where a period of interest only is agreed, it is most often for a short period following which the loan will be structured to amortise over the remaining term. Corporate buy-to-let loans are mainly interest only £349m, (2017: £312m). These loans are continuously monitored to ensure that full repayment is made on the expiry of the loan term.

N&P commercial mortgage balances by geographical region	Book	
	2018	2017
	%	%
Scotland	**–**	–
North East	**0.9**	0.9
Yorkshire & Humberside	**4.1**	3.9
North West	**4.9**	5.4
Midlands	**7.5**	7.5
East	**4.7**	5.0
South West	**5.3**	5.6
Greater London	**45.1**	43.4
South East	**26.1**	26.9
Wales & Northern Ireland	**1.4**	1.4
	100.0	100.0

N&P commercial mortgage balances by lending type	2018	2017
	%	%
Commercial owner occupied	**17.1**	20.1
Commercial investment property	**43.9**	40.4
Corporate Buy-To-Let	**38.1**	37.5
Social Housing	**0.9**	2.0
	100.0	100.0

Notes to the Accounts continued

39. Credit risk on loans and advances to customers continued...

In addition to the N&P commercial lending book, the Group has 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 reviewed risk appetite, and do so when returns and capital efficiency contribute to financial sustainability. At 31 December 2018 the loan book was £265.1m (2017: £328.4m). The Group has written further undrawn term loan facilities in the region of £169.0m (2017: £55.0m) and these are expected to draw down over the next three years.

Impairment

The following table shows as at the year end, all expected credit exposures on loans, both impairment and fair value credit adjustments, 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. The 1 January balances are post transition to IFRS 9 as outlined in Note 1.

Group balances as at	Gross exposures		Collateral Held	
	31 Dec 18	01 Jan 18	31 Dec 18	01 Jan 18
	£m	£m	£m	£m
Stage 1	**31,937.4**	**28,081.8**	**31,935.3**	**28,075.6**
Stage 2	**3,933.4**	**6,065.3**	**3,931.2**	**6,062.7**
Less than 30 days past due	3,792.8	5,918.8	3,790.7	5,916.3
More than 30 days past due	140.6	146.5	140.5	146.4
Stage 3	**346.2**	**395.4**	**345.1**	**393.4**
Less than 90 days past due	229.3	259.1	228.9	258.5
More than 90 days past due	116.9	136.3	116.2	134.9
POCI	**617.1**	**683.9**	**614.6**	**680.6**
Less than 90 days past due	596.5	657.2	595.5	656.4
More than 90 days past due	20.6	26.7	19.1	24.2
Total	**36,834.1**	**35,226.4**	**36,826.2**	**35,212.3**

Group balances as at	Impairment Provision		Credit Fair Value Adjustment	
	31 Dec 18	01 Jan 18	31 Dec 18	01 Jan 18
	£m	£m	£m	£m
Stage 1	**1.7**	**1.1**	**0.1**	**0.3**
Stage 2	**21.7**	**20.0**	**4.9**	**6.6**
Less than 30 days past due	19.8	18.6	4.5	6.2
More than 30 days past due	1.9	1.4	0.4	0.4
Stage 3	**6.7**	**8.2**	**2.8**	**2.9**
Less than 90 days past due	1.7	1.3	0.9	0.5
More than 90 days past due	5.0	6.9	1.9	2.4
POCI	**(1.2)**	**–**	**31.3**	**34.8**
Less than 90 days past due	(1.2)	–	27.7	29.6
More than 90 days past due	0.0	–	3.6	5.2
Total	**28.9**	**29.3**	**39.1**	**44.6**

39. Credit risk on loans and advances to customers continued...

Society balances as at	Gross exposures		Collateral Held	
	31 Dec 18	01 Jan 18	31 Dec 18	01 Jan 18
	£m	£m	£m	£m
Stage 1	**12,195.1**	**12,166.7**	**12,194.4**	**12,163.6**
Stage 2	**2,620.4**	**3,501.3**	**2,619.6**	**3,500.1**
Less than 30 days past due	2,543.9	3,422.0	2,543.1	3,420.9
More than 30 days past due	76.5	79.3	76.5	79.2
Stage 3	**151.5**	**168.8**	**151.3**	**168.5**
Less than 90 days past due	105.8	119.3	105.7	119.2
More than 90 days past due	45.7	49.5	45.6	49.3
POCI	**616.4**	**683.2**	**614.0**	**679.8**
Less than 90 days past due	595.8	656.5	594.9	655.6
More than 90 days past due	20.6	26.7	19.1	24.2
Total	**15,583.4**	**16,520.0**	**15,579.3**	**16,512.0**

Society balances as at	Impairment Provision		Credit Fair Value Adjustment	
	31 Dec 18	01 Jan 18	31 Dec 18	01 Jan 18
	£m	£m	£m	£m
Stage 1	**0.8**	**0.4**	**0.1**	**0.3**
Stage 2	**14.6**	**9.9**	**4.9**	**6.6**
Less than 30 days past due	13.4	9.4	4.5	6.2
More than 30 days past due	1.2	0.5	0.4	0.4
Stage 3	**0.6**	**0.3**	**2.8**	**2.9**
Less than 90 days past due	0.2	0.2	0.9	0.5
More than 90 days past due	0.4	0.1	1.9	2.4
POCI	**(1.2)**	**0.0**	**31.3**	**34.8**
Less than 90 days past due	(1.2)	0.0	27.7	29.6
More than 90 days past due	0.0	0.0	3.6	5.2
Total	**14.8**	**10.6**	**39.1**	**44.6**

The tables showing the days past due split of the stage 1, 2 & 3 balances present fair value credit adjustments separate from gross exposures. This method of presentation has been selected in order to show the total amount of coverage for expected credit losses available to absorb write-offs from either the impairment provision or fair value adjustment.

All accounts in stage 1 are less than 30 days past due. Stage 2 balances have reduced significantly over the course of 2018, this reduction arises from recalibrating the staging approach following model changes to reflect the latest IRB approach to behaviour score. This recalibration ensured that accounts were only classified in Stage 2 where there had been a change in the underlying credit quality of the loan rather than a change in PD caused solely by the model change.

Assets acquired on the merger with N&P and CBS were recognised at fair value, this included accounts considered to be purchased or originated credit impaired (POCI) at the point of acquisition. The discount was recognised as a day 1 fair value credit adjustment. On subsequent remeasurement, the recoverable value of POCI assets can rise or fall with changes in expected credit losses. If there is a reduction in expected credit losses, instead of adjusting the fair value discount the IFRS 9 accounting standard requires a negative impairment provision to be recorded.

Notes to the Accounts continued

39. Credit risk on loans and advances to customers continued...

Impairment – Risk Assessment

The group uses internal models to assess levels of credit risk, segmenting loans into low, medium and high risk or currently impaired. The risk models cover the majority of loans underwritten by the group, with exceptions for the Accord BTL, and Commercial. The Accord BTL population currently has very strict underwriting criteria and limited behavioural history, with only a single possession to date. Commercial lending has highly different behavioural characteristics to the retail mortgages, the appropriate approach to model the risk grade is currently under consideration. The carrying values below do not agree to Note 16 as they exclude EIR, Hedging and other day 1 fair value adjustments.

Lending by Risk Grade – Group

	Stage 1	Stage 2	Stage 3	POCI	2018 Total		2017 Total	
	£m	£m	£m	£m	£m	%	£m	%
Group								
Low risk	26,748.9	2,361.5	–	–	29,110.4	79.1	27,237.1	77.3
Medium risk	1,296.2	1,350.2	–	–	2,646.4	7.2	3,033.4	8.6
High risk	0.8	190.7	–	–	191.5	0.5	142.4	0.4
Impaired	–	–	344.2	591.0	935.2	2.5	1,118.6	3.2
Accord BTL and Commercial	3,891.5	31.0	2.0	26.1	3,950.6	10.7	3,694.9	10.5
Total gross carrying amount	31,937.4	3,933.4	346.2	617.1	36,834.1	100.0	35,226.4	100.0
Impairment provision	(1.7)	(21.7)	(6.7)	1.2	(28.9)		(32.5)	
Fair value credit adjustment	(0.1)	(4.9)	(2.8)	(31.3)	(39.1)		(45.8)	
Carrying amount	31,935.6	3,906.8	336.7	587.0	36,766.1		35,148.1	

Lending by Risk Grade – Society

	Stage 1	Stage 2	Stage 3	POCI	2018 Total		2017 Total	
	£m	£m	£m	£m	£m	%	£m	%
Society								
Low risk	10,388.0	1,522.1	–	–	11,910.1	76.4	12,582.1	76.2
Medium risk	661.6	961.5	–	–	1,623.1	10.4	1,923.8	11.6
High risk	0.4	127.3	–	–	127.7	0.8	74.2	0.4
Impaired	–	–	150.4	591.0	741.4	4.8	890.2	5.4
Commercial	1,145.1	9.5	1.1	25.4	1,181.1	7.6	1,049.7	6.4
Total gross carrying amount	12,195.1	2,620.4	151.5	616.4	15,583.4	100.0	16,520.0	100.0
Impairment provision	(0.8)	(14.6)	(0.6)	1.2	(14.8)		(3.2)	
Fair value credit adjustment	(0.1)	(4.9)	(2.8)	(31.3)	(39.1)		(45.8)	
Carrying amount	12,194.2	2,600.9	148.1	586.3	15,529.5		16,471.0	

39. Credit risk on loans and advances to customers continued...

The average PD by risk grade is as follows:

	Group		Society	
	12m	Lifetime	12m	Lifetime
	%	%	%	%
Low risk	0.1	4.5	0.1	3.5
Medium risk	1.8	19.8	1.7	18.2
High risk	20.0	55.1	19.1	52.7

The table below shows balances and expected credit losses, captured within both impairment provisions and fair value credit adjustments, by origination year for retail loans. The table shows that the credit quality of newly written business is of significantly higher quality than that written before 2009 or acquired as part of business combinations.

	Stage 1	Stage 2	Stage 3	POCI	2018 Balance	2018 ECL
	%	%	%	%	£m	£m
Origination year						
2018	99.9	0.1	–	–	8,533.3	0.3
2017	99.0	0.9	0.1	–	7,258.4	0.9
2016	93.6	6.2	0.2	–	4,197.0	0.6
2013 – 2015	90.7	9.0	0.3	–	8,075.3	0.4
2009 – 2012	82.4	17.0	0.6	–	2,245.6	0.4
Pre-2009	52.0	41.7	6.3	–	3,176.3	14.8
Acquired loans	44.0	34.8	2.8	18.4	3,348.2	50.6
	86.7	**10.7**	**0.9**	**1.7**	**36,834.1**	**68.0**

Impairment – Economic Scenarios

As outlined in Notes 1 & 2, the economic scenarios are a key input into the calculation of expected credit losses under IFRS 9. The Group has applied four economic scenarios derived using external data and statistical methodologies, together with management judgement, to determine scenarios that span a wide range of plausible economic conditions. The core scenario represents the most likely economic forecast and is aligned with the central scenario used in the Group's financial planning processes. The potential threat to the Group from the UK's expected withdrawal from the EU is from the general impact from adverse movements to inflation, economic growth, interest rates and house prices. As such, the economic scenarios used in the IFRS 9 calculations were developed to fully address this risk, with no model overlay considered necessary.

The following table shows the average values of the key economic variables used by economic scenario for the period until December 2023. The table includes the four key parameters used to predict PD – Unemployment, HPI, Bank Rate and CPI. GDP is also presented as it is the key input for determining the economic parameters used and provides context to the nature of the overall scenario. The values in the table are calculated as either a simple average of the rate across the five year forecasting window (Unemployment, Bank Rate and CPI) or as the compound annual growth rate from start to finish (HPI and GDP). For the downturn and stress scenarios, the HPI assumption incorporates a peak to trough reduction of 22.0% and 38.5% respectively.

Notes to the Accounts continued

39. Credit risk on loans and advances to customers continued...

	Upside scenario %	Core scenario %	Downturn scenario %	Stress scenario %	Weighted average %
GDP	2.4	1.7	0.9	(0.2)	1.4
Unemployment	3.1	4.4	6.5	7.8	5.2
HPI	6.2	1.9	(4.4)	(9.2)	(0.5)
Bank Rate	3.6	1.2	0.1	3.4	1.7
CPI	2.8	1.5	(0.5)	2.6	1.4

The following table shows the expected credit loss by economic scenario. The impact of applying multiple economic scenarios give rise to a probability weighted provision of £68.0m, a 57.4% increase in provision over the £43.2m calculated using the core scenario. The total expected credit losses of £68.0m is split between impairment provisions £28.9m and fair value credit adjustments £39.1m.

	December 2018	
	Weighting	Gross ECL
	%	£m
Group ECLs by Scenario		
Upside scenario	20.0	41.3
Core scenario	40.0	43.2
Downturn scenario	25.0	84.3
Stress scenario	15.0	148.3
Probability weighted scenario		68.0

Impairment – Movement Analysis

The following tables analyse the movements in IFRS 9 gross balances and impairment provision during the year by stage. The changes to carrying value include both contractual and early repayments.

	Stage 1	Stage 2	Stage 3	POCI	Total
	£m	£m	£m	£m	£m
Group					
Gross balance at 1 January 2018	**28,080.5**	**6,065.6**	**396.4**	**683.9**	**35,226.4**
Transfers:					
Transfers to stage 1	2,995.3	(2,976.4)	(18.9)	–	–
Transfers to stage 2	(1,755.0)	1,808.8	(53.8)	–	–
Transfers to stage 3	(31.9)	(59.0)	90.9	–	–
Changes to carrying value	(1,068.3)	(151.5)	(8.6)	(11.8)	(1,240.2)
New financial assets originated or purchased	8,493.4	–	–	–	8,493.4
Financial assets derecognised during the period	(4,776.6)	(754.1)	(46.4)	(52.3)	(5,629.4)
Write-offs	–	–	(13.4)	(2.7)	(16.1)
Gross balance at 31 December 2018	**31,937.4**	**3,933.4**	**346.2**	**617.1**	**36,834.1**

39. Credit risk on loans and advances to customers continued...

	Stage 1	Stage 2	Stage 3	POCI	Total
	£m	£m	£m	£m	£m
Society					
Gross balance at 1 January 2018	**12,166.7**	**3,501.3**	**168.8**	**683.2**	**16,520.0**
Transfers:					
Transfers to stage 1	1,352.7	(1,347.9)	(4.8)	–	–
Transfers to stage 2	(985.4)	1,015.7	(30.3)	–	–
Transfers to stage 3	(14.9)	(33.6)	48.5	–	–
Changes to carrying value	(562.7)	(125.0)	(5.2)	(11.8)	(704.7)
New financial assets originated or purchased	2,065.9	–	–	–	2,065.9
Financial assets derecognised during the period	(1,827.2)	(390.1)	(20.5)	(52.3)	(2,290.1)
Write-offs	–	–	(5.0)	(2.7)	(7.7)
Gross balance at 31 December 2018	**12,195.1**	**2,620.4**	**151.5**	**616.4**	**15,583.4**

	Stage 1	Stage 2	Stage 3	POCI	Total
	£m	£m	£m	£m	£m
Group					
Impairment provision at 1 January 2018	**1.1**	**20.0**	**8.2**	**–**	**29.3**
Transfers:					
Transfers to stage 1	–	(1.6)	(0.1)	–	(1.7)
Transfers to stage 2	(0.3)	0.7	(0.7)	–	(0.3)
Transfers to stage 3	(0.1)	(0.4)	0.9	–	0.4
Changes in PDs/LGDs/EADs	0.6	(4.3)	(1.5)	(2.6)	(7.1)
New financial assets originated or purchased	0.3	–	–	–	0.3
Changes to model assumptions and methodologies	0.2	7.6	1.8	0.2	12.6
Unwind of discount	–	1.1	0.4	1.2	2.7
Financial assets derecognised during the period	(0.1)	(1.4)	(0.5)	–	(2.0)
Write-offs	–	–	(1.8)	–	(1.8)
Impairment provision at 31 December 2018	**1.7**	**21.7**	**6.7**	**(1.2)**	**28.9**

Notes to the Accounts continued

39. Credit risk on loans and advances to customers continued...

	Stage 1	Stage 2	Stage 3	POCI	Total
	£m	£m	£m	£m	£m
Society					
Impairment provision at 1 January 2018	**0.4**	**9.9**	**0.3**	–	**10.6**
Transfers:					
Transfers to stage 1	–	–	–	–	–
Transfers to stage 2	(0.2)	1.1	(0.7)	–	0.2
Transfers to stage 3	–	(0.2)	0.9	–	0.7
Changes in PDs/LGDs/EADs	0.4	(4.2)	(0.6)	(2.6)	(7.0)
New financial assets originated or purchased	0.1	–	–	–	0.1
Changes to model assumptions and methodologies	0.1	8.0	0.7	0.2	9.0
Unwind of discount	–	0.8	0.1	1.2	2.1
Financial assets derecognised during the period	–	(0.8)	(0.1)	–	(0.9)
Write-offs	–	–	–	–	–
Impairment provision at 31 December 2018	**0.9**	**14.6**	**0.6**	**(1.2)**	**14.8**

Changes to methodologies and assumptions includes a revised approach for modelling probability of write-off given default and amendments to economic scenarios and weightings.

Forbearance

The Group uses forbearance tools where they are deemed appropriate for an individual customer's circumstances, in line with industry guidance. Forbearance tools, which the Group may offer, include capitalisation, interest only concessions, arrears arrangements and term extensions. The use of account management tools are either fully recognised within provisioning or are low in materiality.

The analysis below shows mortgage balances which have been subject to some form of forbearance during the past two years and is based on the European Banking Authority's guidance on forbearance. The IFRS 9 staging policy moves forborne accounts into stage 3 where the customer is in arrears and forbearance is granted. The stage 3 cure period is twelve months after exit from forbearance and settlement of all arrears, at which point the account can transfer to Stage 2 or Stage 1 dependent on the current behaviour score. On this basis, there is a population of stage 1 accounts shown as forborne. Term extensions are not considered hard indicators of increased credit risk and as such not always considered in default, but are included in the forbearance table below. The Group's impairment provision and fair value adjustments total £17.9m for these loans. Of this balance, £852.5m relates to loans originated before 2009. £60.3m of buy to let loans have been subject to some form of forbearance in the last two years, of these all were originated before 2009.

	Stage 1	Stage 2	Stage 3	POCI	2018 Total	2017 Total
	£m	£m	£m	£m	£m	£m
Group at 31 December 2018						
Arrears arrangements	**167.0**	**242.0**	**228.2**	**98.8**	**736.0**	750.1
Other Concessions	**0.9**	**0.6**	**2.7**	**0.2**	**4.4**	2.8
Term extension	**319.6**	**185.0**	**4.1**	**35.9**	**544.6**	543.0
Interest Only	**4.0**	**3.1**	**–**	**0.9**	**8.0**	8.5
Total gross carrying amount	**491.5**	**430.7**	**235.0**	**135.8**	**1,293.0**	1,304.4

All requests for forbearance on commercial loans are subject to full credit risk appraisal and are predominantly 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 2018 there are no accounts in the N&P commercial loans portfolio subject to forbearance.

40. Fair values

Fair value is the price that would be received to sell an asset or the price paid to transfer a liability in an orderly transaction between market participants at the measurement 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. The Group measures fair value using the following fair value hierarchy:

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).

The table below summarises the carrying value and fair value of financial assets and liabilities measured at amortised cost as at the Balance Sheet date.

	Carrying Value	Fair Values			Total Fair Value
		Level 1	Level 2	Level 3	
	£m	£m	£m	£m	£m
Group **At 31 December 2018**					
Assets					
Cash and balances with the Bank of England	**3,539.8**	**–**	**3,539.8**	**–**	**3,539.8**
Loans and advances to credit institutions	**294.6**	**–**	**294.6**	**–**	**294.6**
Loans and advances to customers	**36,702.4**	**–**	**–**	**37,026.2**	**37,026.2**
Liabilities					
Shares	**29,558.6**	**–**	**29,555.9**	**–**	**29,555.9**
Amounts due to credit institutions	**4,485.1**	**–**	**4,485.1**	**–**	**4,485.1**
Other deposits	**508.6**	**–**	**508.6**	**–**	**508.6**
Debt securities in issue	**5,145.9**	**4,388.0**	**745.3**	**–**	**5,133.3**
Subordinated liabilities	**585.1**	**513.3**	**41.4**	**–**	**554.7**
Subscribed capital	**6.1**	**–**	**6.2**	**–**	**6.2**

Notes to the Accounts continued

40. Fair values continued...

	Carrying Value	Fair Values			Total Fair Value
		Level 1	Level 2	Level 3	
	£m	£m	£m	£m	£m
Society **At 31 December 2018**					
Assets					
Cash and balances with the Bank of England	**3,539.8**	**–**	**3,539.8**	**–**	**3,539.8**
Loans and advances to credit institutions	**169.1**	**–**	**169.1**	**–**	**169.1**
Debt securities	**5,413.4**	**–**	**5,370.5**	**–**	**5,370.5**
Loans and advances to customers	**15,414.6**	**–**	**–**	**15,590.4**	**15,590.4**
Liabilities					
Shares	**29,558.6**	**–**	**29,555.9**	**–**	**29,555.9**
Amounts due to credit institutions	**4,485.1**	**–**	**4,485.1**	**–**	**4,485.1**
Other deposits	**8,863.1**	**–**	**8,863.1**	**–**	**8,863.1**
Debt securities in issue	**4,398.4**	**4,388.0**	**–**	**–**	**4,388.0**
Subordinated liabilities	**585.1**	**513.3**	**41.4**	**–**	**554.7**
Subscribed capital	**6.1**	**–**	**6.2**	**–**	**6.2**

	Carrying Value	Fair Values			Total Fair Value
		Level 1	Level 2	Level 3	
	£m	£m	£m	£m	£m
Group **At 31 December 2017**					
Assets					
Cash and balances with the Bank of England	4,893.9	–	4,893.9	–	4,893.9
Loans and advances to credit institutions	351.0	–	351.0	–	351.0
Debt Securities	5,125.4	–	5,128.9	–	5,128.9
Loans and advances to customers	35,061.2	–	–	35,559.9	35,559.9
Liabilities					
Shares	28,938.0	–	28,944.7	–	28,944.7
Amounts due to credit institutions	4,451.6	–	4,451.6	–	4,451.6
Other deposits	420.2	–	420.2	–	420.2
Debt securities in issue	4,933.3	4,299.8	745.0	–	5,044.8
Subordinated liabilities	593.7	566.8	48.1	–	614.9
Subscribed capital	6.4	–	6.3	–	6.3

40. Fair values continued...

	Carrying Value	Fair Values			Total Fair Value
		Level 1	Level 2	Level 3	
	£m	£m	£m	£m	£m
Society At 31 December 2017					
Assets					
Cash and balances with the Bank of England	4,893.9	–	4,893.9	–	4,893.9
Loans and advances to credit institutions	126.6	–	126.6	–	126.6
Debt securities	5,125.4	–	5,123.4	–	5,123.4
Loans and advances to customers	16,337.3	–	–	16,650.2	16,650.2
Liabilities					
Shares	28,938.0	–	28,944.7	–	28,944.7
Amounts due to credit institutions	4,442.9	–	4,442.9	–	4,442.9
Other deposits	8,468.2	–	8,468.2	–	8,468.2
Debt securities in issue	4,192.1	4,299.8	–	–	4,299.8
Subordinated liabilities	593.7	566.8	48.1	–	614.9
Subscribed capital	6.4	–	6.3	–	6.3

The fair values of all cash in hand, balances with the Bank of England and loans and advances to credit institutions have been measured at par as they are all due in under one year.

The fair value of loans and advances to customers uses a Level 3 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.

For SVR mortgage products, the interest rate on such products is equivalent to a current market product rate and as such the Group considers the fair value of these mortgages to be equal to their carrying value.

Fixed rate mortgages have been discounted using current market product rates. The difference between book value and fair value results from market rate volatility relative to the fixed rate at inception of the loan; in addition to assumptions applied in relation to redemption profiles, which are regularly reviewed and updated where necessary. The fair value of loans and advances to customers is considered to be derived by using Level 3 valuation techniques, as these redemption profiles are not considered to be observable by the market.

Overall the fair value is higher than the carrying value by £323.8m (2017: £498.7m), which arises primarily due to the product rates being greater than the prevailing market rates.

The fair value of shares and deposits that are available on demand approximates to the carrying value. The fair value of fixed term shares and deposits is determined from the projected future cash flows from those deposits, discounted at the current market rates. The estimated fair value of share balances, using a Level 2 method, is now lower than the carrying value by £2.7m (2017: £6.7m higher).

The fair value of debt securities in issue, subordinated liabilities and subscribed capital are calculated using a Level 2 method based on observable market prices. The fair value of subordinated liabilities is lower than carrying value by £30.4m (2017: £21.2m higher) which arises primarily due to the interest rates on the notes being significantly less than the prevailing market rates.

The table below classifies all financial instruments held at fair value on the face of the Group's Balance Sheet according to the method used to establish the fair value.

Notes to the Accounts continued

40. Fair values continued...

	Fair Values			Total Fair Value
	Level 1	Level 2	Level 3	
	£m	£m	£m	£m
Group At 31 December 2018				
Assets				
Debt securities – fair value	**139.6**	**–**	**3.5**	**143.1**
Debt securities – fair value through OCI	**1,527.2**	**–**	**–**	**1,527.2**
Derivative financial instruments	**–**	**554.2**	**10.2**	**564.4**
Investments	**–**	**–**	**6.8**	**6.8**
Liabilities				
Derivative financial instruments	**–**	**97.8**	**–**	**97.8**
Group At 31 December 2017				
Assets				
Debt securities – fair value	–	–	3.8	3.8
Debt securities – available for sale	843.4	–	3.6	847.0
Derivative financial instruments	–	560.8	31.0	591.8
Investments	–	–	6.3	6.3
Liabilities				
Derivative financial instruments	–	152.7	4.2	156.9

The Group's Level 1 portfolio of available for sale debt securities comprises liquid securities for which traded prices are readily available.

Derivative financial instruments are also included and derivative assets and liabilities within Level 2 are valued from discounted cash flow models using yield curves based on observable market data.

Level 3 instruments

Debt Securities – fair value within Level 3 relates to investments in structured assets. Valuations are obtained from third party brokers in order to determine the fair value as there is no active market for these investments. If the Group were to look to sell the investments, it is uncertain whether the proceeds received would be £3.5m. A 10% increase/(decrease) in the valuation would lead to a £0.4m gain/(loss) in the Income Statement.

Debt Securities – Available for sale within Level 3 represents a private investment where the fair value is calculated using internal assumptions on a future transaction taking place. This asset redeemed in December 2018.

Derivative financial instruments within Level 3 are interest rate swaps and equity index swaps. These are valued using the similar present valuation calculations as Level 2 derivative. The interest rate swaps are balance tracking, and the swap notional projected, based on the balance of the underlying mortgage portfolio. The equity index swaps are linked to the performance of specific stocks market indices and are valued using prices obtained from counterparties.

40. Fair values continued...

The changes in the fair value of these derivatives from movements in Level 3 parameters related to prepayment risk will largely offset across the interest rate swaps and equity index swaps as the Group is hedged across these positions. Sensitivity analysis to the individual Level 3 parameters has not been disclosed on the basis that the Group does not have a significant exposure.

The fair values of derivative financial instruments are disaggregated further in Note 34.

Investments within Level 3 relate to equity shares held in banking and credit card service operations. They are valued based on the discounted future cash flows of the deferred cash consideration the Group is due on sale of their shareholding and the underlying market value of the shares.

A discount is applied to the valuation to reflect the marketability of the shares. A change in this assumption of 10% would change the value of the investment by £0.9m.

The following table analyses movements in Level 3 portfolio.

	As at 31 December 2017	Items recognised in the income statement	Net repayments in the period	Gains and losses recognised in other comprehensive income	Transfers into/ (out of) Level 3 portfolio	As at 31 December 2018
	£m	£m	£m	£m	£m	£m
Assets						
Debt securities – fair value	3.8	3.1	(3.4)	–	–	3.5
Debt securities – fair value through OCI	3.6	–	(3.6)	–	–	–
Derivative financial instrument	31.0	0.8	(21.6)	–	–	10.2
Investments	6.3	1.5	–	–	(1.0)	6.8
Liabilities						
Derivative financial instrument	4.2	(3.7)	(0.5)	–	–	–

Movements in Level 3 items through the Income Statement are recognised in 'net gains from financial instruments at fair value'.

Transfers between fair value hierarchies

Transfers between hierarchies are due to a change in market activity levels or the significance of unobservable inputs, meaning it is no longer possible to value the financial instrument using the current method.

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 £17.8m to the pension scheme (2017: £22.2m).

Notes to the Accounts continued

41. Related parties continued...

Key management compensation

The key management personnel compensations are as follows:

	No. of key management personnel	**Compensation**	No. of key management personnel	Compensation
	2018		2017	
		£000		£000
Short-term employee benefits		**2,476**		2,476
Post-employment benefits		**213**		205
Total key management personnel compensation	**9**	**2,689**	12	2,681

Key management compensation in 2018 includes amounts paid to key management personnel who both retired and joined the Society during 2018. The number of key management personnel at 31 December 2018 totalled 9.

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	**Amounts in respect of key management personnel and their close family members**	No. of key management personnel	Amounts in respect of key management personnel and their close family members
	2018		2017	
		£000		£000
Mortgage loans				
At 1 January		**468**		678
Net movements in the year		**(22)**		(210)
At 31 December	**2**	**446**	2	468
Deposit accounts and investments				
At 1 January		**491**		748
Net movements in the year		**330**		(257)
At 31 December	**9**	**821**	9	491

Amounts relating to directors who joined or left during the year are included in net movement in the year.

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 £467,640 (2017: £678,490).

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 £7,032 (2017: £7,800), received interest totalling £2,683 (2017: £4,245), and paid no fees and commissions during the year. Interest paid includes 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:

	2018	2017
	£m	£m
Shares in subsidiaries		
At 1 January	**104.9**	105.0
Net movements	**–**	(0.1)
At 31 December	**104.9**	104.9
Loans to subsidiaries		
At 1 January	**20,993.9**	17,849.0
Net movements	**2,489.1**	3,144.9
At 31 December	**23,483.0**	20,993.9
Deposits from subsidiaries		
At 1 January	**8,332.3**	6,733.7
Net movements	**335.4**	1,598.6
At 31 December	**8,667.7**	8,332.3
Interest receivable on loans	**360.1**	374.5
Interest payable on deposits	**(82.7)**	(71.4)
Fees and expenses receivable	**55.2**	43.4
Fees and expenses payable	**(0.2)**	(0.2)

Transactions with joint venture

As reported in the 2017 Annual Report and Accounts the outstanding investment in MutualPlus Ltd at 31 December 2017 was £0.3m. MutualPlus Ltd was placed into Members' Voluntary Liquidation on 15 December 2016 and was dissolved on 22 September 2018.

Other

The Society has an investment in Arkose Funding Limited. In 2014, a loan of £4.0m to Arkose Funding Limited was fully impaired.

The Society has no further related party matters to report.

42. Fair value through comprehensive income and hedging reserve

Amounts within the fair value through comprehensive income reserve are transferred to the Income Statement upon the disposal of debt securities. During the year a gain of £0.3m (2017: £8.0m) was recognised in net realised gains.

The cash flow hedge reserve relates to fair value adjustments on derivative financial instruments designated as cash flow hedges. The Group applies cash flow hedge accounting to a portfolio of interest rate swaps which are economically hedging either floating rate assets, floating rate liabilities or highly probable forecast issuance of debt. Amounts within the cash flow hedging reserve are transferred to the income statement upon the de-designation of these hedge relationships. During the year a £2.7m loss (2017: £3.8m loss) was transferred to net gains from financial instruments held at fair value in the income statement.

Notes to the Accounts continued

43. Notes to the cash flow statements

	Group		Society	
	2018	2017	**2018**	2017
	£m	£m	**£m**	£m
Non-cash items included in profit before tax:				
Depreciation and amortisation	**19.9**	31.4	**19.8**	31.4
Profit on sale of assets	**(0.2)**	(1.9)	**(0.2)**	(1.9)
Interest on subordinated liabilities and subscribed capital	**25.7**	19.1	**25.7**	19.1
Provisions	**6.5**	30.5	**9.7**	36.3
Fair value adjustment of subordinated liabilities and subscribed capital	**(3.9)**	1.4	**(3.9)**	1.4
Gain on realisation of debt securities	**(8.0)**	(6.1)	**(8.0)**	(6.1)
(Increase) in other assets	**(37.8)**	(6.7)	**(37.5)**	(5.1)
Decrease in other liabilities	**(25.7)**	(15.9)	**(21.6)**	(20.5)
Non-cash items included in profit before tax	**(23.5)**	51.8	**(16.0)**	54.6
(Increase)/decrease in operating assets:				
Loans and advances to customers	**(1,636.3)**	(948.1)	**913.8**	1,270.7
Investments	**(0.5)**	4.0	**(2,489.3)**	(3,140.9)
Derivative financial instruments	**(16.3)**	(177.9)	**(27.1)**	(147.8)
Net increase in operating assets	**(1,653.1)**	(1,122.0)	**(1,602.6)**	(2,018.0)
Increase/(decrease) in operating liabilities:				
Shares	**620.6**	244.8	**620.6**	244.8
Amounts owed to credit institutions	**33.5**	1,330.8	**42.2**	1,331.5
Other deposits	**88.4**	(14.5)	**394.9**	1,569.4
Net increase in operating liabilities	**742.5**	1,561.1	**1,057.7**	3,145.7

The following table reconciles liabilities arising from financing activities.

	2017	Cash flows		Non-cash changes caused by:			2018
		Redemption	Issue	Foreign exchange movement	Accrued interest	Fair value adjustments and other movements	
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Group							
Debt securities in issue	**4,933.3**	(1,043.7)	1,243.5	30.2	(21.0)	3.6	**5,145.9**
Subordinated liabilities	**593.7**	(5.0)	–	–	–	(3.6)	**585.1**
Subscribed capital	**6.4**	–	–	–	–	(0.3)	**6.1**
Total liabilities from financing activities	**5,533.4**	**(1,048.7)**	**1,243.5**	**30.2**	**(21.0)**	**(0.3)**	**5,737.1**

43. Notes to the cash flow statements continued...

	2016	Cash flows		Non-cash changes caused by:			2017
		Redemption	Issue	Foreign exchange movement	Accrued interest	Fair value adjustments and other movements	
	£m	£m	£m	£m	£m	£m	£m
Group							
Debt securities in issue	4,361.4	(213.4)	726.7	111.3	2.3	(55.0)	4,933.3
Subordinated liabilities	297.0	(5.0)	300.0	–	3.0	(1.3)	593.7
Subscribed capital	6.7	–	–	–	–	(0.3)	6.4
Total liabilities from financing activities	**4,665.1**	**(218.4)**	**1,026.7**	**111.3**	**5.3**	**(56.6)**	**5,533.4**

	2017	Cash flows		Non-cash changes caused by:			2018
		Redemption	Issue	Foreign exchange movement	Accrued interest	Fair value adjustments and other movements	
	£m	£m	£m	£m	£m	£m	£m
Society							
Debt securities in issue	4,192.1	(750.0)	943.5	30.2	(21.7)	4.3	**4,398.4**
Subordinated liabilities	593.7	(5.0)	–	–	–	(3.6)	**585.1**
Subscribed capital	6.4	–	–	–	–	(0.3)	**6.1**
Total liabilities from financing activities	**4,792.2**	**(755.0)**	**943.5**	**30.2**	**(21.7)**	**(0.4)**	**4,989.6**

	2016	Cash flows		Non-cash changes caused by:			2017
		Redemption	Issue	Foreign exchange movement	Accrued interest	Fair value adjustments and other movements	
	£m	£m	£m	£m	£m	£m	£m
Society							
Debt securities in issue	3,706.8	–	426.7	111.3	2.0	(54.7)	4,192.1
Subordinated liabilities	297.0	(5.0)	300.0	–	3.0	(1.3)	593.7
Subscribed capital	6.7	–	–	–	–	(0.3)	6.4
Total liabilities from financing activities	**4,010.5**	**(5.0)**	**726.7**	**111.3**	**5.0**	**(56.3)**	**4,792.2**

Annual Business Statement

1. Statutory percentages

	2018	2017	Statutory Limit
	%	%	%
Lending limit	**3.3**	3.4	25.0
Funding limit	**25.5**	25.3	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

	2018	2017
	%	%
As a percentage of shares and borrowings:		
Gross capital	**7.86**	7.72
Free capital	**7.45**	7.37
Liquid assets	**13.87**	15.73
Profit after taxation for the financial year as a percentage of mean total assets	**0.35**	0.30
Management expenses as a percentage of mean total assets	**0.73**	0.83

The above percentages have been prepared from the Group accounts and further details on the above percentages can be found in the glossary on pages 180 to 186.

3. Information Relating to the Directors at 31 December 2018

Director Name and Date of Birth	Business Occupation	Date of Appointment	Other Directorships
J R Heaps, LLB 8 July 1953	Chairman	20 November 2014	TheCityUK Limited The Garden Bridge Trust
N A K Atkar, BSc 11 November 1965	Non-executive Director	25 April 2017	British Business Bank plc British Business Finance Ltd British Business Financial Services Ltd National Financial Services Skills Academy Nomura Bank International plc Nomura Europe Holdings plc Nomura Financial Products Europe Nomura International plc
A E Hutchinson, CBE, BSc 5 February 1967	Charity Chief Executive	4 February 2015	DFS Furniture plc Liverpool Victoria Friendly Society Ltd Your Penny Ltd
G R Ireland, BSc, FCA 17 May 1953	Non-executive Director	1 September 2015	Aspen Insurance Holdings Ltd Aspen Insurance UK Ltd Iccaria Insurance ICC Ltd
A B Lenman, MA, ACMA 25 December 1969	Chief Finance Officer and Executive Director	4 December 2017	None
M A Pain, BSc, FCA 15 June 1961	Non-executive Director	1 August 2013	Axa Insurance UK plc Axa UK plc Empiric Student Property plc Empiric Student Property Trustees Ltd London Square Developments (Holdings) Ltd London Square Ltd LSQ Management Ltd
G P C Parsons, BA 31 July 1963	Company Director	1 May 2013	EasyHotel plc EasyHotel UK Ltd
M C Regnier, MEng, MBA 30 September 1971	Chief Executive Officer and Executive Director	3 June 2014	BCS Loans and Mortgages Ltd
S C White, BComm 4 April 1971	Chief Operating Officer and Executive Director	24 February 2016	Accord Mortgages Ltd YBS Properties (Edinburgh) Ltd Yorkshire Key Services Ltd

The contractual notice period for Mr M C Regnier and Mr S C White is one year. Mr M C Regnier entered into a contract on 3 June 2014 and Mr S C White entered into a contract on 24 February 2016 on this basis. The contractual notice period for Mr A B Lenman is six months and he entered into a contract on 4 December 2017 on this basis.

Documents may be served on the above named directors at: 'Yorkshire Building Society' c/o Deloitte LLP at the following address: 1 City Square, Leeds LS1 2AL.

4. Registered Office

Yorkshire Building Society is a building society incorporated and domiciled in the United Kingdom. The address of the principal office is Yorkshire House, Yorkshire Drive, Bradford, BD5 8LJ.

Glossary

The following glossary defines terminology used within the Annual Report and Accounts:

Additional Tier 1 (AT1) capital	Capital that meets certain criteria set out in CRD IV. In particular, the criteria require that upon the occurrence of a trigger event, the AT1 capital instrument converts to a form of Common Equity Tier 1 capital or the principal is written down on a permanent basis; or grandfathered instruments such as Permanent Interest Bearing Shares (PIBS).
Arrears	Amounts unpaid at their contractual date. A customer is in arrears when they fall behind in meeting their obligations to pay their mortgage.
Basel III	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.
Basel IV	The final regulatory proposals on the Reform of Basel III published by the Basel Committee for Banking Supervision in December 2017. These proposals include reforms of the standardised approach for credit risk, the quantification of CVA risk, operational risk approaches and final calibration and design of the output floor for IRB models. The proposals are to be implemented on a phased basis from January 2022.
Buy-to-let (BTL) mortgages	Lending on property that is rented out to individuals.
Capital Requirements Directive (CRD) & Capital Requirements Regulation	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.
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 retained earnings less regulatory adjustments, as defined under CRD IV. Equivalent to Core Tier 1 defined under previous CRD legislation.
Contractual maturity	The final payment date of a loan or financial instrument, at which all the outstanding loan and interest is repayable.
Council of Mortgage Lenders (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 that are segregated from the issuer's other assets to be solely for the benefit of the holders of the covered bonds.
Credit Valuation Adjustment (CVA)	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. These are adjustments applied to the fair values of derivatives to reflect the creditworthiness of the counterparty.
Cross currency interest rate swap	An arrangement in which two parties exchange equivalent principal amounts of different currencies at inception and subsequently exchange interest payments on the principal amounts. At the maturity of the swap, the principal amounts are re-exchanged at the original rates.
Currency risk	The exposure to risk from assets and liabilities denominated in currencies other than Sterling.
Debt securities In issue	Transferable certificates of indebtedness including certificates of deposits and fixed and floating rate notes.
Debit Valuation Adjustment (DVA)	These are adjustments applied to the fair values of derivatives to reflect the entity's own credit risk.
Defined Benefit Obligation	The present value of expected future benefit payments resulting from past service of employees in the defined benefit pension plan.
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.
Encumbered assets	Assets on the balance sheet which are pledged in order to secure, collateralise or credit-enhance a financial transaction from which they cannot be freely withdrawn.
Expected loss	An estimate of the potential losses on current exposures due to potential defaults.
Exposure	The maximum loss that a financial institution might suffer if a borrower or counterparty fails to meet its obligations to the Group.

Glossary continued...

Exposure at default (EAD)	An estimation of the amount of exposure that will be outstanding at the time of default.
Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Group has access at that date.
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 services 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.
Free capital	The aggregate of gross capital and collective impairment provision less property, plant and equipment, intangible assets and investment properties.
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.
Gross capital	The aggregate of general reserve, hedging reserve, available for sale reserve, subordinated liabilities and subscribed capital.
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 Balance Sheet date.
Individual Liquidity Adequacy Assessment Process (ILAAP)	The Group's internal assessment of the levels of liquidity that need to be held by the Society to meet its regulatory liquidity requirements.
Interest rate swap	An arrangement under which two counterparties agree to exchange periodic interest payments based on a predetermined notional principal amount.

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.
International Financial Reporting Standards (IFRS)	International Financial Reporting Standards issued by the International Accounting Standards Board (IASB).
Level 1 High Quality Liquid Assets (HQLA)	Assets which can be easily and immediately converted into cash at little or no loss of value.
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.
Liquid assets	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.
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, representing management's best estimate of losses in the loan portfolio at the reporting date.
Loan-to-value (LTV)	A ratio showing outstanding loan balance as a percentage of the value of the security.
Loss given default (LGD)	An estimate of the difference between exposure at default (EAD) and the net amount of the expected recovery expressed as a percentage of EAD.
Loss given possession	The loss that is expected to crystallise when a repossessed property is sold.
Management expenses	The aggregate of administrative expenses, depreciation and amortisation.
Market Risk	The risk that the value of, or income derived from, the Group's assets and liabilities changes unfavourably due to movements in interest rates or foreign currency rates.
Mean total assets	The amount produced by halving the aggregate of total assets at the beginning and end of the financial year.

Glossary continued...

Medium-term notes (MTN)	Corporate notes continuously offered by an institution 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.
Minimum Requirement for Eligible Liabilities (MREL)	The minimum requirements a financial institution must hold to meet the loss absorption and recapitalisation components if an institution were to fail.
Net interest income	The difference between the interest received on assets and the interest paid on liabilities.
Net interest margin	The ratio of net interest income as a percentage of mean total assets.
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.
Probability of default (PD)	An estimate of the probability that a borrower will default on their credit obligations.
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.
Repossessions	Property taken into ownership by the Society as a result of the borrower's failure to make contractual loan repayments.
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.

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.
Securitisation	A process by which a group of assets, usually loans, are aggregated into a pool which is used to back the issuance of debt securities in issue. A firm transfers these assets to a special purpose vehicle which then issues securities backed by the assets. The Group has established securitisation structures as part of its funding activities and uses residential mortgages as the asset pool.
Shares	Money deposited by members in a retail savings account with the Society and held as a liability in the balance sheet.
Shares and borrowings	The total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue.
SONIA (Sterling Overnight Interbank Average)	An index that tracks actual market overnight funding rates calculated as a weighted average overnight deposit rate for each business day.
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).
Term Funding Scheme (TFS)	A scheme launched by the Bank of England designed to boost lending to households and businesses by providing term funding to banks and building societies participating in the scheme at rates close to Bank Rate.
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 and subordinated liabilities, less regulatory adjustments.
Total capital ratio	The ratio of total capital to risk weighted assets.

Glossary continued...

UK Corporate Governance Code	The UK code on corporate governance 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.
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.

The following glossary defines Alternative Performance Measures (APM) used within the Annual Report and Accounts:

APM	Closest equivalent statutory measure/ calculation of measure	Reconciling items to statutory measure	Definition and purpose
Income Statement measures			
Core operating profit	Profit before tax.	A full reconciliation between profit before tax as shown in the income statement and core operating profit is shown in the Strategic Report on page 29.	Profit before tax excluding the impact of 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. asset sales). The Group considers this to be an important measure of underlying financial sustainability, and provides readers with helpful additional information on the underlying performance of the business across periods. It is consistent with how business performance is reported to and assessed by the Board.
Cost: income ratio	Management expenses (the aggregate of administrative expenses, depreciation and amortisation) as a percentage of total income.	Administrative expenses and depreciation and amortisation (management expenses) and total income are as shown in the Income Statements on page 94.	This is an industry-standard measure of the Group's costs in relation to its income. This is used by the Group to monitor and manage its overall cost position and understand how efficient the Group is at generating income.
Management expense ratio	Management expenses (the aggregate of administrative expenses, depreciation and amortisation) as a percentage of mean total assets.	Administrative expenses and depreciation and amortisation (management expenses) are as shown in the Income Statements on page 94. Mean total assets are calculated by taking the average of the value of the opening balance for the year and the value of the closing balance, as shown in the Balance Sheet on page 96.	This is an industry-standard ratio of the Group's costs as a proportion of its mean assets during the year, and is used to measure how efficient the Group is at maintaining its asset base.
Net interest margin	Net interest income as a percentage of mean total assets.	Net interest income is as shown in the Income Statements on page 94. Mean total assets are calculated by taking the average of the value of the opening balance for the year and the value of the closing balance, as shown in the Balance Sheet on page 96.	This is an industry-standard measure of the relationship between net interest income (the difference between the interest received on assets and the interest paid on liabilities) and assets. This is a key measure used by the Board to monitor how the Group manages income from its assets and interest paid on funding.
Balance Sheet items			
Asset growth	Total assets at the end of the year less total assets at the start of the year.	Total assets are as shown in the Balance Sheet on page 96.	Movement in total asset over the period.
Average savings rate differential	None	Not applicable	Calculates the average savings rate applied to the Group's savings accounts during the period versus the average UK savings interest rates for the rest of the market, based on savings stock from CACI's Current Account and Savings Database (CSDB), covering 86% of retail savings market (based on stock value). This is used to assess how much the Group is paying out in interest in comparison to peers.
Gross lending	None	Not applicable	The total value of mortgage loans advanced by the Group in the period, including loans for house purchase, further advances, remortgages etc.

Glossary continued...

APM	Closest equivalent statutory measure/ calculation of measure	Reconciling items to statutory measure	Definition and purpose
Lending to first time buyers	None	Not applicable	The total value of mortgage loans advanced by the Group in the period to first time home buyers. This measure displays how the Group is helping people overcome the challenge of buying their first property.
Liquidity ratio	Cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities as a percentage of shares and borrowings.	Cash in hand, balances with the Bank of England, loans and advances to credit institutions, debt securities, and shares are as shown in the Balance Sheet on page 96. Borrowings comprise amounts owed to credit institutions, other deposits and debt securities in issue, also as shown in the Balance Sheet on page 96.	The liquidity ratio measures those assets available to meet requests by savers to withdraw their money, to fund mortgage advances and to fund general business activities. It expresses cash and assets easily converted into cash as a percentage of the Group's liabilities to investors.
Mortgages funded by retail savings and retained profits	Shares and total reserves as a percentage of loans and advances to customers.	Shares, total reserves and loans and advances to customers are as shown in the Balance Sheet on page 96.	The retail savings and reserves to mortgages ratio shows the extent to which the Group is dependent on financing from the wholesale markets.
Mortgage balance growth	Loans and advances to customers at the end of the year less loans and advances to customers at the start of the year.	Loans and advances to customers are as shown in the Balance Sheet on page 96.	Movement in mortgage balances including impairment provisions and fair value accounting adjustments over the period.
Net lending	Loans and advances to customers at the end of the year less loans and advances to customers at the start of the year, excluding movements in provisions and accounting adjustments detailed in Note 16.	Mortgage growth less movements in provisions and accounting adjustments detailed in Note 16.	Net lending represents gross lending less repayment of principal and redemptions, and is a key measure to monitor the Group's overall lending performance. This measures our effectiveness in both new mortgage lending and in retaining borrowers.
Number of accounts more than three months in arrears	None	Not applicable	The number of mortgage accounts where the amount of arrears is greater than three monthly payments, or the account is in possession, as a proportion of the total number of mortgage accounts. The industry average for mortgage arrears is measured as the number of accounts more than three months in arrears (including possessions). We produce this KPI to assess how our level of mortgage arrears compares to the market.
Percentage of outstanding retail mortgage balances in arrears by three months or more	None	Not applicable	The percentage of mortgage account balances where the amount of arrears is equal to or greater than three monthly payments, or the account is in possession, as a proportion of the entire mortgage book. This measures the overall quality of our mortgage book.
Retail Savings balance growth	Shares at the end of the year less shares at the start of the year.	Shares are as shown in the Balance Sheet on page 96.	Movement in overall savings balances over the period, including capitalised interest and accounting adjustments.
Savings inflow/ outflow	None	Not applicable	Displays the cash in/out of savings accounts held, excluding capitalised interest. The Group uses this to monitor its main funding source throughout the year.

APM	Closest equivalent statutory measure/ calculation of measure	Reconciling items to statutory measure	Definition and purpose
Share of the gross mortgage market	None	Not applicable	Displays the Group's total gross lending as a percentage of the gross lending in the UK housing market by banks, building societies and other lenders as measured by the Council of Mortgage Lenders (CML), which represents 97% of the UK mortgage market. From 1 July 2017 the Council of Mortgage Lenders integrated into a new trade association, UK Finance.
Regulatory Measures			
Common Equity Tier 1 (CET1) capital ratio	None	Common Equity Tier 1 capital as defined in Note 31 as a percentage of risk weighted assets. The full calculation of CET1 ratio is shown in Note 31.	This ratio represents the relationship between the strongest form of capital (primarily accumulated profits that have built up over time) and assets, weighted by the level of risk they carry. It is a regulatory-defined ratio whose purpose is to ensure that institutions are able to absorb unexpected losses. It is a key measure of financial sustainability.
Leverage ratio	Reserves as a percentage of total assets.	Tier 1 capital as defined in Note 31 as a percentage of total assets adjusted for certain off-balance sheet exposures.	The leverage ratio is also a regulatory-defined ratio used to assess capital adequacy, but removes the risk-weighting element of assets. It is therefore a more simplified measure of financial sustainability.
Total capital ratio	None	Total capital as defined in Note 31 as a percentage of risk weighted assets. The full calculation of total capital ratio is shown in Note 31.	This measure is used to assess the total amount of capital the Group retains compared to its risk weighted assets, hence it includes externally issued capital. It is also defined by the regulatory authorities.
Non-financial measures			
Absenteeism	None	Not applicable	This indicator is for measuring the average absenteeism rate, as a % of the total working days. This KPI can be an indicator of colleague motivation as a high absence rate may indicate poor motivation and engagement.
Great Place to Work survey result	None	Not applicable	This is an external benchmarking exercise conducted by Great Places to Work, involving an employee survey and a culture audit. The Group uses this measure to understand how successful we are at delivering our vision as a workplace where our people can give their best and thrive. This is monitored annually and reported to the Board as a colleague engagement measure.
Net Promoter Score (NPS)	None	Not applicable	NPS is a measure of how willing customers are to recommend the Group to others. It measurers the difference between the percentage of 'promoters' (those willing to recommend the Group to others) and 'detractors' (those unwilling to recommend the Group). The score can range from -100 if all customers are 'detractors' to +100 if all customers are 'promoters'. The Group uses this as a key measure of customer satisfaction with our products and service.
Resignation rate	None	Not applicable	This measures the number of colleagues who resign from the Group as a proportion of the total number of colleagues. This measure is used to assess whether colleagues feel satisfied working at YBS Group.

Glossary continued...

APM	Closest equivalent statutory measure/ calculation of measure	Reconciling items to statutory measure	Definition and purpose
KPMG Nunwood customer experience survey result	None	Not applicable	The KPMG Nunwood survey ranks UK brands based on their customer experience, and is used by the Group to assess the experience we deliver our customers in relation to other UK organisations in various industries.
Colleague engagement score	None	Not applicable	Our annual colleague engagement survey is used to calculate an engagement score which helps to understand our people's needs and what will lead to their enjoyment and commitment in work.
End Youth Homelessness fundraising	None	Not applicable	Creating a partnership with organisations that have the same purpose, values and ethics as us is a key part of our Society Matters strategy. As a building society one of our core purposes is to help people into a home at every stage in their life, and this is reflected through our partnership with End Youth Homelessness.
Colleagues participating in volunteering	None	Not applicable	We aim to be an active member of the communities we serve. We measure our impact in the community by assessing the proportion of our colleagues who made use of their volunteering allowance to share their skills and make a difference to charities and other good causes.

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