Market Harborough
BUILDING SOCIETY

Annual Report and Accounts 2018

Contents

Chairman's Statement

The UK economy is in a prolonged period of uncertainty, and so, in this context, I am pleased to report that your Society had a very satisfactory 2018. As you will see from our financial results, we delivered mortgage growth and a net inflow in savings. In addition, we made good progress against our strategic and operational goals.

Our core activities of savings and mortgages both grew - with the savings book growing by £15m and the mortgage book by £21m in the year. Our business was enhanced with the introduction of our Online Service which made our savings products more accessible online and supported a significant number of new account openings. In mortgages, we continued to develop our product range and delivered "best buy" local first time buyer mortgages as well as personalised solutions for those with more complex requirements. At the same time, lending quality was maintained, protecting our members from losses.

ECONOMY

UK economic growth in 2018 was 1.4%, down from 1.8% in 2017 and the slowest rate since 2012. The services and construction sectors were the main drivers of growth in the economy but overall business investment has fallen in the last three consecutive quarters, which has not been seen since the global financial crisis. This is in part due to Brexit related uncertainty and in part due to global influences.

The labour market is tight with labour supply and demand being broadly in balance. The unemployment rate is projected to fall to 3.9% by the end of the year. Most survey measures of employment intentions are around their pre-crisis average levels, which, together with an elevated vacancy rate, suggests that demand for labour remains solid. The number of people in work in the UK reached a record 32.6m in December according to ONS data.

Wage growth continued to firm. Whole-economy regular average weekly earnings (AWE) growth (which excludes the volatile bonus component) for the year was 3.4% and outstripped CPI inflation, which was 2.1% at the same point.

Overall, housing market indicators continue to be subdued and UK mortgage approvals have been broadly unchanged since mid-2016. Annualised house price inflation was 0.5% in 2018 according to Nationwide but this masked differences between London (broadly flat) and the North (3-4%). However, price levels relative to 2007 peaks show the North South divide persists. In the North, prices are still close to their 2007 levels but in London they are more than 50% higher. Halifax's house price index is a little higher for 2018, but broadly tells the same story.

BUSINESS RESULTS

Profit for the year was £4.0m before tax which is a significant increase (20%) on 2017's result (£3.3m) and a new record for the Society. This improved profit was generated principally from the 5.5% expansion of our mortgage book combined with a similar average interest rate payable to that of the previous year and the continued benefit of low cost Government funding. Gross Lending of £101m was slightly down on 2017 (£106m) but lower redemptions meant that growth was comparable to 2017 at 6.2%.

At the same time, the average level of funding only increased by £8m, as surplus liquidity was converted into mortgages. The cost base remained flat on 2017. The high staff costs in 2017, due to specialist cyber contractors were not ongoing in 2018, however other operating expenses increased in 2018.

The last two moves on interest rates (0.25% each) have been upwards. The last of these was in August and we held our mortgage rate whilst going back into the savings market with a range of notice and bond products, including a market leading, existing-member, three year bond. These products attracted around £10m of savings lifting total net receipts to £15m in the year.

We were pleased to launch two significant digital developments in 2018. These were firstly, a wholly new website with better technical performance allied to a fresher look, and secondly, the launch of our Online Service which enables fast access to our savings products and also enables the opening of an account and becoming a member in minutes. Users can move money, get important information and communicate securely with our savings team.

The Society's capital position remains strong at 8.5% (Reserves/Total Assets).

As I reported last year, we participated in the Government's Funding for Lending Scheme (FLS) and Term Funding Scheme (TFS) which give the Society low cost funding with a duration of four years. Drawings at the year-end remained at £70m with repayments scheduled over the next three years.

Chairman's Statement (continued)

YOUR SOCIETY

Members are the lifeblood of the Society and we took a number of steps towards making the benefits of membership more tangible. This work focused on making it easier to speak to me and the Board (through a dedicated email address asktheboard@mhbs.co.uk) as well as giving discounts with a number of local businesses and offering 'member only' products. Member cards were introduced and this year's AGM pack gives details of how these can be obtained. We will continue to develop the member offer by adding new benefits to recognise member loyalty.

We take the satisfaction of our employees very seriously and run an anonymised staff survey each year. In 2018 only 2% of our people said that they don't enjoy their job, and the overall satisfaction improved on the previous year. This result gives us confidence that MHBS is a good place to work, and we strive to ensure all our people have meaningful and rewarding work, are treated fairly and properly supported. We keep our benefits and terms under review and plan further enhancements this year.

In 2018, there were a number of changes to our Board. Alison Littley and Brian Brodie both stepped down and we wish them both well and thank them for their valued contributions. In anticipation of Melanie Duke's and my own planned departures (this year and 2020 respectively), we are currently recruiting new NEDs (using a direct campaign alongside a professional recruitment firm). This will provide useful overlap and continuity to the business.

Thank you to all our members - savers and borrowers - for their support in 2018. My own heartfelt thanks also go to the Society's excellent staff, business partners and suppliers for their contribution to our success.

2019 will be another challenging year given the economic and political environment. Although we expect profitability to remain strong, we anticipate that it will reduce from recent record levels. However, the Society is in excellent health with a sound balance sheet and an enthusiastic and skilled workforce.

I look forward to reporting to you again in a year's time.

Nicholas Johnston

Chairman

19 March 2019

Chief Executive's Review

As a mutual, our focus is on doing the best for members. This means delivering excellent service, providing products that meet members' needs whilst building a strong business resilient to threats and shocks. Our products fall into two groups, savings and mortgages, and we had satisfactory results in both with £21m of mortgage growth and net retail savings inflow of £15m.

The Society further strengthened its balance sheet through record profits (the third straight year of record profit) and made progress with a new website and improved IT infrastructure.

MORTGAGES

Mortgage advances in 2018 were £101m (£106m 2017) and this was focused on high quality lending at moderate loan to value (LTV) ratios. As at 31 December the weighted average LTV ratio of all mortgages was 47% giving good protection against any fall in property values. Alongside new loans, our active engagement with borrowers led to retention of business to give mortgage growth of 5.5%.

The performance of our loan book remains very satisfactory. At 31 December the number of loans more than 12 months of payments behind was 2 (2017: 5). The amount in arrears was £7k on accounts with total capital balances of £35k (2017:£26k, on accounts with capital balances of £61k). No commercial, BTL or holiday let loans are in arrears and no repossessions were made in 2018. This level of credit performance compares well with industry and peer averages.

The Bank of England raised base rate from 0.5% to 0.75% in August – we chose not to increase our Standard Variable Rate. As a result, mortgage members did not see their payments increase in 2018.

Competition for new lending was even more aggressive than recent years. We believe that it's better to focus on quality rather than write business at uneconomic rates which don't reflect risk. Our innovation meant that we found new customers not only locally (with best buy first time buyer products) but also older borrowers and those with complex borrowing requirements. Our links with select mortgage brokers give us a national reach.

We are conscious of our responsibilities towards borrowers and have an active programme of contact which facilitates existing borrowers finding the right product and addressing any concerns over the repayment of interest only loans.

FUNDING

Our funding is predominantly through our retail savers. In 2018 we added £15m to retail deposits and much of this inflow was attracted by our improved notice account rates as well as fixed rate bonds. Our three year member bond proved especially popular, and these loyalty based savings will be a feature of our branches and digital channels in 2019. The secure Online Service was launched and has proved a popular route for 24/7 account opening.

We participated in the FLS (Funding for Lending Scheme) and the TFS (Term Funding Scheme). This medium term funding will be repaid over the next few years, and we are well placed for this refinancing, both operationally and financially.

THE SOCIETY AND STAFF

Early in 2018 Online Service replaced the old YouView system. This innovation has proved a valuable channel, and we continue to invest in it to improve the member experience. The Society operates in highly regulated markets and May saw the introduction of GDPR (General Data Protection Regulation). The implementation of this revision to our data responsibilities was successfully achieved. Towards the end of 2018 we agreed to develop a portal through which to service our valued mortgage brokers. This development will allow a step change in efficiency and service for borrowers who access MHBS though a mortgage broker.

We value our staff and were delighted to see one of our team complete a Leadership and Management MSc. This was the first intake for this specialised building society sector degree at Loughborough University. Other successes included four staff passing Certificates in Mortgage Advice and Equity Release as well as an award in Service Operations Management. 2018 also saw our first mental health first aiders in the team.

Staff made a significant contribution to our communities in the year. Nearly 700 hours of volunteering from staff supported LOROS, Cransley, Rainbows, Cancer Research as well as many local schools and clubs. The Society donated £14,000 to its Charitable Foundation which supported local good causes and a further £13,000 to local hospices.

MEMBERS

As well as providing attractive 'members only' savings and mortgage products, we introduced a wider offer to "make membership real". A new membership card provides access to exclusive discounts on respected local partners' products. We plan to add to the range of deals with further benefits. Members also got improved access to the Society's Board through our new dedicated email address, asktheboard@mhbs.co.uk

Chief Executive's Review (continued)

OUTLOOK

At the time of writing, the Brexit outcome remains uncertain and this uncertainty makes it likely that the economy will be subdued with downward pressure on house prices. The Bank of England will keep a close eye on how base rate should be set and various market views suggest upward, downward and static rates in 2019. As a result, predicting rates for savings and mortgages is challenging.

As competitors close branches and the High Street suffers, we remain supportive of offering a walk-in service alongside our digital and other channels. Our branches are important and we plan to offer in-branch advice on keeping safe to those customers who want a friend in financial services.

Our strong profitability supports ongoing investment but we expect market conditions will lead to a period of very satisfactory, but lower, levels of profit. We are not a profit driven organisation and use the good years to build our strength for more trying periods. This strength means we look forward to our forthcoming 150th year with confidence.

Mark Robinson

Chief Executive

19 March 2019

Directors' Report

Your directors have pleasure in presenting their Annual Report for the year ended 31 December 2018.

BUSINESS OBJECTIVES

Your Society's principal business objectives are the provision of secured lending on residential property, savings products for private individuals and small businesses, and related insurance services. The Society operates solely in the UK and all of its operations are based in the UK. Our products are promoted nationally via mortgage brokers, the internet and by post, and in Leicestershire and Northamptonshire via our branches. We seek to develop by offering the combined advantages of value-for-money and innovation in our products and by delivering a first-class personalised service to members.

BUSINESS REVIEW

A review of the Society's business performance during 2018 is included in the Chairman's Statement and the Chief Executive's Review.

FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES

The Group operates in a business environment that contains financial risks. To mitigate these risks, the Board has implemented a clearly defined risk management framework that comprises the following features:

- a risk focused governance structure;
- a risk appetite statement, risk policy statements and risk limits;
- risk identification, monitoring and reporting processes; and
- an effective internal control framework.

The financial instruments used by the Group to mitigate certain risks, particularly interest rate risk, are set out in Note 28 of the accounts.

The Board has established Committees to assist in the implementation and monitoring of risk management across the Group, including the Audit & Compliance Committee, the Risk Committee, the Assets and Liabilities Committee (ALCO), the Remuneration Committee and the Nominations Committee. Details of the role and responsibilities of each Committee are set out in the Corporate Governance Report.

The key policies that the Group has implemented to manage the risks that it faces include a Risk Appetite Statement, Lending Policies, a Conduct Risk Policy and Financial Risk Management Policies (Liquidity and Funding Policy, Interest Rate Risk in the Banking Book Policy and Counterparty Policy). These are reviewed, amended and approved by the Board on a regular basis.

PRINCIPAL RISKS AND UNCERTAINTIES

The principal risks to which the Group is exposed, along with the risk management objectives and policies are set out below:

Business risk and margin compression: the risk of loss or reduction in profitability due to failure to achieve business objectives. The Group's Corporate Plan, approved by the Board, sets out the key objectives and how key risks to achieving those objectives will be managed. The Group manages this risk by ensuring that a diverse range of products and services are in place, the setting of detailed plans and the monitoring of actual performance against these plans by the Board. Key business risks include:

- Competitive mortgage and retail savings markets. The Society's net interest margin remains robust despite the low interest rate environment. There is a risk that increased competition reduces mortgage yields and increases the cost paid for retail savings. The Directors continue to closely monitor the economic environment, the mortgage and savings markets, the balance sheet composition of the Group and product pricing to ensure that the Society's product mix remains appropriate and that net interest margin remains in line with the Corporate Plan;
- Increasing management expenses. Operating costs are likely to increase in the short-term as investment is made in services to improve growth prospects and deliver operating efficiencies. There is a risk that costs continue to increase over and above the growth in interest margin;

Directors' Report (continued)

PRINCIPAL RISKS AND UNCERTAINTIES (CONTINUED)

Operational risk: the risk of loss arising from inadequate or failed internal processes, the actions of people, the Group's IT systems, regulatory compliance, fraud and financial crime. The Group maintains policies and procedures for all key internal processes. The Risk and Compliance function is the Group's principal forum responsible for monitoring operational risk and ensuring that appropriate actions are taken to strengthen internal controls implemented across the business to manage operational risk.

The Society recognises that the risks from cybercrime are of growing concern. The Society recognises this risk to our customers and processes. The Society carried out several cyber related projects and recruited additional specialist staff in both 2017 and 2018 to significantly enhance its resilience and combat risks from cybercrime. In 2018 the Society was awarded the Cyber Essentials Plus standard of assurance, a government backed cyber security certification scheme, endorsing the cyber security standards it employs across all areas of the business. The Society continues to maintain a sustained focus in this area.

Conduct risk: the risk of loss arising through interaction with the customer throughout the product lifecycle that causes some form of consumer detriment. The Conduct Risk Policy sets out the values that staff are expected to demonstrate in all their dealings with consumers and the detailed metrics that are monitored that may indicate consumer detriment to ensure that appropriate and timely action can be taken. As with Operational risk the Risk and Compliance function is the principal forum responsible for monitoring conduct risk, ensuring there are adequate controls implemented and that these are effective in managing conduct risk and delivering good customer outcomes. The Risk and Compliance functions report directly to the Risk Committee and Board in relation to customer outcomes.

Pension obligation risk: the risk of a reduction in profit resulting from the Society, being the funder of last resort, having to make significant contributions to the Society's defined benefit pension scheme. Since 2005, the Group has embarked upon a programme of measures to reduce its pension scheme liabilities for the benefit of pension scheme members and the long-term interests of Society members. Details of the Group's pension scheme including the cost to the Society for the year and the updated scheme valuation (IAS19) at 31 December 2018 are set out in Note 7 and Note 25 of the accounts.

Credit risk: the risk of loss if a customer or counterparty fails to perform its obligations. The risk arises from the Group's loans and advances to customers and the investment of liquid assets with treasury counterparties. Treasury counterparty and sector exposure limits have been established by the Board within the Counterparty Policy and these are monitored by ALCO.

All mortgage applications are assessed with reference to the credit and underwriting criteria set out in the Group's Lending Policies. Details of the Group's arrears performance are set out in the Chief Executive's Review. The Group recognises that the personal and financial circumstances of our borrowers can be affected by deteriorating economic conditions and unplanned events. When this happens, we apply a formal policy directed towards forbearance and fair treatment of customers. The Group uses a number of forbearance measures to assist those borrowers including agreeing a temporary payment concession or a temporary transfer to interest only payments in order to reduce the borrowers' financial pressures. We expect borrowers to resume normal payments once they are able.

Interest rate risk: the risk of reductions in net interest margin arising from unfavourable movements in interest rates due to mismatches between the dates on which interest receivable on assets and interest payable on liabilities are reset to market rates or from the re-pricing of assets and liabilities according to different interest bases. This risk is managed within approved limits set by the Board within the Financial Risk Management Policies using a combination of on and off balance sheet financial instruments and is monitored by ALCO. Further to the monitoring by ALCO, the Board manages this risk via the corporate plan, budgets and forecasts. Details of the Group's interest rate sensitivity and the use of derivatives for hedging purposes are set out in Note 33 of the accounts.

Directors' Report (continued)

PRINCIPAL RISKS AND UNCERTAINTIES (CONTINUED)

Brexit risk: The position on Brexit is currently highly uncertain, and the possibility of a 'No Deal', which the general consensus expects to be damaging to the economy, has increased.

The Society is not directly affected by the impacts of Brexit as the business model is based on lending in GBP that is secured on UK properties. The business model is exposed to the secondary impacts on the economy. These would manifest themselves in the same way as any other economic downturn through decreased house prices and higher unemployment and therefore default rates.

The business does lend to ex pats, some of whom are based in Europe. The underwriting process considers the job / profession of the borrower and ex pats tend to be in the professions with transferable skills and roles. Should they have to return to the UK then they are likely to be as employable as anyone else. Should jobs not be available, the low LTV will offer protection, and the number of properties that may have to be sold or repossessed is clearly immaterial to the wider market.

The ultimate protection against any downturn is loan to value (LTV). The Society has a low LTV portfolio, with only 1.1% of balances exceeding 75% LTV. Furthermore, the stress tests it carries out are more severe than any probable downturn. These stress tests are also incorporated into the IFRS 9 provisioning approach. Differing economic scenarios are probability weighted within the approach – the most severe scenario is given a 5% probability weighting, with the most likely economic scenario a 25% probability weighting.

The Society notes not only the risks to its mortgage assets but also operational risks due to impact on resources, availability of skilled staff and suppliers with connections to the EEA. It believes it is well placed to deal with any such impact.

Liquidity risk: the risk that the Group does not have sufficient financial resources to meet its liabilities as they fall due, or can secure them only at an excessive cost. It arises from the maturity mismatch of the Group's assets and liabilities. The Group's policy is to maintain liquid assets at all times which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due both in business-as-usual and stressed scenarios, to smooth out the effect of maturity mismatches between assets and liabilities, and to maintain the highest level of public confidence in the Group. The Financial Risk Management Policies detail liquidity risk limits set by the Board and these are reviewed daily by the Group's Finance department and monitored each time the ALCO meets. Further details of liquidity and funding are set out below.

Concentration risk: the risk of loss due to either a large individual or connected exposure, or significant exposures to groups of counterparties who could be affected by common factors, including geographical location. The Board has set limits for the geographical concentration of mortgage assets and the maximum value of exposures to single or connected mortgage borrowers and treasury counterparties and these are monitored by the Board and ALCO.

Directors' Report (continued)

PRINCIPAL RISKS AND UNCERTAINTIES (CONTINUED)

BOARD RISK FRAMEWORK

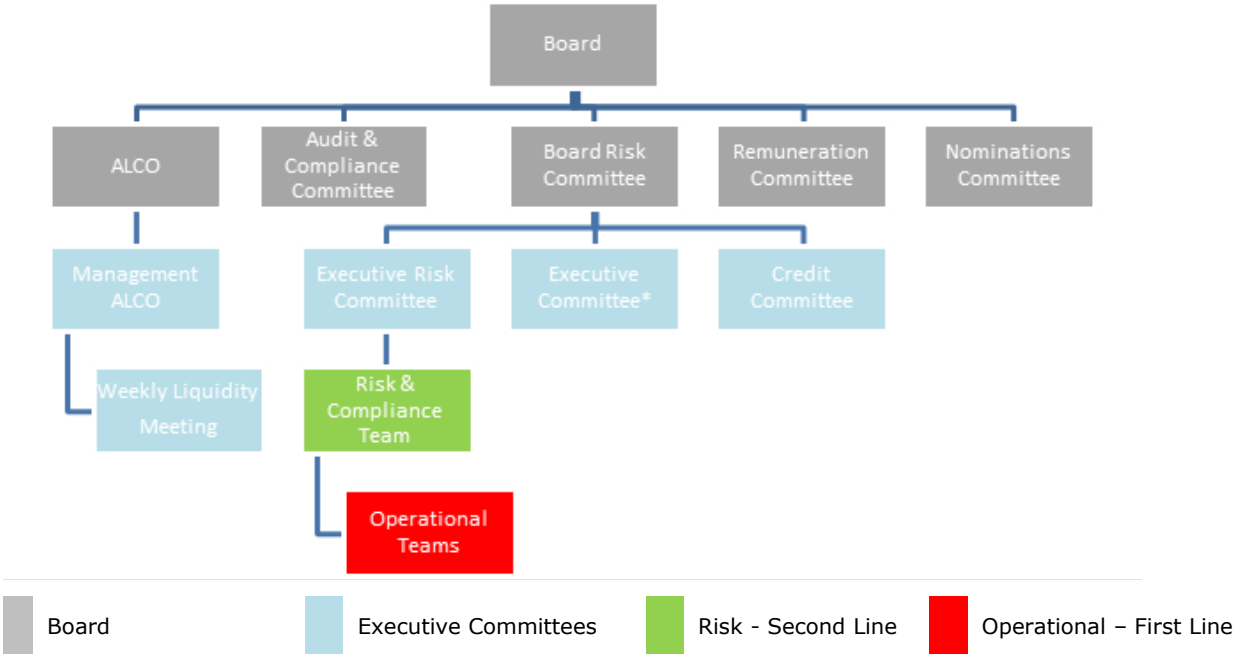
The risk management framework is designed to safely deliver the Corporate Plan in line with the Board's risk appetite. The Board is responsible for ratification of all policies. All of the senior management are involved in the development of risk management policies and their subsequent monitoring as part of their core roles.

The Society operates a 'three lines of defence' model that is appropriate to a business of its scale and complexity.

The approach is applied to all of the key business risks, such that for each of them there is a specific Board committee responsible for setting policies to manage that risk in accordance with the overall risk appetite, financial risk management objectives and policies.

The Group's objective is to minimise the impact of financial and other risks upon its performance. An explanation of the financial risks and the controls in place to manage them (including the use of derivatives) is given in notes 28 to 33 to the annual accounts.

The Society's risk governance structure is detailed below:



*This Committee can escalate risk matters to any of the Board Committees or Board itself

Directors' Report (continued)

KEY PERFORMANCE INDICATORS

The following "key performance indicators" provide an overview, in tabular form, of the Group's progress.

	2018 Group	2017 Group	2016 Group
Total assets	£469m	£424m	£418m
New mortgage lending	£101m	£106m	£108m
Growth in mortgage assets	5.5%	6.2%	3.1%
Net increase / (decrease) in retail deposits	£15m	(£26m)	£18m
Liquidity to funding ratio*	17.8%	17.8%	22.6%
Management expenses as a percentage of mean total assets	1.5%	1.6%	1.4%
Post-tax profit	£3.2m	£2.7m	£2.3m
Profit as a percentage of mean total assets	0.7%	0.6%	0.5%
Net interest receivable as a percentage of mean total assets	3.4%	3.4%	3.1%
Gross capital as a percentage of shares and borrowings	9.4%	9.5%	8.8%
Free capital as a percentage of shares and borrowings	9.2%	9.1%	8.5%

* Includes 2018:£26m (2017:£46m, 2016:£51m) "off-balance sheet" liquidity drawn under the Funding for Lending Scheme

For a definition of terms see the Annual Business Statement on page 89.

NON-FINANCIAL INDICATORS

Customer surveys in 2018 showed that 90% of new savers and 94% of new mortgage customers would recommend us. In December 2018 88% of employees responded to a satisfaction survey; 90% of respondents agreed that they enjoyed their job. During 2018 the Society continued to support the development of its staff; 8 employees celebrated examination passes and the achievement of qualifications in 4 different professional subjects.

GENDER DIVERSITY

In 2016 the Society was one of the first businesses to sign up to the Women in Finance Charter announced by HM Treasury. Under the Charter, the Society has pledged to promote gender diversity in the workplace, by setting targets for the proportion of women to be represented at senior levels within the Society and publish annually its progress against these targets.

2018 Average	Male	Female	Total	% Female
Board of Directors	5	3	8	38%
Executive Management	3	3	6	50%

2017 Average	Male	Female	Total	% Female
Board of Directors	6	2	8	25%
Executive Management	3	4	7	57%

Directors' Report (continued)

GENDER DIVERSITY (CONTINUED)

The Board agreed a long term target of one third of each group to be made up of the under-represented gender, whilst recruiting the best candidate for any vacancy that arises.

PROPERTY PLANT AND EQUIPMENT

Freehold premises owned by the Group are shown in the accounts at cost less depreciation.

DIRECTORS

As at 31 December 2018 the Board comprised six non-executive directors and two executive directors. The Board meets at least six times a year with the addition of two strategy sessions. Board Committees meet at intervening times. Any additional meetings are held as required.

The directors holding office during the year were:

Non-executive directors	Executive directors
Nicholas Johnston : Chairman	Mark Robinson : Chief Executive
Kenneth Piggott : Vice-Chairman and Senior Independent Director (retired 26 April 2018)	Nicholas Fielden : Finance Director
Melanie Duke : Vice-Chairman and Senior Independent Director (from 26 April 2018)	
Brian Brodie (until 3 May 2018)	
Jonathan Fox	
Alison Littley (until 20 September 2018)	
Andrew Merrick	
Zoe Shapiro	
Michael Thomas	

The Society maintains liability cover for the directors as permitted by the Building Societies Act 1986.

GOING CONCERN

The directors have prepared forecasts of the Society's financial position for the period ending twelve months from the date of approval of these Annual Report and Accounts. They have also considered the effect on the Society's business of operating under stressed but plausible operating conditions. As a result they are satisfied that the Society and the Group have adequate resources to continue in business for the foreseeable future. For this reason, the Annual Report and Accounts continue to be prepared on a going concern basis.

The directors have considered the impacts of the UK leaving the EEA and have concluded that this would not impact the going concern basis under which these accounts have been prepared.

OTHER MATTERS

Corporate and Social Responsibility

Your Society seeks to act responsibly in all its activities and has considered its operational impact on the economic, social and physical environment. Its policy on the Modern Slavery Act is available on our website www.mhbs.co.uk as is its commitment to the UK Money Markets Code.

Directors' Report (continued)

OTHER MATTERS (CONTINUED)

Capital Adequacy

The Society meets the requirements of the Capital Requirements Directive (CRD) which requires the Society to assess the adequacy of its capital through an Internal Capital Adequacy Assessment Process (ICAAP). Through the application of the ICAAP the Board is satisfied that the Society holds a level of capital more than sufficient to satisfy both the CRD's Pillar 1 minimum capital requirements and to cover those risks that the Board has identified under Pillar 2. The Pillar 3 disclosures required under the CRD are available from the Society's Secretary, or on our website www.mhbs.co.uk

Supplier Payment Policy

It is the Society's policy to agree the terms of payment with suppliers in advance and to make payment within the agreed terms of credit once the supplier has performed in accordance with the terms of the contract. The number of creditor days was 10 at 31 December 2018 (31 December 2017: 0).

Post Balance Sheet Events

There are no post balance sheet events to report.

Auditor

The Directors who held 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 to make themselves aware of any relevant audit information and to establish that the Society's auditor is aware of that information.

The Auditor, KPMG LLP, has indicated their willingness to continue as external auditors to the Society and therefore a resolution for their re-election will be put to the Annual General Meeting in 2019.

On behalf of the Board of Directors:

Nicholas Johnston

Chairman

19 March 2019

Statement of Directors' Responsibilities

DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT, THE ANNUAL BUSINESS STATEMENT, THE DIRECTORS' REPORT AND THE ANNUAL ACCOUNTS

The directors are responsible for preparing the Annual Report, Annual Business Statement, Directors' Report and the annual accounts in accordance with applicable law and regulations.

The Building Societies Act 1986 ("the Act") requires the directors to prepare group and society annual accounts for each financial year. Under that law they have elected to prepare the group and society annual accounts in accordance with IFRSs as adopted by the EU and applicable law.

The Group and Society annual accounts are required by law and IFRSs as adopted by the EU to present fairly the financial position and the performance of the group and the society; the Building Societies Act 1986 provides in relation to such annual accounts that references in the relevant part of that Act to annual accounts giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the group and society annual accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- assess the Group and Society's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the Group or the Society or to cease operations, or have no realistic alternative but to do so.

In addition to the annual accounts the Act requires the directors to prepare, for each financial year, an Annual Business Statement and a Directors' Report, each containing prescribed information relating to the business of the group.

DIRECTORS' RESPONSIBILITIES FOR ACCOUNTING RECORDS AND INTERNAL CONTROLS

The directors are responsible for ensuring that the group:

- keeps proper accounting records that disclose with reasonable accuracy at any time the financial position of the group and society, in accordance with the Act;
- takes reasonable care to establish, maintain, document and review such systems and controls as are appropriate to its business in accordance with the rules made by the Financial Conduct Authority and Prudential Regulation Authority under the Financial Services and Markets Act 2000.

The directors are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Society's website. Legislation in the UK governing the preparation and dissemination of annual accounts may differ from legislation in other jurisdictions.

Nicholas Johnston

Chairman

19 March 2019

Corporate Governance Report

The Board is responsible for the governance of the Society on behalf of the members. The Board is committed to best practice in corporate governance, and has regard to the principles of the UK Corporate Governance Code 2016 (the Code) issued by the Financial Reporting Council. Although the Code does not directly apply to mutual organisations, the Group has regard to its principles as they apply to a building society.

THE BOARD

Your Board assumes full responsibility for the overall stewardship of the Society and recognises the importance of effective and responsible management, both in complying with statutory and prudential requirements and in protecting the interests of members and staff. The Board is responsible for the Society's strategy and direction, and for monitoring the performance of the executive management team to ensure that the Society develops in accordance with its stated business objectives.

The directors are happy to make themselves available to members who may wish to contact the Society and resolve problems. Your Board has also appointed a Senior Independent Director for this purpose.

The role of the Chairman of the Board and the Chief Executive are held by different people and are distinct in their purpose, with division of responsibility set out in writing.

The Chief Executive has direct charge of the Group on a day-to-day basis and is accountable to the Board for the financial and operational performance of the Group as well as for the formation of its strategy. Some responsibilities are delegated to the Group's managers and officers and these are listed and reviewed by the Board.

The Chairman, who is elected by the Board annually, leads the Board in approving its strategy and in the achievement of its objectives. The Chairman is responsible for organising the business of the Board, ensuring its effectiveness and setting its agenda.

One of the independent non-executive directors is appointed as the senior independent director, to provide a sounding board for the Chairman and to serve as an intermediary for the other directors as necessary.

The Board consists of two executive directors and six non-executive directors. It considers that all the non-executive directors are independent in both character and opinion, and collectively bring to the Society a wide range of valuable expertise. Members of the Board stand for re-election at least every three years and annually should their service exceed nine years.

The individual performance of non-executive directors is appraised annually by the Chairman, and that of the Chairman by the Vice-Chairman following consultation with the other Board members. The Board is satisfied that the Chairman does not have other business commitments which might prevent him from giving full attention to the Society's interests.

New directors receive formal induction training and all directors are provided with on-going training to provide continual updating of their skills. All directors must meet the test of fitness and propriety as laid down by the PRA as 'Approved Persons' to fulfil their Controlled Functions as directors.

All directors have access to the advice of the Secretary and, if necessary, are able to take independent professional advice at the Society's expense.

The Board is responsible for determining strategies for risk management and internal control. Senior management is responsible for designing, operating and monitoring risk management and internal control processes. The Risk Committee (on behalf of the Board) is responsible for reviewing the adequacy of these processes. The Society's risk profile is compiled by senior management, reviewed in detail by the Risk Committee and approved by the Board.

The Internal Audit function is outsourced to Deloitte LLP under specific terms of reference and provides independent and objective assurance that these processes are adequate and applied effectively. A copy of the Internal Audit Charter is available to members from the Society's Secretary upon request and from the Society's website www.mhbs.co.uk.

BOARD COMMITTEES

There are five Board Committees, covering the areas of Audit and Compliance, Risk, Assets and Liabilities, Nominations and Remuneration. The Terms of Reference for each of the Board Committees can be found on the Society's website; www.mhbs.co.uk.

Audit and Compliance Committee

The Audit and Compliance Committee meets at least quarterly and was chaired by Michael Thomas, its other members being Melanie Duke, Zoe Shapiro, Andrew Merrick (from 1 January 2018), Brian Brodie (1 January 2018 until 3 May 2018) and Alison Littley (from 1 January 2018 until 20 September 2018). All members of the Committee have experience that is relevant to the role, with at least one member being required to have recent financial experience. All are or were non-executive directors.

The activities of the Audit and Compliance Committee are set out more fully in the Audit Committee Report.

Corporate Governance Report (continued)

BOARD COMMITTEES (CONTINUED)

The main function of the Committee is to assist the Board in fulfilling its oversight responsibilities. It deals with matters relating to internal and external audit, accounting policies and procedures, and compliance with regulatory requirements. For further information regarding the work of the Committee and how it discharged its responsibilities refer to the Audit Committee Report.

Risk Committee

The Committee meets at least four times each year. It is responsible for identifying and monitoring risks to the Society's strategy, operations and performance. Its key responsibilities are:

- Development and monitoring of the Risk Framework;
- Monitoring risks to the Society and agreeing the key risks;
- Monitoring Credit Risk in the lending book;
- Monitoring Operational including Cyber Risk and Conduct Risk; and
- Appraising stress tests.

The Committee was chaired by Zoe Shapiro; other members being Michael Thomas, Jonathan Fox, Andrew Merrick (from 1 January 2018), Brian Brodie (from 1 January 2018 until 3 May 2018) and Alison Littley (from 1 January 2018 until 20 September 2018); all of whom are, or were, non-executive directors.

Assets and Liabilities Committee

The Assets and Liabilities Committee (ALCO) meets at least four times each year and is responsible for the management and composition of the Society's balance sheet, monitoring the Society's exposure to interest rate variations and monitoring compliance with the Society's liquidity & funding, counterparty and IRRBB (interest rate risk in the banking book) management policies. It recommends, as appropriate, changes to these policies. Members are Melanie Duke (Chair of the Committee), Nicholas Fielden, Nicholas Johnston, Mark Robinson, Michelle Pledger (from 1 March 2018), Michael Thomas, Andrew Merrick (from 1 January 2018) and Alison Littley (from 1 February 2018 until 20 September 2018). All are directors of the Society, with the exception of Michelle Pledger and four of whom are non-executive directors.

Nominations Committee

The Committee is chaired by Nicholas Johnston, its other members being Kenneth Piggott (until 26 April 2018), Michael Thomas (who joined after Kenneth Piggott's retirement) and Melanie Duke. The Committee meets not less than twice each year to review succession planning, and also, whenever a director vacancy is expected, to make recommendations for appointments to the Board. Board succession planning ensures that the correct mix of skills is represented on the Board and its Committees. The Board is mindful of the Walker Report on diversity, including gender, race and ethnicity. In 2016 the Board agreed a target of at least one third of the Board to be made up of the under-represented gender, whilst recruiting the best candidate for the role.

In sourcing suitable candidates for consideration, the Committee uses one or more of the following methods:

- Open advertising;
- The services of a search and selection agency; and
- Advertising to the Society's membership.

The appointment of directors is based on objective skills based criteria as well as the ability to meet the requirements of the PRA's approved person's regime and the assurance that candidates can commit the time required to fulfil the role effectively.

Remuneration Committee

The Committee meets at least three times each year and is responsible for determining the remuneration of the Chairman, executive directors and other senior managers, and for making recommendations to the Board on remuneration for staff and non-executive directors. It consists of two non-executive directors: Kenneth Piggott (Chair until 26 April 2018), Jonathan Fox (Chair from 26 April 2018) and Melanie Duke. The remuneration policies for executive and non-executive directors are set out in the Directors' Remuneration Report.

Corporate Governance Report (continued)

BOARD COMMITTEES (CONTINUED)

Attendance at Board and Committee meetings during the year was as follows:

Director	Board	Audit & Compliance	Risk	Assets & Liabilities	Nominations	Remuneration
Nicholas Johnston	6 (6)	-	-	4 (4)	3 (3)	-
Kenneth Piggott	2 (2)	-	-	-	-	1 (1)
Melanie Duke	5 (6)	5 (5)	-	4 (4)	3 (3)	3 (3)
Brian Brodie	2 (2)	2 (2)	2 (2)	-	-	-
Nicholas Fielden	6 (6)	5 (5)*	4 (4)*	4 (4)	-	3 (3)*
Jonathan Fox	6 (6)	-	4 (4)	-	-	3 (3)
Alison Littley	4 (4)	3 (3)	3 (3)	2 (3)	-	-
Andrew Merrick	4 (6)	4 (5)	3 (4)	3 (4)	-	-
Mark Robinson	6 (6)	5 (5)*	3 (4)*	4 (4)	3 (3)*	3 (3)*
Zoe Shapiro	5 (6)	5 (5)	4 (4)	-	-	-
Michael Thomas	6 (6)	5 (5)	4 (4)	4 (4)	3 (3)	-

( ) = number of meetings eligible to attend.

Attendance by invitation is marked with *

Proceedings of all Committees are formally minuted and minutes are subsequently considered by the full Board.

All of the Committees carried out self-evaluation exercises during the year, which were reviewed by the full Board. The Board also carried out its own self-evaluation.

SUBSIDIARY COMPANY

The Society has one subsidiary company, Market Harborough Mortgages Ltd, which is managed by a separate Board of Directors comprising Nicholas Johnston (Chairman), Mark Robinson and Nicholas Fielden. The Company became dormant on 1 January 2016.

RELATIONS WITH MEMBERS

Dialogue with members

The Society's members are all customers of the Society. Engagement with customers is undertaken in various ways including social media, regular literature and mainstream media.

The Society is keen to find out its members' views so that it can continually improve. It provides them with a number of ways and opportunities to give their feedback. A dedicated email address (asktheboard@mhbs.co.uk) is promoted, inviting members to engage with the Board. Each enquiry will receive a response and questions and answers shared on the Society's website. The Society surveys a selection of its members on a regular basis through its customer satisfaction survey to provide input into the services and products it offers. The results of this feedback are shared in Board meetings. Members of the Board visit branches and meet with members as part of their role. The Society also encourages its members to attend its annual general meeting where they are able to ask questions and voice their opinions.

Furthermore, each year as part of the AGM documentation, the Society produces a members' magazine called 'Your Society' which provides news about the Society as well as information on its products and services. In addition the Society also sends a copy of its summary financial statement which provides an abridged version of information contained within the Annual Report and Accounts.

Corporate Governance Report (continued)

CONSTRUCTIVE USE OF THE AGM

Each year notice of the AGM is given to all members who are eligible to vote. Members are sent voting forms and are encouraged to vote online, by post, at a local branch or by person or proxy at the AGM.

All postal and proxy votes are counted using independent scrutineers.

All members of the Board are present at the AGM each year (unless, exceptionally, their absence is unavoidable) and the Chairman of the Audit, Nominations, Risk and Remuneration Committees are therefore available to answer questions.

The Notice of the AGM and related papers are sent at least 21 days before the AGM in accordance with the Building Societies Act 1986.

On behalf of the Board of Directors:

Nicholas Johnston

Chairman

19 March 2019

Audit Committee Report

This report explains how the Society applies the principles of the UK Corporate Governance Code April 2016 (the Code) relating to the operation of the Audit Committee and the system of internal control. The report details how the Committee discharged its responsibilities in line with the provisions of the April 2016 version of the Financial Reporting Council's 'Guidance on Audit Committees'. In particular it details the significant issues reviewed and concluded on including the Committee's assessment of those areas on which accounting judgement was exercised. The Audit Committee met five times during 2018 and in addition met with the external and internal auditors without the Executive Directors present.

FINANCIAL AND BUSINESS REPORTING

The Code prescribes that the Board should present a fair, balanced and understandable assessment of the company's position and prospects.

The Directors are responsible for preparing the Annual Report and Accounts. At the request of the Board, the Committee considered whether the 2018 Report and Accounts are fair, balanced and understandable and whether it provided the necessary information for members and other stakeholders to assess the Society's position and performance, business model and strategy. In order to do this, the Committee considered the accounting policies adopted by the Society, the presentation and disclosure of financial information and, in particular, the key judgements made by management.

In evaluating this year's financial reporting process, the Committee noted that members of the Board are involved at an early stage in agreeing the overall tone and content of the Report and Accounts and that members of the Executive Committee and the Board review, comment on and challenge early drafts as part of a robust verification process.

The Committee also paid particular attention during the year to the following matters which are important by virtue of their potential impact on the Society's results, particularly because they involve a high level of complexity, judgement or estimation by management:

Brexit impact

The Committee considered the risks to the Society's business and resources. Modelling of various economic downturns has been carried out to predict the potential impact on loan losses and provisioning. Operational impacts have also been considered such as the availability of skilled resource staff and the impact on suppliers with connections to EEA. The Committee noted that the liability arising from the defined benefit retirement benefits would also be impacted due to the economic impact from Brexit. The Society considered that it was well placed to cope with the potential risks arising from Brexit. More details can be found in the Principal risks and uncertainties on page 5.

Provisioning for loan impairment

The Committee monitored loan impairment provisions by considering key assumptions contained in the Society's provisioning model and the relevant disclosure in the Report and Accounts. In particular, the Committee examined and challenged the assumptions adopted and the impact of the low level of impairment data, and has satisfied itself with the level of impairment provisions made for the mortgage portfolio.

IFRS 9

IFRS 9 became effective from 1 January 2018 and the most significant impact it has had on the Society's accounts was to change the basis of loan impairment provisioning from an incurred loss to an expected credit loss methodology.

A significant project was undertaken during 2017 to develop the modelling and analysis necessary to comply with IFRS 9. This project was led by the Finance Director and the proposed approach was presented to, discussed with, and agreed by the Audit Committee. The IFRS 9 approach taken has been subject to liaising regularly with KPMG who have updated the Audit Committee with their views during the project as to the suitability of the approach to the Society's business model.

The impact of IFRS 9 adoption is covered in note 39 to these Annual Report and Accounts.

Effective Interest Rate

Interest income on the Society's mortgages is measured under the effective interest method. This method includes an estimation of mortgage product lives which is based on observed customer behaviour and management's judgement. The Committee has examined the approach taken including the revised mortgage product lives, and has satisfied itself that the estimates and accounting treatment are appropriate.

Retirement Benefit Liabilities

The Society operates one defined benefit pension scheme. This was closed to future accrual in 2005, however the Society remains responsible for making good the liabilities under the scheme. The scheme is revalued under the requirements of IAS19 each year and the movements in the deficit are reflected in the Group's accounts. The current deficit is £1.4m. The Committee has considered the valuation assumptions used by the Actuary and satisfied itself that these assumptions are appropriate.

Audit Committee Report (continued)

EXTERNAL AUDIT

The Committee considered matters raised during the statutory external audit, through discussion with senior management of the business and the external auditor, and concluded that there were no adjustments required that were material to the financial statements.

In light of its enquiries above, the Committee is satisfied that, taken as a whole, the 2018 Annual Report and Accounts is fair, balanced and understandable and provides a clear and accurate presentation of the Society's position and prospects.

Audit Committee and Auditor

The Code prescribes that the Board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the Society's auditors.

The Audit Committee is responsible for providing oversight of the external audit process by monitoring the relationship with the external auditor, agreeing its remuneration and terms of engagement, and making recommendations to the Board on the appointment, re-appointment or removal of the external auditor as appropriate. As part of the external audit process, KPMG highlights any material control weaknesses that come to its attention.

The Committee is also responsible for monitoring the performance, objectivity and independence of the external auditor, ensuring that the policy to provide non-audit services is appropriately applied. Such services included a collateral and regulatory audit in support of the Society's funding from the Term Funding Scheme. In order to retain independence and objectivity, the Society's policy is to tender for audit services on a regular basis. Both the external and internal audits were put out to tender in October 2014 and presentations from three audit firms were received by a panel consisting of Executive and Non-Executive Directors. As a result of the tender, Deloitte LLP were appointed as internal auditor and KPMG were recommended and subsequently appointed as external auditor at the 2015 AGM. Further to consideration by the Committee, KPMG are recommended as external auditor to the Society at the 2019 AGM.

INTERNAL CONTROLS

The Society recognises the importance of good systems of internal control in the achievement of its objectives and the safeguarding of its assets. Good internal controls also facilitate the effectiveness and efficiency of operations, help to ensure the reliability of internal and external reporting and assist in compliance with applicable laws and regulations.

Management is responsible for designing an appropriate internal control framework whereas the Audit Committee is responsible for ensuring that the Board receives appropriate assurance over the effective operation as well as design of this framework. Consistent with these responsibilities, the Committee undertook the following activities during 2018 to satisfy itself over the robustness of the internal control framework:

- Compliance

  The Society's Compliance function provides second line assurance on activities across the Society. The outputs of Compliance activities are reported to the Committee, together with progress updates on management's implementation of the findings. During the year the Committee approved the Compliance annual plan of work and it also approved an overarching Compliance Approach document setting out how the Compliance function remains independent of the areas it reviews.

- Internal Audit

  The Society's Internal Audit function provides independent assurance to the Board, via the Audit Committee, on the effectiveness of the internal control framework. The information received and considered by the Committee during 2018 provided assurance that there were no material breaches of control and that the Society maintained an adequate internal control framework that met the principles of the UK Corporate Governance Code. The Audit Committee is also responsible for agreeing the annual budget of Internal Audit and for approving its annual risk based plan of work. Internal Audit provides the Committee with reports on its findings and recommendations as well as updates on the progress made by management in addressing these findings, including verification that actions have been accurately reported as complete. The Committee is satisfied that, throughout 2018, Internal Audit had an appropriate level of resource to deliver its plan of work and that it discharged its responsibilities effectively.

Michael Thomas

Chair of the Audit Committee

19 March 2019

Directors' Remuneration Report

This report sets out the Board's policy on the remuneration of directors. The Society has adopted high standards of corporate governance and this includes the provision to its members of full details of directors' remuneration. Members will be asked to vote at the Annual General Meeting on an advisory resolution on the Board's policy on the remuneration of directors.

The Society had a very successful year in 2018, delivering post-tax profits of £3.2m. In addition, the Society's strong capital position was preserved and good progress was made against strategic objectives. The Remuneration Committee has taken these factors into account when considering the appropriateness of remuneration at the Society.

REMUNERATION COMMITTEE

The Remuneration Committee is responsible for determining the remuneration of the Chairman and the salary and other benefits of the executive directors and other senior managers, and makes recommendations to the Board concerning the remuneration of non-executive directors and other staff. The Committee consists of two independent non-executive directors. In 2018 they were Kenneth Piggott (Chair) to 26 April, Jonathan Fox (Chair from 26 April) and Melanie Duke. The Society's Chief Executive and Finance Director comment upon proposals and provide information, as and when required, and attend meetings at the Committee's request.

The Committee's terms of reference were last reviewed and updated in March 2018 and they are available on the Society's website. In making its decisions and recommendations the Committee takes into account all relevant factors, including a review of comparative benefit packages from similar financial organisations. The Committee seeks independent professional advice on director and senior executive pay on a periodic basis. In 2017 it commissioned such advice from Total Reward Solutions. This advice informed its decisions and recommendations for 2017 and 2018.

The Committee supports linking reward to performance. In doing so, it pays close attention to the performance of the Society and the risks to which it is exposed, external market conditions, and its overall responsibility to members within a framework of good corporate governance.

POLICY AIMS AND OBJECTIVES

The Committee's decision-making processes take into account:

- The need to recruit, retain and motivate staff with appropriate skills and experience to make an effective contribution to the Society's strategy and operations, and so to act in the long-term interests of the Society's members;
- The need for a clear and uncomplicated link between performance and remuneration;
- The levels of remuneration, as a reference, for similar jobs within the UK financial services sector;
- The need for pay arrangements not to directly or indirectly expose the Society to inappropriate risk;
- The PRA Rulebook;
- The application of provisions of the FCA's Remuneration Code for dual regulated firms (PRA & FCA regulated); and
- The provisions of the UK Corporate Governance Code insofar as they relate to building societies.

The Society seeks to ensure that its remuneration decisions are in line with its business strategy and long term objectives, and consistent with the Society's current financial condition and future prospects. Incentive schemes take into account the need to retain a strong balance sheet, and variable remuneration amounts will not be paid unless they are sustainable within the Society's situation as a whole. No payments under incentive schemes are guaranteed and all schemes are non-contractual.

CONFLICTS OF INTEREST

The Society seeks to ensure that its remuneration decisions avoid conflicts of interest. The Remuneration Committee is aware of the potential for such conflicts when considering remuneration for directors, and seeks external professional advice where appropriate.

CONTRACTUAL ARRANGEMENTS

The Society will not enter into an employment contract which would compensate any individual for failing to perform his/her duties satisfactorily. Contractual notice periods will not exceed one year, and any contractual entitlement to a termination payment will not exceed twelve months' salary and benefits. Bonus schemes for executive directors and other senior managers make provision for clawback of payments in the event of subsequent determination of wrong doing.

Directors' Remuneration Report (continued)

STATUTORY CONSIDERATIONS

The Society will ensure that its remuneration decisions are in line with statutory requirements, for example, in relation to equal pay and non-discrimination and ensure compliance with regulatory requirements such as the Remuneration Code.

EXECUTIVE DIRECTORS

For executive directors the Society seeks to establish an appropriate balance between the fixed and variable elements of remuneration. The Committee has been mandated by the Board to ensure that fixed remuneration is in line with the market rate for executive directors in similar positions at comparable organisations. Performance appraisals of the executive directors are carried out at least annually to assess their success in meeting individual and corporate objectives.

The Committee has been mandated by the Board to reward exceptional performance through incentive schemes. Awards under the incentive schemes reflect the outcomes of appraisals.

The main components of the executive directors' remuneration are:

- Base salary and core benefits
- Variable remuneration incentive schemes

Base salaries take into account the content and responsibilities of the job, salary levels in comparable organisations and individual performance in the role. The Chief Executive is appraised annually by the Chairman, and the Chief Executive carries out a performance assessment of the Finance Director.

Pension Benefits

The Society contributes to a defined contribution scheme for eligible staff, including executive directors, who may elect to receive this contribution as a pension allowance.

Other Benefits

The Society provides other taxable benefits to executive directors, namely the provision of a car allowance and private medical insurance.

Neither of the executive directors has a contractual notice period which exceeds one year, or a contractual entitlement to a termination payment which would exceed twelve months' salary and benefits.

Variable Remuneration

In considering the targets for both the annual and the long term incentive schemes, the Remuneration Committee will have regard to the goals set by the Board in the Society's three-year Corporate Plan. None of the incentive payments are pensionable.

Annual Incentive Scheme

Annual incentives are paid in cash on the achievement of key targets which will be of benefit to the Society and its members, and which take into account individual performance. The structure of the scheme is approved by the Remuneration Committee at the beginning of each financial year. The rewards for 2018 were based on the Society meeting its business performance targets and the personal performance of the individual (including a component relating to compliance with regulatory matters). The scheme was subject to a cap of 20% of base salary (excluding allowances).

Long Term Incentive Scheme

Long term incentive schemes are set annually, based on performance over a three year period as measured against pre-determined business objectives. The structure of each new three-year scheme is approved by the Remuneration Committee at the commencement of the period to which it relates.

Currently the schemes include targets for growth and mix of mortgage assets, profitability and the achievement of strategic objectives (including stakeholder satisfaction). The schemes are capped at 10% of base salary (excluding allowances).

Directors' Remuneration Report (continued)

EXECUTIVE DIRECTORS (CONTINUED)

Executive Directors' Remuneration

The emoluments below represent audited information.

2018 All figures £	Salary	Benefits	Performance pay annual incentive scheme	Performance pay long-term incentive scheme	Pension Allowance[1]	Total
Mark Robinson	182,708	2,077	30,299	16,341	24,224	**255,649**
Nicholas Fielden	147,210	1,428	24,350	13,133	16,207	**202,328**
Total	**329,918**	**3,505**	**54,649**	**29,474**	**40,431**	**457,977**

2017 All figures £	Salary	Benefits	Performance pay annual incentive scheme	Performance pay long-term incentive scheme	Pension Allowance[1]	Total
Mark Robinson	176,048	15,283	28,802	12,552	25,602	258,287
Nicholas Fielden	143,984	642	25,719	10,087	15,850	196,282
Total	**320,032**	**15,925**	**54,521**	**22,639**	**41,452**	**454,569**

[1]Pension Allowance includes both contributions paid to the Society's defined contributory pension scheme and cash payments in lieu of contributions.

The benefits received by Executive Directors relate to private medical insurance and, in 2017, to the provision of a company car. The Executive Directors now receive a car allowance included in their salary as reported above; Mark Robinson 2018: £14,657 (2017:£9,680), Nicholas Fielden 2018: £12,155 (2017:£11,888). Only base salaries are pensionable. No pension is payable on benefits or allowances.

NON-EXECUTIVE DIRECTORS

The Board aims to ensure that fees are in line with the amount paid to non-executive directors in similar positions at comparable organisations. The Remuneration Committee makes recommendations to the full Board in respect of any changes to the remuneration of non-executive directors. As is conventional, additional fees are paid to the Chairs of the Assets and Liabilities Committee, Audit and Compliance Committee, Risk Committee and Remuneration Committee, in recognition of the additional workload and responsibility.

Non-executive directors' remuneration does not include any bonus payments, pension or other benefits. Non-executive directors do not have service contracts providing for notice periods which exceed three months; neither do they have any contractual entitlement to termination payments. Their effectiveness is appraised annually by the Chairman, and the Board as a whole, under the leadership of the Vice-Chairman, assesses the Chairman's performance.

Directors' Remuneration Report (continued)

NON EXECUTIVE DIRECTORS (CONTINUED)

Non-Executive Directors' Remuneration

Directors' fees **All figures £**	**2018**	**2017**
Nicholas Johnston – as Chairman	41,331	40,509
Kenneth Piggott – as Vice Chairman, Senior Independent Director and Chair of Remuneration Committee to 26 April 2018	11,530	34,052
Melanie Duke – as Chair of Assets and Liabilities Committee *and as Vice Chairman and Senior Independent Director (from 27 April 2018)*	30,505	25,165
Brian Brodie from 1 January 2018 to 3 May 2018	8,415	0
Jonathan Fox *- and as Chair of Remuneration Committee (from 27 April 2018)*	26,428	23,796
Alison Littley from 1 January 2018 to 30 September 2018	16,836	0
Andrew Merrick from 1 January 2018	24,811	0
Zoe Shapiro - as Chair of Risk Committee	27,505	26,965
Michael Thomas – as Chair of Audit and Compliance Committee	27,505	26,965
Total	**214,866**	**177,452**

Fees include amounts paid to the Chairs of the Assets and Liabilities Committee, Audit and Compliance Committee, Risk Committee and Remuneration Committee of £3,250 in 2018 and £3,175 in 2017. A taxable annual travel allowance of £1,800 / £2,400 was paid to non-executive directors travelling more than 35 / 80 miles to meetings at the Society, which is included in the fees above.

Jonathan Fox

Chair of Remuneration Committee

19 March 2019

KPMG

Independent auditor's report

to the members of Market Harborough Building Society

1. Our opinion is unmodified

We have audited the Group and Society annual accounts of Market Harborough Building Society for the year ended 31 December 2018 which comprise the Statement of Comprehensive Income, Group and Society Statement of Financial Position, Statement of Changes in Members' Interests and Group and Society Cash Flow Statement, and the related notes, including the accounting policies in note 1.

In our opinion the annual accounts:

- give a true and fair view of the state of affairs of the Group and of the Society as at 31 December 2018 and of the income and expenditure of the Group and of the Society for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Building Societies Act 1986 and regulations made under it.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the audit committee.

We were appointed as auditor by the members in April 2015. The period of total uninterrupted engagement is for the 4 financial years ended 31 December 2018.

We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard applicable to public interest entities. No non-audit services prohibited by that standard were provided.

Overview	
Materiality: Group annual accounts as a whole	£196,000 (2017: £150,000) 4.7% (2017: 4.5%) of profit before tax
Coverage	100% (2017: 100% of group profit before tax)

Risks of material misstatement		vs 2017
Other matter	The impact of uncertainties due to Britain exiting the European Union on our audit	▲
New Risk	Defined benefit pension obligation	▲
Recurring risks	Impairment losses on loans and advances to customers	◀▶
	Income recognition (EIR)	◀▶

2. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgment, were of most significance in the audit of the annual accounts and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including 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. We summarise below the key audit matters, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the annual accounts as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

We assessed the key audit matters of the Society and the Group to be the same.

Key audit matter	The risk	Our response
The impact of uncertainties due to Britain exiting the European Union on our audit *Refer to page 7, (Directors Report) and page 17 (Audit Committee Report).*	**Unprecedented levels of uncertainty** All audits assess and challenge the reasonableness of estimates, in particular as described in impairment of loans and advances to customers, interest receivable on loans, income recognition (Effective interest rate, 'EIR') and Defined benefit pension obligation, below, and related disclosures and the appropriateness of the going concern basis of preparation of the annual accounts. All of these depend on assessments of the future economic environment and the Group's future prospects and performance. Brexit is one of the most significant economic events for the UK and at the date of this report its effects are subject to unprecedented levels of uncertainty of outcomes, with the full range of possible effects unknown.	We developed a standardised firm-wide approach to the consideration of the uncertainties arising from Brexit in planning and performing our audits. Our procedures included: — **Our Brexit knowledge** – We considered the directors' assessment of Brexit-related sources of risk for the Group's business and financial resources compared with our own understanding of the risks. We considered the directors' plans to take action to mitigate the risks. — **Sensitivity analysis** – When addressing impairment of loans and advances to customers, interest receivable on loans, income recognition (Effective interest rate, 'EIR'), Defined benefit pension obligation and other areas that depend on forecasts, we compared the directors' sensitivity analysis to our assessment of the worst reasonably possible, known adverse scenario resulting from Brexit uncertainty. — **Assessing transparency** – As well as assessing individual disclosures as part of our procedures on impairment of loans and advances to customers, interest receivable on loans, income recognition (Effective interest rate, 'EIR') and Defined benefit pension obligation, we considered all of the Brexit related disclosures together, including those in the directors' report, comparing the overall picture against our understanding of the risks. **Our results** As reported under impairment of loans and advances to customers, interest receivable on loans, income recognition (Effective interest rate, 'EIR') and Defined benefit pension obligation, we found the resulting estimates and related disclosures of sensitivity and disclosures in relation to going concern to be acceptable. However, no audit should be expected to predict the unknowable factors or all possible future implications for a Group and this is particularly the case in relation to Brexit.

Key audit matter	The risk	Our response
Impairment losses on loans and advances to customers (£643,000; 2017: £910,000) *Refer to page 17 (Audit Committee Report), page 35 (accounting policy) and page 39 (accounting estimate and judgement)*	**Subjective estimate** IFRS 9 was implemented by the Society on 1 January 2018. The calculation of credit provisions in line with IFRS 9 is an inherently judgemental area within the financial statements and there is a risk that the key assumption used for calculating impairment provisions may not be supported by robust and objective evidence, or may be out of line with wider industry experience, or not reflective of external conditions. Under IFRS 9 the staging criteria used to define whether an asset has been subject to a Significant Increase in Credit Risk ('SICR') drive whether an asset requires a 12 month or lifetime expected credit loss ('ECL'). We have therefore determined the staging criteria to be the key assumption and have identified a significant risk over the appropriateness of the staging criteria determined by the Society and the application of these to assets within the ECL calculation.	Our procedures included: — **Tests of detail**: We assessed the staging criteria used by the Society to determine SICR and the application of that criteria to the loan book. We tested, on a sample basis, that assets were included in the correct staging bucket within the model. We assessed whether the Excel model performs the impairment calculation as designed, by testing the integrity of the model. — **Benchmarking assumptions:** We compared the loan portfolio key metrics, including arrears trends and provision coverage with those of comparable lenders and challenged these using our knowledge of recent impairment experience in this industry. — **Assessing transparency**: We assessed the adequacy of the Group's disclosures in respect of the degree of estimation involved in arriving at the provision. **Our results** — We found the resulting estimate of impairment losses on loans and advances to customers to be acceptable (2017: result acceptable).
Defined benefit pension obligation (Group: £10,3m (gross liability); 2017: £11.0m (gross liability)) *Refer to page 17 (Audit Committee Report), page 35 (accounting policy) and page 59 (financial disclosures).*	**Subjective valuation** The Society operates a defined benefit pension scheme which has been closed to new members for several years. At year-end, the Society holds a net defined benefit pension scheme liability on the statement of financial position, which includes gross pension obligations. Small changes in the assumptions and estimates used to value the Society's pension obligation (before deducting scheme assets) would have a significant effect on the Society's net defined benefit obligation. The effect of these matters is that, as part of our risk assessment, we determined that the defined benefit obligation has a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the annual accounts as a whole. The annual accounts (note 25) disclose the sensitivity estimated by the Society.	Our procedures included: — **Evaluation of actuary:** We evaluated the competence, independence and objectivity of the Society's actuary in assessing management's reliance upon their expert valuation services. — **Benchmarking assumptions:** Challenging, with the support of our own actuarial specialists, the key assumptions applied in calculating the defined benefit pension liability, being the discount rate, inflation rate mortality/life expectancy and the impact of GMP equalisation, against externally derived data; and — **Assessing transparency:** Considering the adequacy of the group's disclosures in respect of the sensitivity of the deficit to these assumptions. **Our results** — We found the resulting defined benefit pension obligation to be acceptable (2017: acceptable).

Key audit matter	The risk	Our response
Income recognition (Effective interest rate, 'EIR') Balance sheet liability £449k (2017: £566k); *Refer to page 17 (Audit Committee Report), page 35 (accounting policy) and page 39 (accounting estimate and judgement).*	**Subjective estimate** Accounting standards require interest receivable on loans and advances to customers to be recognised using the effective interest rate ('EIR') method. This results in all directly attributable interest, fees and costs being recognised on an even yield basis over the expected life of the loans. Using an Excel based model, interest earned and fees earned and incurred on loans are recognised using the effective interest rate ('EIR') method that spreads directly attributable expected cash flows over the expected lives of the loans. The directors apply judgement in deciding and assessing the expected repayment profiles used to determine the EIR period. The most critical element of judgement in this area is the estimation of the future redemption profiles of the loans. This is informed by product mix and past customer behaviour of when loans are repaid. In addition, the directors apply judgement in determining whether or not fees and costs, including early redemption charges, should be included in the methodology.	Our procedures included: — **Historical comparison:** We assessed the reasonableness of the expected repayment profile assumptions against historical experience of loan lives based on customer behaviour, product mix and recent performance. — **Sensitivity analysis:** We assessed the model for its sensitivities to changes in the key assumptions by considering alternative behavioural lives to help us assess the criticality of the assumptions used and identify areas for potential audit focus. — **Tests of detail:** We assessed the mathematical accuracy of models through reperformance of the model calculations, and checked the effective interest rates used within the monthly calculations agrees to the models. We assessed whether the Excel model performs the EIR calculation as designed, by testing the integrity of the model. Through inspection the Society's product literature and general ledger, we challenged the fees and costs included or excluded from the EIR estimates, including early redemption charges. — **Assessing transparency:** We assessed the adequacy of the Group's disclosures about the degree of estimation involved in arriving at the interest income recognised. **Our results** — We found the resulting income recognised under the Income recognition (Effective interest rate, 'EIR') to be acceptable (2017: acceptable).

3. Our application of materiality and an overview of the scope of our audit

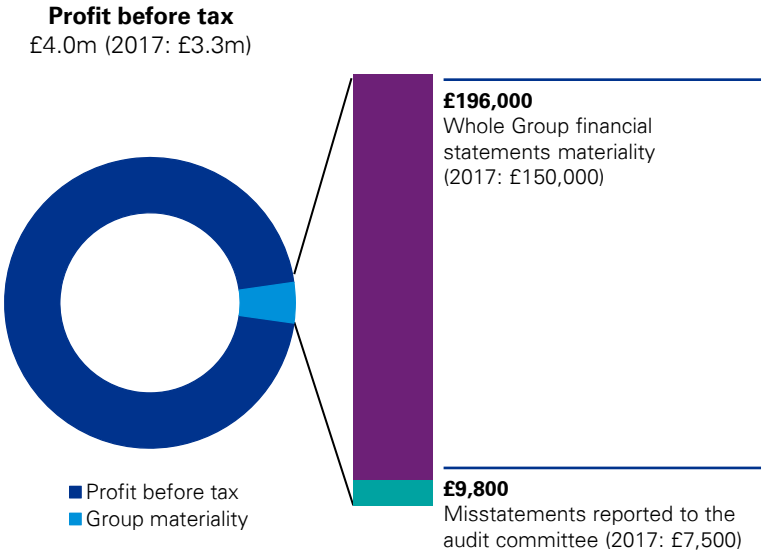
Materiality

Materiality for the annual accounts as a whole was set at £196,000 (2017: £150,000), determined with reference to a benchmark of Profit before Tax of £4.0m (2017: £3.3m), of which it represents 4.7% (2017: 4.5%).

We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £9,800 (2017: £7,500), in addition to other identified misstatements that warranted reporting on qualitative grounds.

Materiality for the Society annual accounts as a whole was set at the same level as the Group.

Our audit of the Group was undertaken to the materiality level specified above, on 100% of the Group's results, and was all performed at the Society's head office in Market Harborough.



4. We have nothing to report on going concern

The directors have prepared the annual accounts on the going concern basis as they do not intend to liquidate the Group and Society or to cease their operations, and as they have concluded that the Group and Society's financial position means that this is realistic. They have also concluded that there are no material uncertainties that could have cast significant doubt over its ability to continue as a going concern for at least a year from the date of approval of the annual accounts ("the going concern period").

Our responsibility is to conclude on the appropriateness of the directors' conclusions and, had there been a material uncertainty related to going concern, to make reference to that in this audit report. However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the absence of reference to a material uncertainty in this auditor's report is not a guarantee that the Group and the Society will continue in operation.

In our evaluation of the directors' conclusions, we considered the inherent risks to the Group and Society's business model and analysed how those risks might affect the Group and Society's financial resources or ability to continue operations over the going concern period. The risk that we considered most likely to adversely affect the Group and Society's available financial resources over this period was the impact of Brexit on the Society's liquidity and capital resources.

As these were risks that could potentially cast significant doubt on the Group and Society's ability to continue as a going concern, we considered sensitivities over the level of available financial resources indicated by the Group and Society's financial forecasts taking account of reasonably possible (but not unrealistic) adverse effects that could arise from these risks individually and collectively and evaluated the achievability of the actions the directors consider they would take to improve the position should the risks materialise.

Based on this work, we are required to report to you if we have anything material to add or draw attention to in relation to the directors' statement in Note 1 to the annual accounts on the use of the going concern basis of accounting with no material uncertainties that may cast significant doubt over the Group and Society's use of that basis for a period of at least twelve months from the date of approval of the annual accounts.

We have nothing to report in these respects, and we did not identify going concern as a key audit matter.

5. We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the annual accounts. Our opinion on the annual accounts does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our annual accounts audit work, the information therein is materially misstated or inconsistent with the annual accounts or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

Annual Business Statement and Directors' Report

In our opinion:

- the Annual Business Statement and the Directors' Report have each been prepared in accordance with the applicable requirements of the Building Societies Act 1986 and regulations thereunder;
- the information given in the Directors' Report for the financial year is consistent with the accounting records and the annual accounts; 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.

6. We have nothing to report on the other matters on which we are required to report by exception

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 Group,
- the annual accounts are not in agreement with the accounting records and returns; 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 these respects.

7. Respective responsibilities

Directors' responsibilities

As explained more fully in their statement set out on page 12, the directors are responsible for: the preparation of the annual accounts including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of annual accounts that are free from material misstatement, whether due to fraud or error; assessing the Group and 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 they 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

Our objectives are to obtain reasonable assurance about whether the annual accounts as a whole are free from material misstatement, whether due to fraud, other irregularities (see below), or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the annual accounts.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

Irregularities – ability to detect

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the annual accounts from our general commercial and sector experience, through discussion with the directors (as required by auditing standards), and from inspection of the Group and Society's regulatory correspondence and discussed with the directors the policies and procedures regarding compliance with laws and regulations. We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit. The potential effect of these laws and regulations on the annual accounts varies considerably.

Firstly, the Group and Society are subject to laws and regulations that directly affect the annual accounts including financial reporting legislation (including related Building Society legislation) and taxation legislation, and we assessed the extent of compliance with these laws and regulations as part of our procedures on the related annual account items.

Secondly, the Group and Society are subject to many other laws and regulations where the consequences of non-compliance could have a material effect on amounts or disclosures in the annual accounts, for instance through the imposition of fines or litigation or the loss of the Group or Society's licence to operate. We identified the following areas as those most likely to have such an effect: regulatory capital and liquidity and certain aspects of building society legislation recognising the financial and regulated nature of the Group and Society's activities.

Auditing standards limit the required audit procedures to identify non-compliance with these laws and regulations to enquiry of the directors and inspection of regulatory and legal correspondence, if any.

These limited procedures did not identify actual or suspected non-compliance.

Owing to the inherent limitations of an audit, there is an unavoidable risk that we may not have detected some material misstatements in the annual accounts, even though we have properly planned and performed our audit in accordance with auditing standards. For example, the further removed non-compliance with laws and regulations (irregularities) is from the events and transactions reflected in the annual accounts, the less likely the inherently limited procedures required by auditing standards would identify it. In addition, as with any audit, there remained a higher risk of non-detection of irregularities, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls. We are not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

8. The purpose of our audit work and to whom we owe our responsibilities

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.

Simon Clark
(Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
One Snowhill
Snow Hill Queensway
Birmingham
B4 6GH
19 March 2019

Income Statements

For the year ended 31 December 2018 All figures £'000	Note	2018 Group	2017 Group	2018 Society	2017 Society
Interest income calculated using the effective interest method	4	15,085	14,110	15,085	14,110
Interest payable and similar charges	5	(4,193)	(4,086)	(4,193)	(4,086)
Net Interest Income		**10,892**	**10,024**	**10,892**	**10,024**
Fees and commissions receivable		297	265	297	265
Fees and commissions payable		(100)	(148)	(100)	(148)
Other operating income		13	9	13	9
Net gains from derivative financial instruments	6	14	12	14	12
Total Net Income		**11,116**	**10,162**	**11,116**	**10,162**
Administrative expenses	7	(6,529)	(6,623)	(6,529)	(6,623)
Depreciation and amortisation	17,18	(382)	(305)	(382)	(305)
Other operating charges		(12)	(50)	(12)	(50)
Other finance cost	25	(207)	(47)	(207)	(47)
Operating Profit		**3,986**	**3,137**	**3,986**	**3,137**
Impairment losses on loans and advances		11	228	11	228
Provision for liabilities – FSCS levy	24	11	(29)	11	(29)
Profit Before Tax		**4,008**	**3,336**	**4,008**	**3,336**
Tax on profit on ordinary activities	11	(811)	(655)	(811)	(655)
Profit For The Financial Year		**3,197**	**2,681**	**3,197**	**2,681**

IFRS9 became effective from 1 January 2018 and does not require the restatement of comparatives. The numbers presented above are reported under IFRS9 for 2018 and under IAS39 for 2017.

The notes on pages 35 to 88 form part of these Annual Report and Accounts.

All of the above arise from continuing operations.

All of the above arose in the UK.

Statement of Comprehensive Income

For the year ended 31 December 2018 All figures £'000	Note	2018 Group	2017 Group	2018 Society	2017 Society
Profit For The Financial Year		**3,197**	**2,681**	**3,197**	**2,681**
Items that will not be reclassified to the income statement					
Re-measurement of defined benefit obligation	25	186	222	186	222
Tax on items that will not be reclassified to the income statement		(28)	(28)	(28)	(28)
Other comprehensive income for the period net of income tax		**158**	**194**	**158**	**194**
Total Comprehensive Income For The Period		**3,355**	**2,875**	**3,355**	**2,875**

The notes on pages 35 to 88 form part of these Annual Report and Accounts.

Statement of Financial Position

As at 31 December 2018 All figures £'000	Note	2018 Group	2017 Group	2018 Society	2017 Society
Cash in hand and balances at central banks		48,681	25,485	48,681	25,485
Loans and advances to credit institutions	12	6,379	5,372	6,379	5,372
Derivative financial instruments	13	230	166	230	166
Loans and advances to customers	14	411,125	389,809	411,125	389,809
Other assets	16	432	436	432	436
Property, plant and equipment	17	1,697	1,827	1,697	1,827
Intangible assets	18	118	229	118	229
Deferred tax asset	19	371	470	371	470
Total Assets		**469,033**	**423,794**	**469,033**	**423,794**
Shares	20	340,246	319,465	340,246	319,465
Amounts owed to credit institutions	21	45,130	25,044	45,130	25,044
Amounts owed to other customers	22	40,887	40,022	40,887	40,022
Derivative financial instruments	13	97	116	97	116
Other liabilities and accruals	23	753	751	1,938	1,936
Current tax liabilities		408	285	408	285
Provisions for liabilities and charges	24	6	30	6	30
Retirement benefit liabilities	25	1,429	1,569	1,429	1,569
Total Liabilities		**428,956**	**387,282**	**430,141**	**388,467**
General reserve	26	40,077	36,512	38,892	35,327
Total Reserves		**40,077**	**36,512**	**38,892**	**35,327**
Total Reserves and Liabilities		**469,033**	**423,794**	**469,033**	**423,794**

IFRS9 became effective from 1 January 2018 and does not require the restatement of comparatives. The numbers presented above are reported under IFRS9 for 2018 and under IAS39 for 2017.

The notes on pages 35 to 88 form part of these Annual Report and Accounts.

Approved by the Board of Directors on 19 March 2019, and signed on its behalf by:

Nicholas Johnston — **Chairman**

Mark Robinson — **Chief Executive**

Statement of Changes in Members' Interests

Group 2018 All figures £'000	General reserve	Total
Balance at 31 December 2017	36,512	36,512
Impact of initial recognition of IFRS 9	260	260
Deferred tax element of initial recognition of IFRS 9	(50)	(50)
Balance at 1 January 2018	**36,722**	**36,722**
Profit for the year	3,197	3,197
Other comprehensive income for the year (net of tax)		
Re-measurement of defined benefit obligation	158	158
Total Other Comprehensive Income	**158**	**158**
Total comprehensive income	**3,355**	**3,355**
Balance At 31 December 2018	**40,077**	**40,077**

Society 2018 All figures £'000	General reserve	Total
Balance at 31 December 2017	35,327	35,327
Impact of initial recognition of IFRS 9	260	260
Deferred tax element of initial recognition of IFRS 9	(50)	(50)
Balance at 1 January 2018	**35,537**	**35,537**
Profit for the year	3,197	3,197
Other comprehensive income for the year (net of tax)		
Re-measurement of defined benefit obligation	158	158
Total Other Comprehensive Income	**158**	**158**
Total comprehensive income	**3,355**	**3,355**
Balance At 31 December 2018	**38,892**	**38,892**

Statement of Changes in Members' Interests (continued)

Group 2017 **All figures £'000**	**General reserves**	**Total**
Balance at 1 January 2017	33,637	33,637
Profit for the year	2,681	2,681
Other comprehensive income for the year (net of tax)		
Re-measurement of defined benefit obligation	194	194
Total other comprehensive income	**194**	**194**
Total other comprehensive income for the period	**2,875**	**2,875**
Balance At 31 December 2017	**36,512**	**36,512**

Society 2017 **All figures £'000**	**General reserves**	**Total**
Balance at 1 January 2017	32,452	32,452
Profit for the year	2,681	2,681
Other comprehensive income for the year (net of tax)		
Re-measurement of defined benefit obligation	194	194
Total other comprehensive income	**194**	**194**
Total other comprehensive income for the period	**2,875**	**2,875**
Balance At 31 December 2017	**35,327**	**35,327**

The notes on pages 35 to 88 form part of these Annual Report and Accounts.

Cash Flow Statement

For the year ended 31 December 2018 All figures £'000	Note	2018 Group	2017 Group	2018 Society	2017 Society
Profit before tax		4,008	3,336	4,008	3,336
Depreciation and amortisation		382	305	382	305
Loss/(profit) on disposal of property, plant and equipment		0	(6)	0	(6)
Fair value gain on derivative instruments		(14)	(12)	(14)	(12)
(Decrease)/increase in impairment of loans and advances		(7)	(210)	(7)	(210)
Total Cash Flows From Operating Activities		**4,369**	**3,413**	**4,369**	**3,413**
Decrease /(increase) in other assets		(2)	103	(2)	103
(Decrease)/increase in other liabilities		42	(273)	42	(273)
(Increase) in loans and advances to customers		(21,137)	(22,792)	(21,137)	(22,792)
(Decrease)/increase in shares		20,822	(25,614)	20,822	(25,614)
Increase/(decrease) with other credit institutions		20,000	25,000	20,000	25,000
Increase with other customers		866	4,665	866	4,665
(Decrease) in retirement benefit obligation		46	(114)	46	(114)
Taxation paid		(667)	(611)	(667)	(611)
Net Cash Generated From Operating Activities		**24,339**	**(16,223)**	**24,339**	**(16,223)**
Proceeds from disposal of property, plant and equipment		7	49	7	49
Purchase of property, plant and equipment		(122)	(68)	(122)	(68)
Purchase of intangible assets		(26)	(33)	(26)	(33)
Net Cash Generated From Investing Activities		**(141)**	**(52)**	**(141)**	**(52)**
Net Cash Generated From Financing Activities		**0**	**0**	**0**	**0**
Net Change In Cash Or Cash Equivalents		**24,198**	**(16,275)**	**24,198**	**(16,275)**
Cash and cash equivalents at 1 January		**30,852**	**47,127**	**30,852**	**47,127**
Cash And Cash Equivalents At 31 December	27	**55,050**	**30,852**	**55,050**	**30,852**

The notes on pages 35 to 88 form part of these Annual Report and Accounts.

Notes to the Annual Report and Accounts

1. PRINCIPAL ACCOUNTING POLICIES

The principal accounting policies adopted in the preparation of these Annual Report and Accounts are set out below.

Basis of accounting

Both the Society and Group annual accounts are prepared and approved by the directors in accordance with IFRS as adopted by the EU and those parts of the Building Societies Act 1986 and Building Societies (Accounts and Related Provisions) Regulations 1998 applicable to societies reporting under IFRS.

This is the first set of the Group's annual financial statements in which IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers have been applied. Changes to significant accounting policies are below.

The directors have prepared forecasts of the Society's financial position for the period ending twelve months from the date of approval of these Annual Report and Accounts. They have also considered the effect on the Society's business of operating under stressed but plausible operating conditions. As a result they are satisfied that the Society and the Group have adequate resources to continue in business for the foreseeable future. For this reason, the Annual Report and Accounts continue to be prepared on a going concern basis.

The directors have considered the impacts of the UK leaving the EEA and have concluded that this would not impact the going concern basis under which these accounts have been prepared.

The accounting policies for the Group also include those for the Society unless otherwise stated.

Use of judgements and estimates

In preparing these consolidated financial statements, management has made judgements and estimates that affect the application of the Group's accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and judgements are reviewed on an ongoing basis. Revisions to estimates are recognised prospectively.

Judgements

Information about judgements made in applying accounting policies that have the most significant effects on the amounts recognised in the consolidated financial statements applicable to 2018 only are included in:

- Note 14: loans and advances to customers – the assessment of the expected life of mortgages will change the timescale over which interest income is released and thus impact the gross carrying value of the mortgages.
- Note 28: classification of financial assets - the assessment of the business model within which the assets are held and assessment of whether the contractual terms of the financial asset are solely payments of principal and interest (SPPI) on the principal amount outstanding.
- Note 31: establishing the criteria for determining whether credit risk on the financial asset has increased significantly since initial recognition, determining methodology for incorporating forward-looking information into measurement of expected credit loss (ECL) and selection and approval of models used to measure ECL.

Assumptions and estimation uncertainties

Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment in the year ended 31 December 2018 is included in the following note:

- Note 31: impairment of financial instruments: determining inputs into the ECL measurement model, including incorporation of forward-looking information.

Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment in the years ended 31 December 2018 and 31 December 2017 is included in the following notes:

- Note 13: determination of the fair value of financial instruments with significant unobservable inputs.
- Note 25: measurement of defined benefit obligations: key actuarial assumptions.
- Note 19: recognition of deferred tax assets: availability of future taxable profit against which carry-forward tax losses can be used.
- Note 31: impairment of financial instruments: key assumptions used in estimating recoverable cash flows.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Changes in accounting policies

The Group has adopted IFRS 9 and IFRS 15 from 1 January 2018. Also, the Group early adopted Prepayment Features with Negative Compensation (Amendments to IFRS 9), issued in October 2017. A number of other new standards are also effective from 1 January 2018 but they do not have a material effect on the Group's financial statements.

Due to the transition method chosen by the Group in applying IFRS 9, comparative information throughout these financial statements has not been restated to reflect its requirements.

The adoption of IFRS 15 did not impact the timing or amount of fee and commission income from contracts with customers and the related assets and liabilities recognised by the Group. Accordingly, the impact on the comparative information is limited to new disclosure requirements.

The effect of initially applying these standards is mainly attributed to the following:

- Impairment losses recognised on financial assets (see Note 14); and
- Disclosures related to IFRS 7 (see Notes 14, 28, 31 and 39);

Except for the changes below, the Group has consistently applied the accounting policies as set out in Note 1 to all periods presented in these consolidated financial statements.

IFRS 9 Financial Instruments

IFRS 9 sets out requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This standard replaces IAS 39 Financial Instruments: Recognition and Measurement. The requirements of IFRS 9 represent a significant change from IAS 39. The new standard brings fundamental changes to the accounting for financial assets and to certain aspects of the accounting for financial liabilities.

As permitted by IFRS 9, the Group has elected to continue to apply the hedge accounting requirements of IAS 39.

As a result of the adoption of IFRS 9, the Group has adopted consequential amendments to IAS 1 Presentation of Financial Statements, which require separate presentation in the statement of profit or loss and OCI of interest revenue calculated using the effective interest method. Previously, the Group disclosed this amount in the notes to the financial statements.

Additionally, the Group has adopted consequential amendments to IFRS 7 Financial Instruments: Disclosures that are applied to disclosures about 2018, but have not been applied to the comparative information.

The key changes to the Group's accounting policies resulting from its adoption of IFRS 9 are summarised below. The full impact of adopting the standard is set out in Note 39.

IFRS 9 Classification of financial assets and financial liabilities

IFRS 9 contains three principal classification categories for financial assets: measured at amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). IFRS 9 classification is generally based on the business model in which a financial asset is managed and on its contractual cash flows. The standard eliminates the previous IAS 39 categories of held-to-maturity, loans and receivables and available-for-sale. For an explanation of how the Group classifies financial assets under IFRS 9, see Note 28.

IFRS 9 largely retains the existing requirements in IAS 39 for the classification of financial liabilities. However, although under IAS 39 all fair value changes of liabilities designated under the fair value option were recognised in profit or loss, under IFRS 9 fair value changes are generally presented as follows:

- the amount of change in the fair value that is attributable to changes in the credit risk of the liability is presented in OCI; and
- the remaining amount of change in the fair value is presented in profit or loss.

For an explanation of how the Group classifies financial liabilities under IFRS 9, see Note 28

IFRS 9 Impairment of financial assets

IFRS 9 replaces the 'incurred loss' model in IAS 39 with an 'expected credit loss' model. The new impairment model also applies to certain loan commitments and financial guarantee contracts but not to equity investments.

Under IFRS 9, credit losses are recognised earlier than under IAS 39. For an explanation of how the Group applies the impairment requirements of IFRS 9, see 'Financial Assets and Liabilities' below.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

IFRS 9 Transition

Changes in accounting policies resulting from the adoption of IFRS 9 have been applied retrospectively, except as described below.

- Comparative periods have not been restated. Differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9 are recognised in retained earnings and reserves as at 1 January 2018. Accordingly, the information presented for 2017 does not reflect the requirements of IFRS 9 and therefore is not comparable to the information presented for 2018 under IFRS 9.

  The Group used the exemption not to restate comparative periods but considering that the amendments made by IFRS 9 to IAS 1 introduced the requirement to present 'interest income calculated using the effective interest rate' as a separate line item in the statement of profit or loss and changed the description of the line item from 'interest income' reported in 2017 to 'interest income calculated using the effective interest method'.

- The following assessments have been made on the basis of the facts and circumstances that existed at the date of initial application.
  - The determination of the business model within which a financial asset is held.

For more information and details on the changes and implications resulting from the adoption of IFRS 9, see Note 39.

IFRS 15 Revenue from Contracts with Customers

IFRS 15 establishes a comprehensive framework for determining whether, how much and when revenue is recognised. It replaced IAS 18 Revenue, IAS 11 Construction Contracts and related interpretations.

The Group initially applied IFRS 15 on 1 January 2018 retrospectively in accordance with IAS 8 without any practical expedients. The timing or amount of the Group's fee and commission income from contracts with customers was not impacted by the adoption of IFRS 15.

Basis of consolidation

Subsidiary companies are defined as those in which the Society has the power over relevant activities, has exposure to the rights of variable returns and has the influence to affect those returns. Subsidiaries are fully consolidated from the date on which control is transferred to the Group and de-consolidated from the date that control ceases. The Group accounts consolidate the assets, liabilities and results of the Society and of its subsidiary, eliminating intercompany balances and transactions. All entities have accounting periods ending on 31 December.

The results of subsidiary undertakings acquired or disposed of during the year are included in the income statements from the effective date of acquisition or up to the effective date that ownership ceases. The Society has one subsidiary company which remained dormant throughout the financial period; no acquisitions or disposals were made during 2018.

Interest

Effective interest rate

Interest income and expense are recognised in profit or loss using the effective interest method. The 'effective interest rate' is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the gross carrying amount of the financial asset.

When calculating the effective interest rate for financial instruments, the Group estimates future cash flows considering all contractual terms of the financial instrument, but not ECL.

The calculation of the effective interest rate includes transaction costs and fees and charges paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

In calculating interest income and expense, the effective interest rate is applied to the gross carrying amount of the asset (when the asset is not credit-impaired) or to the amortised cost of the liability. The effective interest rate is revised as a result of periodic re-estimation of cash flows of floating rate instruments to reflect movements in market rates of interest. The effective interest rate is also revised for fair value hedge adjustments at the date amortisation of the hedge adjustment begins.

However, for financial assets that have become credit-impaired subsequent to initial recognition, interest income is calculated by applying the effective interest rate to the amortised cost less the expected credit loss of the financial asset. If the asset is no longer credit-impaired, then the calculation of interest income reverts to the gross basis.

For financial assets that were credit-impaired on initial recognition, interest income is calculated by applying the credit-adjusted effective interest rate to the amortised cost of the asset. The calculation of interest income does not revert to a gross basis, even if the credit risk of the asset improves.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Fees and commission

Fee and commission income and expense that are integral to the effective interest rate on a financial asset or financial liability are included in the effective interest rate.

Other fee and commission income – including account servicing fees, commission relating to the sale of third party products, placement fees and syndication fees – is recognised as the related services are performed. If a loan commitment is not expected to result in the draw-down of a loan, then the related loan commitment fee is recognised in the income statement.

A contract with a customer that results in a recognised financial instrument in the Group's financial statements may be partially in the scope of IFRS 9 and partially in the scope of IFRS 15. If this is the case, then the Group first applies IFRS 9 to separate and measure the part of the contract that is in the scope of IFRS 9 and then applies IFRS 15 to the residual.

Other fee and commission expenses relate mainly to transaction and service fees, which are expensed as the services are received.

Leases

The leases entered into by the Group are operating leases. The rental charges payable under operating leases are charged to the income statement on a straight-line basis over the life of the lease.

Taxation

Income Tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in other comprehensive income, in which case it is recognised in other comprehensive income.

Current Tax

Current tax is the expected tax payable on the taxable income and gains arising in the accounting period.

Deferred Tax

Deferred tax is provided using the statement of financial position liability method, providing for temporary differences between the carrying amount of assets and liabilities for accounting purposes and the amounts used for taxation purposes.

Deferred tax assets and liabilities are recognised gross on the statement of financial position and deferred tax assets are only recognised where it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Both current and deferred taxes are determined using the rates enacted or substantively enacted at the statement of financial position date.

Tax relating to actuarial gains/(losses) on retirement benefit obligations is recognised in other comprehensive income.

Financial assets and financial liabilities

Recognition and initial measurement

The Group initially recognises loans and advances, deposits and debt securities on the date on which they are originated. All other financial instruments (including regular-way purchases and sales of financial assets) are recognised on the trade date, which is the date on which the Group becomes a party to the contractual provisions of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at FVTPL, transaction costs that are directly attributable to its acquisition or issue.

Note 28 sets out the amount of each class of financial asset or financial liability that has been designated as at FVTPL. A description of the basis for each designation is set out in the note for the relevant asset or liability class. Note 28 discloses the levels of the fair value hierarchy and how it is applied in accordance with IFRS13.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Estimates and judgements

In determining the expected life of mortgage assets, the Group uses historical and forecast redemption data as well as management judgement.

At regular intervals throughout the year, the expected life of mortgage assets is reassessed for reasonableness. Any variation in the expected life of mortgage assets will change the carrying value in the statement of financial position and the timing of the recognition of interest income.

A one month increase in average life of a mortgage, allied to the assumption that this additional time would be on SVR would result in a reduction in the value of loans on the statement of financial position by approximately £379k.

Classification – applicable from 1 January 2018

On initial recognition, a financial asset is classified as measured at: amortised cost, fair value through other comprehensive income (FVOCI) or fair value through profit and loss (FVTPL).

A financial asset is measured at amortised cost if it meets both of the following conditions and is not designated as at FVTPL:

- the asset is held within a business model whose objective is to hold assets to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest(SPPI).

All other financial assets are classified as measured at FVTPL.

Classification – Business model assessment

The Group makes an assessment of the objective of a business model in which an asset is held at a portfolio level because this best reflects the way the business is managed and information is provided to management. The information considered includes:

- the stated policies and objectives for the portfolio and the operation of those policies in practice. In particular, whether management's strategy focuses on earning contractual interest revenue, maintaining a particular interest rate profile, matching the duration of the financial assets to the duration of the liabilities that are funding those assets or realising cash flows through the sale of the assets;
- how the performance of the portfolio is evaluated and reported to the Group's management;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and its strategy for how those risks are managed;
- how managers of the business are compensated (e.g. whether compensation is based on the fair value of the assets managed or the contractual cash flows collected); and
- the frequency, volume and timing of sales in prior periods, the reasons for such sales and its expectations about future sales activity. However, information about sales activity is not considered in isolation, but as part of an overall assessment of how the Group's stated objective for managing the financial assets is achieved and how cash flows are realised.

Financial assets that are held for trading or managed and whose performance is evaluated on a fair value basis are measured at FVTPL because they are neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets.

Classification –Assessment of whether contractual cash flows are SPPI

For the purposes of this assessment, 'principal' is defined as the fair value of the financial asset on initial recognition. 'Interest' is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs (e.g. liquidity risk and administrative costs), as well as profit margin.

In assessing whether the contractual cash flows are SPPI, the Group considers the contractual terms of the instrument. This includes assessing whether the financial asset contains a contractual term that could change the timing or amount of contractual cash flows such that it would not meet this condition. In making the assessment, the Group considers:

- contingent events that would change the amount and timing of cash flows;
- leverage features;
- prepayment and extension terms;
- terms that limit the Group's claim to cash flows from specified assets (e.g. non-recourse loans); and
- features that modify consideration of the time value of money (e.g. periodical reset of interest rates).

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

The Society holds a portfolio of long-term fixed-rate loans for which the Group has the option to propose to revise the interest rate at periodic reset dates. These reset rights are limited to the market rate at the time of revision. The borrowers have an option to either accept the revised rate or redeem the loan at par without penalty. The Group has determined that the contractual cash flows of these loans are SPPI because the option varies the interest rate in a way that is consideration for the time value of money, credit risk, other basic lending risks and costs associated with the principal amount outstanding.

Classification – applicable before 1 January 2018

The Group classified non-derivative financial assets as either loans and receivables or available-for-sale assets. Management determined the classification of financial assets at initial recognition. No assets were classified as held to maturity.

The Group's loans and advances to customers and to credit institutions were classified as loans and receivables. Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

The Group measured its loans and receivables at amortised cost less impairment provisions.

The initial value may, if applicable, include certain upfront costs and fees such as procuration fees, legal fees, mortgage indemnity guarantee premiums and application fees, which are recognised over the expected life of mortgage assets. Mortgage discounts are also recognised over the expected life of mortgage assets as part of the effective interest rate.

Throughout the year and at each year end, the mortgage life assumptions are reviewed for appropriateness. Any changes to the expected life assumptions of the assets are recognised through interest receivable and similar income and reflected in the carrying value of the mortgage assets.

Financial liabilities

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortised cost or FVTPL.

Fair Value Measurement

'Fair value' is 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. The fair value of a liability reflects its non-performance risk.

The best evidence of the fair value of a financial instrument on initial recognition is normally the transaction price – i.e. the fair value of the consideration given or received. If the Group determines that the fair value on initial recognition differs from the transaction price and the fair value is evidenced neither by a quoted price in an active market for an identical asset or liability nor based on a valuation technique for which any unobservable inputs are judged to be insignificant in relation to the measurement, then the financial instrument is initially measured at fair value, adjusted to defer the difference between the fair value on initial recognition and the transaction price. Subsequently, that difference is recognised in profit or loss on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

Derecognition of financial assets – applicable before and after 1 January 2018

The Group derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire or it transfers the rights to receive the contractual cash flows in a transaction in which substantially all of the risks and rewards of ownership of the financial asset are transferred or in which the Group neither transfers nor retains substantially all of the risks and rewards of ownership and it does not retain control of the financial asset.

On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset derecognised) and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in OCI is recognised in profit or loss.

The Group do not assess mortgage product switches as requiring treatment as a modification to the financial asset. These are accounted for as above, a derecognition.

Dercognition of financial liabilities – applicable before and after 1 January 2018

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled, or expire.

Notes to the Annual Report and Accounts (continued)

Principal **ACCOUNTING POLICIES (CONTINUED)**

Impairment from 1 January 2018

The Group recognises loss allowances for ECL on the following financial instruments that are not measured at FVTPL:

- financial assets that are debt instruments; and
- loans and advances to customers
- Loan commitments issued.

The Group measures loss allowances at an amount equal to lifetime ECL except for other financial instruments on which credit risk has not increased significantly since their initial recognition (see Note 31).

The Group considers a debt investment security to have low credit risk when its credit risk rating is equivalent to the globally understood definition of 'investment grade'. The Group does not apply the low credit risk exemption to any other financial instruments.

12-month ECL are the portion of ECL that result from default events on a financial instrument that are possible within the 12 months after the reporting date. Financial instruments for which a 12-month ECL is recognised are referred to as 'Stage 1 financial instruments'.

Life-time ECL are the ECL that result from all possible default events over the expected life of the financial instrument. Financial instruments for which a lifetime ECL is recognised but which are not credit-impaired are referred to as 'Stage 2 financial instruments'. These financial instruments have experienced a significant increase in credit risk since inception, further detail is provided in Note 31. As a backstop all financial instrument 30 days past due will be included in 'Stage 2'.

Estimates and judgements

The Group makes estimates and judgements that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. These are described below:

Impairment losses on loans and advances to customers

The Group reviews its mortgage advances portfolio at least on a quarterly basis to assess impairment. In determining whether an impairment loss should be recorded, the Group is required to exercise a degree of judgement. Impairment provisions are calculated using historical arrears experience, modelled credit risk characteristics and expected cash flows.

Estimates are applied to determine prevailing market conditions (e.g. interest rates and house prices), customer behaviour (e.g. default rates) and the length of time expected to complete the sale of properties in possession. The accuracy of the provision would therefore be affected by unexpected changes to these assumptions.

A sensitivity analysis of these assumptions is provided in Note 39 of the Accounts.

Measurement of ECL

ECL are a probability-weighted estimate of credit losses. They are measured as follows:

- financial assets that are not credit-impaired at the reporting date: as the present value of all cash shortfalls (i.e. the difference between the cash flows due to the entity in accordance with the contract and the cash flows that the Group expects to receive);
- financial assets that are credit-impaired at the reporting date: as the difference between the gross carrying amount and the present value of estimated future cash flows;
- undrawn loan commitments: as the present value of the difference between the contractual cash flows that are due to the Group if the commitment is drawn down and the cash flows that the Group expects to receive;

See also Note 31.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Credit-impaired financial assets

At each reporting date, the Group assesses whether financial assets carried at amortised cost and debt financial assets carried at FVOCI (referred to as 'Stage 3 financial assets'). A financial asset is 'credit-impaired' when one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred.

Evidence that a financial asset is credit-impaired includes the following observable data:

- significant financial difficulty of the borrower or issuer;
- a breach of contract such as a default or past due event;
- the restructuring of a loan or advance by the Group on terms that the Group would not consider otherwise;
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- or the disappearance of an active market for a security because of financial difficulties.

A loan that has been renegotiated due to a deterioration in the borrower's condition is usually considered to be credit-impaired unless there is evidence that the risk of not receiving contractual cash flows has reduced significantly and there are no other indicators of impairment. In addition, a retail loan that is overdue for 90 days or more is considered credit-impaired even when the regulatory definition of default is different.

Presentation of allowance for ECL in the statement of financial position

Loss allowances for ECL are presented in the statement of financial position as follows:

- financial assets measured at amortised cost: as a deduction from the gross carrying amount of the assets;
- loan commitments: generally, as a provision. Where a financial instrument includes both a drawn and an undrawn component, and the Group cannot identify the ECL on the loan commitment component separately from those on the drawn component, the Group presents a combined loss allowance for both components. The combined amount is presented as a deduction from the gross carrying amount of the drawn component. Any excess of the loss allowance over the gross amount of the drawn component is presented as a provision;

Write-off

Loans and debt securities are written off (either partially or in full) when there is no reasonable expectation of recovering a financial asset in its entirety or a portion thereof. This is generally the case when the Group determines that the borrower does not have assets or sources of income that could generate sufficient cash flows to repay the amounts subject to the write-off. This assessment is carried out at the individual asset level.

Recoveries of amounts previously written off are included in 'impairment losses on financial instruments' in the statement of profit or loss and OCI. Financial assets that are written off could still be subject to enforcement activities in order to comply with the Group's procedures for recovery of amounts due.

Impairment before 1 January 2018 under IAS 39

At each reporting date, the Group assessed whether there was objective evidence that financial assets not carried at FVTPL were impaired. A financial asset or a group of financial assets was 'impaired' when objective evidence demonstrated that a loss event had occurred after the initial recognition of the asset(s) and that the loss event had an impact on the future cash flows of the asset(s) that could be estimated reliably.

In addition, a retail loan that was overdue for 90 days or more was considered impaired. Where a collective assessment was made, each category or class of financial asset is split into groups of assets with similar credit risk characteristics. The Group measured the amount of impairment loss by applying expected loss factors based on the Group's experience of default, loss emergence periods, the effect of in house price movements and any adjustment for the expected forced sales value.

Objective evidence that financial assets were impaired included:

- significant financial difficulty of a borrower or issuer;
- default or delinquency by a borrower;
- the restructuring of a loan or advance by the Group on terms that the Group would not consider otherwise;
- indications that a borrower or issuer would enter bankruptcy;
- the disappearance of an active market for a security; or
- observable data relating to a group of assets, such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlated with defaults in the group.

A loan that was renegotiated due to a deterioration in the borrower's condition was usually considered to be impaired unless there was evidence that the risk of not receiving contractual cash flows had reduced significantly and there were no other indicators of impairment.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Estimates and judgements

The Group reviews its mortgage advances portfolio at least on a quarterly basis to assess impairment. In determining whether an impairment loss should be recorded, the Group is required to exercise a degree of judgement. Impairment provisions are calculated using historical arrears experience, modelled credit risk characteristics and expected cash flows.

Estimates are applied to determine prevailing market conditions (e.g. interest rates and house prices), customer behaviour (e.g. default rates) and the length of time expected to complete the sale of properties in possession. The accuracy of the provision would therefore be affected by unexpected changes to these assumptions.

Individual assessment

An individual measurement of impairment was based on management's best estimate of the present value of the cash flows that were expected to be received. In estimating these cash flows, management made judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset was assessed on its merits, and the workout strategy and estimate of cash flows considered recoverable were independently approved by the Credit Risk function.

Measurement of impairment

Impairment losses on assets measured at amortised cost were calculated as the difference between the carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Impairment losses on available-for-sale assets were calculated as the difference between the carrying amount and the fair value.

Where certain emerging impairment characteristics are considered significant but not assessed as part of the impairment calculation, management may elect to apply an overlay to the impairment provision.

Reversal of impairment

For assets measured at amortised cost, if an event occurring after the impairment was recognised caused the amount of impairment loss to decrease, then the decrease in impairment loss was reversed through profit or loss.

Presentation

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans and receivables or held-to-maturity investment securities. Interest on the impaired assets continued to be recognised through the unwinding of the discount.

Write-off

The Group writes off a loan or an investment debt security, either partially or in full, and any related allowance for impairment losses, when there was no realistic prospect of recovery.

Cash and cash equivalents

'Cash and cash equivalents' include notes and coins on hand, unrestricted balances held with central banks and highly liquid financial assets with original maturities of three months or less from the date of acquisition that are subject to an insignificant risk of changes in its fair value, and are used by the Group in the management of its short-term commitments.

Cash and cash equivalents are carried at amortised cost in the statement of financial position.

Derivatives held for risk management purposes and hedge accounting

Derivatives continue to be accounted for under IAS39.

Derivatives held for risk management purposes include all derivative assets and liabilities that are not classified as trading assets or liabilities. Derivatives held for risk management purposes are measured at fair value in the statement of financial position. The Society does not hold derivatives for trading purposes.

The Group designates certain derivatives held for risk management as well as certain non-derivative financial instruments as hedging instruments in qualifying hedging relationships. On initial designation of the hedge, the Group formally documents the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationship. The Group makes an assessment, both on inception of the hedging relationship and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value or cash flows of the respective hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80–125%. For a cash flow hedge of a forecast transaction, the Group makes an assessment of whether the forecast transaction is highly probable to occur and presents an exposure to variations in cash flows that could ultimately affect profit or loss.

These hedging relationships are discussed below.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Fair value hedges

When a derivative is designated as the hedging instrument in a hedge of the change in fair value of a recognised asset or liability or a firm commitment that could affect profit or loss, changes in the fair value of the derivative are recognised immediately in profit or loss. The change in fair value of the hedged item attributable to the hedged risk is recognised in profit or loss. If the hedged item would otherwise be measured at cost or amortised cost, then its carrying amount is adjusted accordingly.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. However, if the derivative is novated to a Central Clearing Counterparty (CCP) by both parties as a consequence of laws or regulations or contract changes due to commercial reasons without changes in its terms except for those that are necessary for the novation, then the derivative is not considered expired or terminated.

Any adjustment up to the point of discontinuation to a hedged item for which the effective interest method is used is amortised to profit or loss as an adjustment to the recalculated effective interest rate of the item over its remaining life.

On hedge discontinuation, any hedging adjustment made previously to a hedged financial instrument for which the effective interest method is used is amortised to profit or loss by adjusting the effective interest rate of the hedged item from the date on which amortisation begins. If the hedged item is derecognised, then the adjustment is recognised immediately in profit or loss when the item is derecognised.

Estimates and judgements

The Group employs the following techniques in determining the fair value of its derivatives and financial assets:

Derivative financial instruments - calculated by discounted cash flow models using yield curves that are based on observable market data.

A change in the yield curve of 1% would change the total net fair value of derivative financial instruments by £1,298k.

The classification of these fair value techniques is in line with the fair value hierarchy detailed in IFRS 13: 'Fair Value Measurement' which splits the source of input when deriving fair values into three levels, as follows:

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 or indirectly.

Level 3 – inputs for the asset or liability that are not based on observable market data.

Loans and advances

Loans and advances from 1 January 2018

'Loans and advances' captions in the statement of financial position include:

- loans and advances measured at amortised cost are initially measured at fair value plus incremental direct transaction costs, and subsequently at their amortised cost using the effective interest method; and
- loans and advances mandatorily measured at FVTPL or designated as at FVTPL are measured at fair value with changes recognised immediately in profit or loss

Loans and advances before 1 January 2018

'Loans and advances' were non-derivative financial assets with fixed or determinable payments that were not quoted in an active market and that the Group did not intend to sell immediately or in the near term.

Loans and advances to banks were classified as loans and receivables. Loans and advances to customers are classified as loans and receivables.

Loans and advances were initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method. When the Group chose to designate the loans and advances as measured at FVTPL they were measured at fair value with face value changes recognised immediately in profit or loss.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Property and equipment

Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and any accumulated impairment losses.

Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

Any gain or loss on disposal of an item of property and equipment is recognised within other income in profit or loss.

Depreciation

Depreciation is calculated to write off the cost of items of property and equipment less their estimated residual values using the straight-line method over their estimated useful lives, and is generally recognised in profit or loss. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Group will obtain ownership by the end of the lease term.

The estimated useful lives of significant items of property and equipment are as follows:

- Land is not depreciated
- Buildings - 100 years
- IT equipment - 3–5 years; and
- Fixtures and fittings - 5 years.

Depreciation methods, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

Intangible assets

Software

Software acquired by the Group is measured at cost less accumulated amortisation and any accumulated impairment losses.

Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate: that the product is technically feasible, 'its intention and ability to complete the development and use the software in a manner that will generate future economic benefits', and that it can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is stated at capitalised cost less accumulated amortisation and any accumulated impairment losses.

Subsequent expenditure on software assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Software is amortised on a straight-line basis in profit or loss over its estimated useful life, from the date on which it is available for use. The estimated useful life of software for the current and comparative periods is three to five years.

Amortisation methods, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

Impairment of non-financial assets

At each reporting date, the Group reviews the carrying amounts of its non-financial assets (other than deferred tax assets) to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated.

The 'recoverable amount' of an asset or Cash-generating unit (CGU) is the greater of its value in use and its fair value less costs to sell. 'Value in use' is based on the estimated future cash flows, discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or CGU.

An impairment loss is recognised if the carrying amount of an asset or CGU exceeds its recoverable amount.

Provisions

Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The unwinding of the discount is recognised as finance cost.

Notes to the Annual Report and Accounts (continued)

PRINCIPAL ACCOUNTING POLICIES (CONTINUED)

Loan commitments

Loan commitments are firm commitments to provide credit under pre-specified terms and conditions.

Financial guarantees issued or commitments to provide a loan at a below-market interest rate are initially measured at fair value. Subsequently, they are measured as follows:

- from 1 January 2018: at the higher of the loss allowance determined in accordance with IFRS 9 and the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15; and
- before 1 January 2018: at the higher of the amount representing the initial fair value amortised over the life of the guarantee or the commitment and the present value of any expected payment to settle the liability when a payment under the contract has become probable.

Liabilities arising from financial guarantees and loan commitments are included within provisions.

Employee benefits

Defined contribution plans

Obligations for contributions to defined contribution plans are expensed as the related service is provided and recognised as personnel expenses in profit or loss. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in future payments is available.

Defined benefit plans

The Group's net obligation in respect of its defined benefit plan is calculated by estimating the amount of future benefit that employees have earned in the current and prior periods, discounting that amount and deducting the fair value of any plan assets.

The calculation of defined benefit obligations is performed annually by a qualified actuary using the projected unit credit method. When the calculation results in a potential asset for the Group, the recognised asset is limited to the present value of economic benefits available in the form of any future refunds from the plan or reductions in future contributions to the plan. To calculate the present value of economic benefits, consideration is given to any applicable minimum funding requirements.

Re-measurements of the net defined benefit liability, which comprise actuarial gains and losses, the return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in OCI. The Group determines the net interest expense (income) on the net defined benefit liability (asset) for the period by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the then-net defined benefit liability (asset), taking into account any changes in the net defined benefit liability (asset) during the period as a result of contributions and benefit payments. Net interest expense and other expenses related to defined benefit plans are recognised in personnel expenses in profit or loss.

When the benefits of a plan are changed or when a plan is curtailed, the resulting change in benefit that relates to past service or the gain or loss on curtailment is recognised immediately in profit or loss. The Group recognises gains and losses on the settlement of a defined benefit plan when the settlement occurs.

Estimates and judgements

The Group operates a defined benefit pension scheme. Significant judgements (on such areas as future interest and inflation rates and mortality rates) have to be exercised in estimating the value of the assets and liabilities of the scheme, and hence of its net deficit.

The assumptions are outlined in note 25 to the accounts. Of these assumptions, the main determinant of the liability is the discount rate. A variation of 0.5% in the discount rate will change liabilities by approximately 11%.

Other long-term employee benefits

The Group's net obligation in respect of long-term employee benefits is the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is discounted to determine its present value. Re-measurements are recognised in profit or loss in the period in which they arise. The long term incentive bonuses are disclosed in the Directors' remuneration report.

Notes to the Annual Report and Accounts (continued)

2. FUTURE ACCOUNTING DEVELOPMENTS

A number of International Accounting Standards Board (IASB) pronouncements have been issued but are not effective for this financial year. The standard considered most relevant to the Group are detailed below.

IFRS 16 - 'Leases'

This is effective from 1 January 2019.

Accounting by lessees will be changed significantly, with a right of use asset recognised on the balance sheet for all leases, based on discounted future commitments. This includes leases presently treated as operating leases and not recognised on the balance sheet. The Group's commitments under such leases are described in note 35 and a review of the standard indicates the changes will not have a material impact on the Group's results or financial position.

3. SEGMENTAL ANALYSIS

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

4. INTEREST INCOME CALCULATED USING THE EFFECTIVE INTEREST METHOD

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
On loans fully secured on residential property	14,471	13,769	14,471	13,769
On other loans	477	510	477	510
On liquid assets	241	79	241	79
Net interest (expense) on derivatives	(104)	(248)	(104)	(248)
Total	**15,085**	**14,110**	**15,085**	**14,110**

Included within interest income is £4k (2017: £6k) in respect of interest income accrued on impaired loans two or more months in arrears.

5. INTEREST PAYABLE AND SIMILAR CHARGES

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
On shares held by individuals	3,453	3,498	3,453	3,498
On deposits and other borrowings	757	643	757	643
Net interest (income) on derivatives	(17)	(55)	(17)	(55)
Total	**4,193**	**4,086**	**4,193**	**4,086**

Notes to the Annual Report and Accounts (continued)

6. NET GAINS FROM DERIVATIVE FINANCIAL INSTRUMENTS

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Derivatives in designated fair value hedge relationships	79	199	79	199
Adjustments to hedged items in fair value hedge accounting relationships	(69)	(185)	(69)	(185)
Derivatives not in designated fair value hedge relationships	4	(2)	4	(2)
Total	**14**	**12**	14	**12**

The net gains from derivative financial instruments of £14k (2017: gain of £12k) represents the net fair value movement on derivative instruments that are matching risk exposure on an economic basis.

Some accounting volatility arises on these items due to accounting ineffectiveness on designated hedges, or because hedge accounting is not achievable on certain items. The movement is primarily due to timing differences in income recognition between derivative instruments and the hedged assets or liabilities. This gain or loss will trend to zero over time and this is taken into account by the Board when considering the Group's underlying performance.

7. ADMINISTRATIVE EXPENSES

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Staff costs				
Wages and salaries	3,557	3,832	3,557	3,832
Social security costs	339	340	339	340
Other pension costs	167	176	167	176
Total staff costs	4,063	4,348	4,063	4,348
Operating lease rentals	21	22	21	22
Other administrative costs	2,445	2,253	2,445	2,253
Total	**6,529**	**6,623**	**6,529**	**6,623**

8. AUDITOR'S REMUNERATION

Included in other administrative costs are the fees paid to auditors. These are analysed below:

All figures £'000 and exclude VAT	2018 Group	2017 Group	2018 Society	2017 Society
Audit of these Annual Report and Accounts	77	74	77	74
Other assurance services	20	0	20	0
Total	**97**	**74**	**97**	**74**

Notes to the Annual Report and Accounts (continued)

9. STAFF NUMBERS

The average number of staff for the Group and the Society, including executive directors, all of whom were employed in the UK, was:

Full Time Equivalents	2018 Group	2017 Group	2018 Society	2017 Society
Full time employees	59	64	59	64
Part time employees	33	33	33	33
Total	**92**	**97**	**92**	**97**

Full Time Equivalents	2018 Group	2017 Group	2018 Society	2017 Society
Head office	78	83	78	83
Branches	14	14	14	14
Total	**92**	**97**	**92**	**97**

10. DIRECTORS' EMOLUMENTS AND TRANSACTIONS

Directors' Emoluments

Group and Society All figures £'000	2018	2017
For services as non-executive directors	215	177
For services as executive directors	458	455
Total	**673**	**632**

Directors Transactions

Full details of emoluments for non-executive directors are given in the Directors' Remuneration Report under the heading "Non-Executive Directors' Remuneration". Full details of emoluments for executive directors are given in the Directors' Remuneration Report under the heading "Executive Directors' Remuneration"

There have been no significant contracts during the year in which any director had a material interest.

At the year end, there were no outstanding mortgage loans (2017: nil) granted in the ordinary course of business to directors of the Society.

A register is maintained in accordance with the requirements of Section 68 of the Building Societies Act 1986, and the requisite particulars are available for inspection at the Society's head office during the period of 15 days expiring with the annual general meeting, and at the annual general meeting on 26 April 2018.

Notes to the Annual Report and Accounts (continued)

11. TAX ON PROFIT ON ORDINARY ACTIVITIES

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Current tax	822	643	822	643
Adjustment in respect of prior years	5	47	5	47
Total current tax	**827**	**690**	**827**	**690**
Origination and reversal of temporary difference	(15)	3	(15)	3
Effect of change in tax rate on deferred tax	2	0	2	0
Adjustment in respect of prior years	(3)	(38)	(3)	(38)
Total deferred tax	**(16)**	**(35)**	**(16)**	**(35)**
Total tax expense	**811**	**655**	**811**	**655**

The total tax charge for the period differs from that calculated using the UK standard rate of corporation tax. The differences are explained below.

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Profit before tax	**4,008**	**3,336**	**4,008**	**3,336**
Expected tax at 19%	804	643	804	643
Expenses not deductible for corporation tax purposes	4	3	4	3
Effect of change in tax rate on deferred tax	2	0	2	0
Adjustment in respect of prior years	1	9	1	9
Total tax expense	**811**	**655**	**811**	**655**

At Summer Budget 2015, the government announced legislation setting the Corporation Tax main rate at 19% for the years starting the 1 April 2017, 2018 and 2019 and at 17% for the year starting 1 April 2020. Existing temporary differences may therefore unwind in periods subject to this reduced rate.

12. LOANS AND ADVANCES TO CREDIT INSTITUTIONS

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Repayable on call and short notice (included within cash and cash equivalents)	6,369	5,367	6,369	5,367
Other loans and advances to credit institutions	10	5	10	5
Total	**6,379**	**5,372**	**6,379**	**5,372**

At 31 December 2018 the Group and Society had no cash (2017:£nil) deposited against derivative contracts.

Notes to the Annual Report and Accounts (continued)

13. DERIVATIVE FINANCIAL INSTRUMENTS

The Group mitigates the credit risk of derivatives by holding collateral in the form of cash where credit risk exceeds an agreed threshold as set out below.

Derivative transactions are entered into under International Swaps and Derivatives Association (ISDA) master agreements. In general, under these agreements, in certain circumstances – e.g. when a credit event such as a default occurs – all outstanding transactions under the agreement with the counterparty are terminated. The termination values are therefore assessed for settlement of all transactions with the counterparty. There is no right of set off. The Group executes a credit support annex in conjunction with each ISDA agreement, which requires the Group and its counterparties to post collateral to mitigate counterparty credit risk, where collateral is only posted should the minimum threshold amount of £250,000 be reached. No derivatives are currently collateralised.

The Society does not transact derivatives on exchanges or with Central Clearing Parties and therefore no collateral is posted daily.

Before fair value hedge accounting is applied by the Group, the Group determines whether an economic relationship between the hedged item and the hedging instrument exists based on an evaluation of the qualitative characteristics of these items and the hedged risk that is supported by quantitative analysis. The Group considers whether the critical terms of the hedged item and hedging instrument closely align when assessing the presence of an economic relationship. The Group evaluates whether the fair value of the hedged item and the hedging instrument respond similarly to similar risks. The Group further supports this qualitative assessment by using regression analysis to assess whether the hedging instrument is expected to be and has been highly effective.

The Group establishes a hedge ratio by aligning the par amount of the fixed-rate loan or deposit and the notional amount of the interest rate swap designated as a hedging instrument. Under the Group policy, in order to conclude that a hedge relationship is effective, all of the following criteria should be met.

- The regression co-efficient (R squared), which measures the correlation between the variables in the regression, is at least 0.9.
- The slope of the regression line is within a 0.8–1.25 range.
- The confidence level of the slope is at least 95%.

In these hedge relationships, the main sources of ineffectiveness are:

- the effect of the counterparty and the Group's own credit risk on the fair value of the interest rate swap, which is not reflected in the fair value of the hedged item attributable to the change in interest rate; and
- differences in maturities of the interest rate swap and the loans or the deposit products.

There were no other sources of ineffectiveness in these hedge relationships.

The effective portion of fair value gains on derivatives held in qualifying fair value hedging relationships and the hedging gain or loss on the hedged items are included in net gains from derivative financial instruments (Note 6).

At 31 December 2018, the Group held the following interest rate swaps as hedging instruments in fair value hedges of interest risk.

Group and Society As at December 2018	**Maturity**		
All figures £'000	**Less than 1 year**	**1 – 5 years**	**More than 5 years**
Hedge of retail deposits			
Nominal amount	2,000	0	0
Average fixed interest rate	1.5%		
Hedge of loans and advances			
Nominal amount	12,000	53,000	0
Average fixed interest rate	0.8%	1.1%	

Notes to the Annual Report and Accounts (continued)

DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

The amounts relating to items designated as hedging instruments and hedge ineffectiveness were as follows.

Group and Society As at December 2018 All figures £'000	Notional	Fair Value Assets	Fair Value Liabilities	Change in fair value used for calculating hedge ineffectiveness for 2018	Ineffectiveness recognised in profit or loss
Derivatives designated as fair value hedges – interest rate swaps	60,000	228	(94)	79	10

The line item in the statement of financial position where the hedging instrument is included is derivative financial instruments.

The line item in the profit or loss that includes hedge ineffectiveness is Net gains / (losses) from derivative financial instruments.

Group and Society As at December 2017 All figures £'000	Notional	Assets Fair Value	Liabilities Fair Value
Unmatched derivatives – interest rate swaps	6,000	0	(5)
Derivatives designated as fair value hedges – interest rate swaps	45,000	166	(111)
Total recognised derivative asset / (liability)	**51,000**	**166**	**(116)**

Notes to the Annual Report and Accounts (continued)

DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

The amounts relating to items designated as hedged items were as follows

Group and Society As at December 2018 All figures £'000	Carrying amount		Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item		Change in value used for calculating hedge ineffectiveness
	Assets	Liabilities	Assets	Liabilities	
Retail deposits	0	1,309		(40)	19
Loans and advances	52,868	0	(115)		(88)

The line item in the statement of financial position in which the hedged item is included is shares for retail deposits and loans and advances to customers for loans and advances. There was no accumulated amount of fair value hedged adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses.

14. LOANS AND ADVANCES TO CUSTOMERS

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Loans fully secured on residential property	401,591	378,198	401,591	378,198
Other loans fully secured on land	10,292	12,548	10,292	12,548
Gross loan receivables	**411,883**	**390,746**	**411,883**	**390,746**
Stage 1 (see below)	(257)		(257)	
Stage 2 (see below)	(386)		(386)	
Stage 3 (see below)	0		0	
Individual impairment provision (see below)		(480)		(480)
Collective impairment provision (see below)		(430)		(430)
Provision for impairment losses on loans and advances	**(643)**	**(910)**	**(643)**	**(910)**
Net loan receivables	**411,240**	**389,836**	**411,240**	**389,836**
Fair value adjustment for hedged risk	(115)	(27)	(115)	(27)
Total	**411,125**	**389,809**	**411,125**	**389,809**

The Group has pledged £112m (2017: £88m) of mortgage loan pools with the Bank of England. Of these mortgage loan pools £84m (2017: £87m) are encumbered mortgage assets through the Funding for Lending Scheme and the Term Funding Scheme.

In determining the expected life of mortgage assets, the Group uses historical and forecast redemption data as well as management judgement.

At regular intervals throughout the year, the expected life of mortgage assets is reassessed for reasonableness. Any variation in the expected life of mortgage assets will change the carrying value in the statement of financial position and the timing of the recognition of interest income.

A one month increase in average life of a mortgage, allied to the assumption that this additional time would be on SVR would result in a £119k increase in the gross carrying value of loans and advances.

Notes to the Annual Report and Accounts (continued)

LOANS AND ADVANCES TO CUSTOMERS (CONTINUED)

The movement in provision for impairment losses on loans and advances for the Group may be analysed as follows:

Group and Society 2018 **All figures £'000**	**Loans fully secured on residential property**	**Other loans fully secured on land**	**Total**
Stage 1 provision at 1 January	153	44	**197**
Provision for loan impairment	74	(14)	**60**
Stage 1 provision at 31 December	**227**	**30**	**257**
Stage 2 provision at 1 January	234	29	**263**
Provision for loan impairment	126	(4)	**122**
Stage 2 provision At 31 December	**360**	**25**	**386**
Stage 3 provision at 1 January	190	0	**190**
Provision for loan impairment	(190)	0	**(190)**
Stage 3 provision at 31 December	**0**	**0**	**0**

Group and Society 2017 **All figures £'000**	**Loans fully secured on residential property**	**Other loans fully secured on land**	**Total**
Individual provision			
At 1 January	550	0	**550**
Provision for loan impairment	(70)	0	**(70)**
At 31 December	**480**	**0**	**480**
Collective provision			
At 1 January	570	0	**570**
Provision for loan impairment	(140)	0	**(140)**
At 31 December	**430**	**0**	**430**

15. INVESTMENTS IN SUBSIDIARY UNDERTAKINGS

The Society directly holds 100% of the issued ordinary share capital of Market Harborough Mortgages Limited. The principal activity of the company is mortgage related finance. Its share capital is £1 (2015: £1). Its principal place of business is Welland House, The Square, Market Harborough, Leicestershire, LE16 7PD. It is registered in England and Wales. There have been no additions or disposals of investments during the year. Market Harborough Mortgages Limited became dormant from 1 January 2016.

Notes to the Annual Report and Accounts (continued)

16. OTHER ASSETS

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Prepayments and accrued income	427	414	427	414
Other debtors	5	22	5	22
Total	**432**	**436**	**432**	**436**

17. PROPERTY PLANT AND EQUIPMENT

Group & Society 2018 All figures £'000	Freehold Property	Leasehold Property	Equipment Fixtures & Fittings	Motor Vehicles	Total
At 1 January	1,640	73	3,396	25	5,134
Additions	0	0	122	0	122
Disposals	0	0	(12)	0	(12)
Total cost at 31 December	**1,640**	**73**	**3,506**	**25**	**5,244**
At 1 January	0	73	3,222	12	3,307
Charge for the year	120	0	120	5	245
On disposals	0	0	(5)	0	(5)
Total depreciation at 31 December	**120**	**73**	**3,337**	**17**	**3,547**
Net book value at 31 December	**1,520**	**0**	**169**	**8**	**1,697**

All of the freehold property and leasehold property included above was occupied by the Society.

Group & Society 2017 All figures £'000	Freehold Property Restated	Leasehold Property	Equipment Fixtures & Fittings	Motor Vehicles	Total
At 1 January	1,640	73	3,409	122	5,244
Additions	0	0	68	0	68
Disposals	0	0	(81)	(97)	(178)
Total cost at 31 December	**1,640**	**73**	**3,396**	**25**	**5,134**
At 1 January	0	73	3,180	53	3,306
Charge for the year	0	0	123	14	137
On disposals	0	0	(81)	(55)	(136)
Total depreciation at 31 December	**0**	**73**	**3,222**	**12**	**3,307**
Net book value at 31 December	**1,640**	**0**	**174**	**13**	**1,827**

Notes to the Annual Report and Accounts (continued)

18. INTANGIBLE ASSETS

Group & Society 2018 All figures £'000	Purchased Software
At 1 January	3,478
Additions	26
Total cost at 31 December	**3,504**
At 1 January	3,249
Charge for the year	137
Total amortisation at 31 December	**3,386**
Net book value at 31 December	**118**

Group & Society 2017 All figures £'000	Purchased Software
At 1 January	3,445
Additions	33
Total cost at 31 December	**3,478**
At 1 January	3,081
Charge for the year	168
Total amortisation at 31 December	**3,249**
Net book value at 31 December	**229**

Notes to the Annual Report and Accounts (continued)

19. DEFERRED TAX

Deferred tax movement All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
At 1 January	470	531	470	531
Adjustment for prior years	(3)		(3)	
IFRS 9 transitional adjustment	(50)		(50)	
Income statement credit	16	35	16	35
Recognised directly in other comprehensive income	(62)	(96)	(62)	(96)
At 31 December	**371**	**470**	**371**	**470**

The deferred tax charge in the income statement comprises the following temporary differences:

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Property, plant and equipment	5	19	5	19
IFRS 9 transitional adjustment	3	(29)	3	(29)
Pensions and other post tax retirement benefits	7	7	7	7
Effect of change in tax rate	(2)	0	(2)	0
Adjustment for prior years	3	38	3	38
Other provisions	0	0	0	0
Total	**16**	**35**	**16**	**35**

Deferred income tax assets are attributable to the following items:

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Pensions and other post-retirement benefits	243	267	243	267
Property, plant and equipment	10	7	10	7
Other provisions	118	196	118	196
Total	**371**	**470**	**371**	**470**

In 2016, a reduction in the corporation tax rate to 19% from 1 April 2017 and to 17% from 1 April 2020 was substantively enacted into legislation. All deferred tax balances have been recognised at 17%, being the rate enacted at the balance sheet date at which the balances are expected to reverse.

Notes to the Annual Report and Accounts (continued)

20. SHARES

Group and Society All figures £'000	2018	2017
Held by individuals	339,026	318,226
Other shares	1,260	1,260
Fair value adjustment for hedged risk	(40)	(21)
Total	**340,246**	**319,465**

21. AMOUNTS OWED TO CREDIT INSTITUTIONS

Group and Society All figures £'000	2018	2017
Amounts owed to credit institutions	45,130	25,044
Total	**45,130**	**25,044**

At 31 December 2018 the Society has drawn £45m under the Term Funding Scheme, included above. The drawings are repayable to the Bank of England by 2022.

22. AMOUNTS OWED TO OTHER CUSTOMERS

Group and Society All figures £'000	2018	2017
Retail customers:		
On demand	7,219	8,864
Notice	26,657	31,158
Local authorities		
Term	7,011	0
Total	**40,887**	**40,022**

23. OTHER LIABILITIES AND ACCRUALS

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Accruals and deferred income	549	584	549	584
Other taxes and social security	156	133	156	133
Amounts due to subsidiary	0	0	1,185	1,185
Other creditors	48	34	48	34
Total	**753**	**751**	**1,938**	**1,936**

Notes to the Annual Report and Accounts (continued)

24. PROVISIONS FOR LIABILITIES AND CHARGES

Group and Society All figures £'000	2018	2017
FSCS levy		
At 1 January	30	63
Charge for the year	(11)	29
Provision utilised	(13)	(62)
Total at 31 December	**6**	**30**

25. RETIREMENT BENEFIT LIABILITIES

Defined benefit scheme

The Society operates a pension scheme providing benefits based on final pensionable pay that was closed for the accrual of future benefits on 6 April 2005 and replaced with a defined contribution group personal pension scheme. The assets of the former are held separately from those of the Society being invested with an insurance company in managed funds.

The pension cost is assessed following the advice of a qualified independent actuary using the projected unit method. The latest funding review of the scheme was at 6 April 2018 and takes into account the closure of the scheme for future service accrual. This review showed that the market value of the scheme assets at 6 April 2018 was £9.2 million and that the actuarial value of those assets represented 93% of the benefits that had accrued to members after allowing for expected future increase in salaries.

Following the High Court ruling in October 2018, the liability reported includes an increase of £172k relating to an additional provision for GMP equalisation. This additional charge has been accounted for through the Income Statement for 2018.

An updated actuarial valuation at 31 December 2018 was carried out on a market value basis by a qualified independent actuary, as follows:

Group and Society Growth and rates of return	2018	2017
Discount rate	2.8	2.4
Rate of increase in salaries	3.5	3.3
Rate of increase in pensions	3.4	3.4
Inflation	3.4	3.4

Group and Society Expected life at 31 December (normal retirement age of 62)	2018	2017
Expected life at retirement for a new pensioner (yrs) - Male	22.5	22.7
Expected life at retirement for a new pensioner (yrs) - Female	24.8	24.9
Expected life at retirement in 20 years' time (yrs) – Male	23.9	24.1
Expected life at retirement in 20 years' time (yrs) - Female	26.2	26.3

Notes to the Annual Report and Accounts (continued)

RETIREMENT BENEFIT LIABILITIES (CONTINUED)

Approximate sensitivities of the principal assumptions are set out in the table below which shows the increase or reduction in the pension obligations that would result. Each sensitivity considers one change in isolation.

Group and Society All figures £'000	Change in assumption	2018	2017
Discount rate	Decrease by 0.5%	Increase by 11%	Increase by 11%
Rate of inflation	Increase by 0.5%	Increase by 6%	Increase by 6%
Rate of increase in salaries	Increase by 0.5%	Increase by 1%	Increase by 1%
Life expectancy	Increase by 1 year	Increase by 3%	Increase by 3%

Fair Value of scheme assets Group and Society All figures £'000	2018	2017
As at 1 January	9,460	8,842
Expected return on pension scheme assets	225	229
Contributions by employer	179	172
Benefits paid	(380)	(245)
Gain on asset returns	(623)	462
At 31 December	**8,861**	**9,460**

Present value of defined benefit obligations Group and Society All figures £'000	2018	2017
As at 1 January	(11,029)	(10,747)
Interest on pension scheme liabilities	(450)	(287)
Benefits paid	380	245
Experience gain/loss on liabilities	7	3
Loss on changes in assumptions	802	(243)
At 31 December	**(10,290)**	**(11,029)**

Notes to the Annual Report and Accounts (continued)

RETIREMENT BENEFIT LIABILITIES (CONTINUED)

The amounts recognised in the statement of financial position are determined as follows:

Group and Society All figures £'000	2018	2017
Present value of funded obligations	(10,290)	(11,029)
Fair value of plan assets	8,861	9,460
Liability in the statement of financial position	**(1,429)**	**(1,569)**

The actual return on plan assets was a loss of £398k (2017: £691k gain). The amounts recognised in the statement of comprehensive income are as follows:

Group and Society All figures £'000	2018	2017
Amounts recognised in finance income		
Interest cost	(450)	(287)
Expected return on plan assets	225	229
Total	**(225)**	**(58)**

Movement in the liability recognised in the statement of financial position:

Group and Society All figures £'000	2018	2017
Opening defined benefit obligation	(1,569)	(1,905)
Total as above	(225)	(58)
Employer contributions	179	172
Re-measurement gains/(losses)	186	222
Closing defined benefit obligation	**(1,429)**	**(1,569)**

The amounts recognised in the statement of other comprehensive income are as follows:

Group and Society All figures £'000	2018	2017
Actual return less expected return on plan assets	(623)	462
Experience gain/(loss) arising on scheme liabilities	7	3
Changes in assumptions underlying the present value of the scheme liabilities	802	(243)
Re-measurement of defined benefit obligation	**186**	**222**

Notes to the Annual Report and Accounts (continued)

RETIREMENT BENEFIT LIABILITIES (CONTINUED)

The major categories of plan assets are:

Group and Society **All figures £'000**	**2018**	**2017**
Equities	1,800	2,083
Bonds	6,256	6,483
Cash	104	232
Property	701	662
Total	**8,861**	**9,460**

The average duration of the defined benefit obligation at 31 December 2018 is 18.0 years (2017: 20.0 years). The table below shows an analysis by term to retirement of Scheme membership and past service liability as at the date of the last full actuarial valuation, 6 April 2018:

		Term to Retirement							
	Pensioners	0-5 years	6 – 10 years	11-15 years	16-20 years	21-25 years	26-30 years	31-35 years	36 + years
Proportion of total liabilities (funding basis)	54.1%	17.1%	16.8%	5.2%	4.1%	2.6%	0.1%	0.0%	0.0%
Number of members	52	14	13	7	10	8	1	0	0

During 2018 the Group made additional contributions of £184k (2017: £184k) as part of its funding plan. The Group and Society expect to contribute £184k to the fund during 2019. History of experience gains and losses for the current and previous four years is as follows:

Group & Society **All figures £'000**	**2018**	**2017**	**2016**	**2015**	**2014**
Present value of defined benefit obligation	(10,290)	(11,029)	(10,747)	(7,878)	(9,478)
Fair value of plan assets	8,861	9,460	8,842	7,643	7,604
Plan (deficit)	(1,429)	(1,569)	(1,905)	(235)	(1,874)
Experience adjustments on plan liabilities	(7)	(3)	(32)	263	(26)
Percentage of scheme liabilities	0.1%	0.0%	0.3%	-3.3%	0.3%

Following the Government announcement in July 2010 to link pension payments to the Consumer Price Index (CPI) rather than the Retail Prices Index (RPI) the Group has reviewed its position. At 31 December the Group continues to use RPI in assessing pension payments.

The Society has agreed a schedule of contributions with the pension scheme expiring in June 2021, with the intention of eliminating the deficit.

Defined contribution scheme

Since April 2005 the Society has operated a defined contribution group personal pension scheme for eligible employees. Contributions of £167k were paid in 2018 (2017: £176k) to personal pension plans held in the names of individual employees with a major UK insurance company.

There were no outstanding contributions at the beginning or end of the year.

Notes to the Annual Report and Accounts (continued)

26. GENERAL RESERVE

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
At 31 December 2017	36,512	33,637	35,327	32,452
IFRS 9 transitional adjustment	210	0	210	0
At 1 January 2018	**36,722**	**33,637**	**35,537**	**32,452**
Profit for the financial year	3,197	2,681	3,197	2,681
Net gain recognised directly in other comprehensive income	158	194	158	194
At 31 December	**40,077**	**36,512**	**38,892**	**35,327**

27. CASH AND CASH EQUIVALENTS

All figures £'000	2018 Group	2017 Group	2018 Society	2017 Society
Cash in hand	200	230	200	230
Balances with Bank of England	48,481	25,255	48,481	25,255
Loans and advances to credit institutions (note 12)	6,369	5,367	6,369	5,367
Total	**55,050**	**30,852**	**55,050**	**30,852**

28. FINANCIAL INSTRUMENTS

The Group is a retailer of financial instruments, mainly in the form of mortgages, savings and an introducer for insurance products. Through its normal operations it is exposed to a number of risks, the most significant of which are liquidity, credit risk in the mortgage book, credit risk in the treasury portfolio and interest rate risks (see below). The Group has a formal structure for managing these, including established risk limits, reporting lines, mandates and other control procedures. This structure is reviewed regularly by the Society's Board when considering the responsibility for managing and controlling the balance sheet exposures of the Group. The Assets and Liabilities Committee monitors interest rate risk in the balance sheet, including in accordance with the Society's policy regarding interest rate risk in the banking book as approved by the Board. The Risk Committee monitors other risk against the Board risk appetite statements.

Instruments used for risk management purposes include derivative financial instruments (derivatives). Derivatives are financial contracts or agreements whose value is derived from one (or more) underlying price, rate or index inherent in the contract or agreement, such as the interest rate. The principal derivatives used by the Group in balance sheet risk management are interest rate swaps, caps and collars which are used to hedge Group balance sheet exposures arising from fixed and capped rate mortgage lending, and fixed rate savings products. Such derivatives are only used in accordance with Section 9A of the Building Societies Act 1986, to reduce the risk of loss arising from changes in interest rates or other factors specified in the legislation. They are not used in trading activity or for speculative purposes.

The fair values of these hedges at 31 December 2018 are shown in note 13.

Financial assets and liabilities are measured on an on-going basis either at fair value or at amortised cost. Note 1 describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised.

Notes to the Annual Report and Accounts (continued)

FINANCIAL INSTRUMENTS (CONTINUED)

The tables below analyse the Group's assets and liabilities by financial classification:

Group & Society 2018 All figures £'000	Amortised cost	Mandatorily at FVTPL	Total
Cash and balances at central banks	48,681	0	48,681
Loans and advances to credit institutions	6,379	0	6,379
Derivative financial instruments	0	230	230
Loans and advances to customers	411,125	0	411,125
Total financial assets	**466,185**	**230**	**466,415**
Shares	340,246	0	340,246
Amounts owed to credit institutions	45,130	0	45,130
Amounts owed to other customers	40,887	0	40,887
Derivative financial instruments	0	97	97
Total financial liabilities	**426,263**	**97**	**426,360**

Group & Society 2017 All figures £'000	Held at amortised cost		Held at fair value		Total
	Loans and receivables	Financial liabilities	Derivatives designated as fair value hedges	Unmatched derivatives	
Cash and balances at central banks	25,485	0	0	0	25,485
Loans and advances to credit institutions	5,372	0	0	0	5,372
Derivative financial instruments	0	0	166	0	166
Loans and advances to customers	389,809	0	0	0	389,809
Total financial assets	**420,666**	**0**	**166**	**0**	**420,832**
Shares	0	319,465	0	0	319,465
Amounts owed to credit institutions	0	25,044	0	0	25,044
Amounts owed to other customers	0	40,022	0	0	40,022
Derivative financial instruments	0	0	111	5	116
Total financial liabilities	**0**	**384,531**	**111**	**5**	**384,647**

There have been no reclassifications other than those caused by the adoption of IFRS 9 in either year.

Amounts owed to credit institutions are borrowings from the Bank of England under the Term Funding Scheme.

Notes to the Annual Report and Accounts (continued)

FINANCIAL INSTRUMENTS (CONTINUED)

Classification of financial assets and financial liabilities on 1 January 2018, the date of initial application of IFRS 9:

Group & Society 2018 **All figures £'000**	**Note**	**Original classification under IAS 39**	**New classification under IFRS 9**	**Original carrying amount under IAS 39**	**New carrying amount under IFRS 9**
Financial Assets					
Cash and balances at central banks	27	Loans and receivables	Amortised cost	25,485	25,485
Loans and advances to credit institutions	12	Loans and receivables	Amortised cost	5,372	5,372
Derivative financial instruments	13	FVTPL	FVTPL (mandatory)	166	166
Loans and advances to customers	31	Loans and receivables	Amortised cost	389,809	390,069
Total financial assets				**420,832**	**421,092**
Financial Liabilities					
Shares	20	Amortised cost	Amortised cost	319,465	319,465
Amounts owed to credit institutions	21	Amortised cost	Amortised cost	25,044	25,044
Amounts owed to other customers	22	Amortised cost	Amortised cost	40,022	40,022
Derivative financial instruments	13	FVTPL	FVTPL (mandatory)	116	116
Total financial liabilities				**384,647**	**384,647**

Notes to the Annual Report and Accounts (continued)

FINANCIAL INSTRUMENTS (CONTINUED)

Classification of financial assets and financial liabilities on 1 January 2018 of initial application of IFRS 9 (continued):

Group & Society 2018 **All figures £'000**	**IAS 39 carrying amount 31 December 2017**	**Remeasurement**	**IFRS 9 carrying amount 1 January 2018**
Financial Assets			
Cash and balances at central banks	25,485	0	25,485
Loans and advances to credit institutions	5,372	0	5,372
Derivative financial instruments	166	0	166
Loans and advances to customers	389,809	260	390,069
Total financial assets	**420,832**	**260**	**421,092**
Financial Liabilities			
Shares	319,465	0	319,465
Amounts owed to credit institutions	25,044	0	25,044
Amounts owed to other customers	40,022	0	40,022
Derivative financial instruments	116	0	116
Total financial liabilities	**384,647**	**0**	**384,647**

Fair value of financial assets and liabilities

Fair value is the value for which an asset or liability could be exchanged or settled between knowledgeable willing parties in an arm's length transaction. The estimated fair value of the financial assets and liabilities above has been calculated using the following valuation methodology (which is explained in note 1):

Notes to the Annual Report and Accounts (continued)

FINANCIAL INSTRUMENTS (CONTINUED)

Note	Valuation Category	Methodology
1	Level 1	The fair value of cash in hand and deposits with central banks is the amount repayable on demand.
2	Level 2	The fair value of overnight deposits is the amount repayable on demand. The estimated fair value of loans and advances to credit institutions is calculated based on discounted expected future cash flows.
3	Level 3	Loans and advances are recorded net of provisions for impairment together with the fair value adjustment for hedged items as required by IFRS 9. The estimated fair value of loans and advances represents the discounted amount of estimated future cash flows expected to be received taking account of expected prepayment rates. Estimated cash flows are discounted at prevailing market rates for items of similar remaining maturity. The fair values have been adjusted where necessary to reflect any observable market conditions at the time of valuation.
4	Level 3	The fair value of shares and deposits and other borrowings with no stated maturity is the amount repayable on demand. The fair value of fixed interest bearing deposits and other borrowings without a quoted market price is based on expected future cash flows determined by the contractual terms and conditions discounted at prevailing market rates for items of similar remaining maturity.

The table below analyses the book and fair values of the Group's financial instruments held at amortised cost at 31 December.

Group & Society All figures £'000	Note	2018 Book value	2018 Fair value	2017 Book value	2017 Fair value
Financial assets					
Cash and balances at central banks	1	48,681	48,681	25,485	25,485
Loans and advances to credit institutions	2	6,379	6,379	5,372	5,372
Loans and advances to customers	3	411,125	412,167	389,809	392,183
Financial liabilities					
Shares	4	340,246	340,478	319,465	319,753
Amounts owed to credit institutions	4	45,130	45,130	25,044	25,044
Amounts owed to other customers	4	40,887	40,887	40,022	40,022

Notes to the Annual Report and Accounts (continued)

FINANCIAL INSTRUMENTS (CONTINUED)

Fair value of financial assets and liabilities carried at fair value

The table below summarises the fair values of the Group's financial assets and liabilities that are accounted for at fair value, analysed by the valuation methodology used by the Group to derive the financial instruments fair value:

Group & Society 2018 All figures £'000	Level 1	Level 2	Level 3	Total
Financial assets				
Derivative financial instruments		230		230
Financial liabilities				
Derivative financial instruments		(97)		(97)

Group & Society 2017 All figures £'000	Level 1	Level 2	Level 3	Total
Financial assets				
Derivative financial instruments		166		166
Financial liabilities				
Derivative financial instruments		(116)		(116)

Valuation techniques

The following is a description of the determination of fair value for financial instruments which are accounted for at fair value using valuation techniques. The fair value hierarchy detailed in IFRS 13: 'Fair Value Measurement' splits the source of input when deriving fair values into three levels, as follows:

- 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 or indirectly
- Level 3 – inputs for the asset or liability that are not based on observable market data

The main valuation techniques employed by the Group to establish fair value of the financial instruments disclosed above are set out below:

Interest rate swaps

- Level 2 - Interest rate swaps valuation is also based on the 'present value' method. Expected interest cash flows are discounted using the prevailing 3 month LIBOR yield curves. The 3 month LIBOR yield curves are generally observable market data which is derived from quoted interest rates in similar time bandings which match the timings of the interest cash flows and maturities of the instruments.

Notes to the Annual Report and Accounts (continued)

29. CREDIT RISK

Credit risk is the risk that the Group incurs a financial loss arising from the failure of a customer or counterparty to meet their contractual obligations. The Group structures the level of credit risk it undertakes, by maintaining a credit governance framework involving delegated approval authority levels and credit procedures, the objective of which is to build and maintain risk asset portfolios of high quality.

The Group's maximum credit risk exposure is detailed in the table below:

Group and Society **All figures £'000**	**2018**	**2017**
Cash and balances at central banks	48,681	25,485
Loans and advances to credit institutions	6,379	5,372
Other debtors	5	22
Derivative financial instruments	230	166
Loans and advances to customers	411,240	389,836
Total statement of financial position exposure	**466,535**	**420,881**
Off balance sheet exposure – mortgage commitments	14,896	18,586
Total credit risk exposure	**481,431**	**439,467**

30. TREASURY CREDIT RISK

Treasury credit risk is the risk that the counterparty may default. The elements on the statement of financial position that represent treasury credit risk are:

- Loans and advances to credit institutions
- Debt securities
- Derivative financial instruments

ALCO is responsible for approving treasury counterparties for both derivatives and investment purposes. Limits are placed on the amount of risk accepted in relation to one counterparty, or group of counterparties, and to industry sectors. This is monitored daily by the Society's Finance team and reviewed by the ALCO.

The Group's policy only permits lending to central government (which includes the Bank of England), UK local authorities, banks with a high credit rating and certain building societies. Regular analysis of counterparty credit risk and monitoring of publicly available information is performed to highlight possible exposures.

An analysis of the Group's treasury asset concentration is shown in the table below:

Group & Society	**2018** **£'000**	**2018** **%**	**2017** **£'000**	**2017** **%**
Bank of England (AA)	48,483	89%	25,256	82%
AA to AA-	3,479	6%	1,562	5%
A+ to A	2,898	5%	3,810	12%
Other	200	0%	229	1%
Total	**55,060**	**100%**	**30,857**	**100%**

The Group has no exposure to foreign exchange risk. All instruments are denominated in Sterling.

All treasury exposures qualify as 'stage 1' exposures under IFRS 9 for impairment provisioning. No derivative exposures are currently collateralised. Should the fair value exceed £250,000 with any counterparty then collateral would be required.

Notes to the Annual Report and Accounts (continued)

31. CUSTOMER CREDIT RISK

All mortgage loan applications are assessed with reference to the Group's lending policy, which includes assessing applicants for potential fraud risk, and which is approved by the Board.

The lending portfolio is monitored by the Risk Committee to ensure that it remains in line with the stated risk appetite of the Group, including adherence to the lending principles, policies and lending limits.

Credit risk management information is comprehensive and is circulated to the Risk Committee to ensure that the portfolio remains within the Group's risk appetite.

It is the Group's policy to strive for good customer outcomes and lend responsibly by verifying at the outset that the customer can meet the mortgage repayments. This is achieved by obtaining specific information from the customer concerning income and expenditure but also external credit reference agency data.

The Group does not have any exposure to the sub-prime market.

Impairment of Financial Assets

IFRS 9 changes the basis of recognition of impairment of financial assets from an incurred loss to an expected credit loss ('ECL') approach for financial assets held at amortised cost and fair value. This introduces a number of new concepts and changes to the approach to provisioning set out in IAS 39.

ECLs are based on an assessment of the probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD'), discounted to give a net present value. The estimation of ECL should be unbiased and probability weighted, considering all reasonable and supportable information, including forward looking economic assumptions and a range of possible outcomes. This has the effect of recognising losses on loans earlier than previously recognised, as IAS 39 requires provisions to be made only at the point where there is objective evidence of credit impairment.

IFRS 9 divides loans into three classes:

- No significant increase in credit risk since advance ('Performing')
- A significant increase in credit risk ('Underperforming')
- Impaired loans ('Non-Performing')

The Group's definition of a 'significant increase in credit risk' that results in a loan being categorised as Underperforming is determined by a combination of information available about the customer (e.g. credit bureau information) as well as the actual performance of the account. A loan is considered to be Underperforming when it meets any of the following criteria:

- A material reduction in the creditworthiness of the customer since inception as evidenced by an external credit score.
- Over 30 days in arrears
- Subject to forbearance. Loans subject to forbearance can be considered in two main categories; those which are loans which are on interest only to owner-occupier borrowers who will be aged over 70 at the maturity of the loan, where there is insufficient equity to sell and downsize, and others where the Society is in an arrangement with the borrower. The latter can be 'repaired' whereas this is very unlikely for the former.
- A high risk repayment strategy for owner-occupier interest only properties with insufficient equity for the borrower to sell and downsize.
- Other material information that has come to light since the loans inception (e.g. the customer entering into a debt management plan)

A loan is characterised as a Non-Performing loan when it meets any of the following criteria:

- Over 90 days in arrears
- Customer is declared bankrupt
- Owner-occupied interest only mortgage where there is no strategy of repayment, the strategy is described as 'sale and downsize' but there is insufficient equity, or the strategy is simply described as 'other' with no detail.

Where a loan which was previously underperforming or non-performing becomes a performing loan, the balance will move back to the relevant category.

The provisions on performing loans are equal to the level of expected credit default events within the next year. These accounts would have been largely unprovided for under IAS 39, although some cases with adverse qualitative indicators were likely to attract an emergence provision.

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

The provisions on both Underperforming and Non-Performing loans are made based on the expected credit losses over the expected life of the loan taking account of forward looking economic assumptions and a range of possible outcomes. The Group has decided to consider the impairment position under four economic scenarios of increasing severity ranging from a benign scenario that is based on the current position to the most severe scenario that is based on that used by the Bank of England to stress test the banking system.

Impairment Implementation

The areas of key judgements within the IFRS 9 provisions are:

- Future economic forecasts and the linkage to arrears levels.
- The weighting that should be given to the different economic forecasts.
- The extent to which the customer credit score can reduce before it is considered to constitute a material reduction in credit-worthiness.
- The degree of management override that should be applied to circumstances where a probability of default / exposure at default approach is unsuitable (such as older interest only borrowers).

All scenarios are based upon creating an expected loss through applying:

- A probability of default
- A loss given default. This is a function of the erosion of the underlying security.

The approach is to separately evaluate the incremental risks posed to the security value and to the customer's probability of default. Risk drivers are separately considered to establish how they will cumulatively impact the risk to the security or the probability of default.

The result of this evaluation is to allocate the loan into a high, medium or low category for both security and probability of default as well as a numeric value to use for the erosion of security and the probability of default that could be used for each loan.

The probability weighting for the four scenarios chosen are:

- Benign (neutral economic scenario) – 45%
- Base (allied to the Society's expectations in its Corporate Plan)– 25%
- Downturn (economic recession) – 25%
- Severe ('tail event' downturn) – 5%

The key sensitivities that have been considered and modelled are:

- Changed weightings between the economic scenarios
- Increasing the probability of default by +/- 25% in each scenario
- Increasing the reduction in the value of security by 5% in each scenario
- Reducing the expected life of the portfolio

Changes to the economic scenario weightings will have the greatest impact upon the results. If the weightings are changed as below:

- Benign – 40%
- Base – 30%
- Downturn – 25%
- Severe – 5%

The resulting provision would be £10k higher

If the weightings are changed as below:

- Benign – 40%
- Base – 25%
- Downturn – 30%
- Severe – 5%

The resulting provision would be £28k higher

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

If the weightings are changed as below:

- Benign – 40%
- Base – 25%
- Downturn – 25%
- Severe – 10%

The resulting provision would be £172k higher

The key weightings are therefore those impacting the Downturn and Severe scenarios. The Severe scenario is designed to be such an 'outlier' that the probability of it happening more than once a century is considered remote (e.g. 1930s depression occurring in a home-owning economy). Thus the key weighting is that attaching to the Downturn, and a c£30k movement for each 5% increase in probability (where Base decreases by 5%) is not especially volatile.

The expected life impacts the proportion of the whole life credit loss that is used for Performing loans. The remaining life is estimated at 1.25 years, if it were to reduce to 1 year the provision would increase by c£60k.

If the probability of default were to increase by 25% in each scenario then the provision would increase by c£95k. If it were to decrease by 25% then the provision would fall by c£96k.

If the post haircut property values fell by a further 5% in all scenarios this would increase the provision requirement by c£110k. If the post haircut security values were to increase by 10% in all scenarios this would reduce the provision by c£249k (2017: £150k).

The Group monitors concentration of credit risk by sector and by geographic location. An analysis of concentrations of credit risk from loans and advances is shown below:

Group and Society **All figures £'000**	**2018**	**2017**
Loans and Advances to Customers (Gross Receivables)		
Loans fully secured on residential property	401,591	378,198
Other loans fully secured on land	10,292	12,548
Total	**411,883**	**390,746**

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

Loans fully secured on residential property

The maximum credit risk exposure is detailed below:

Group and Society **All figures £'000**	**2018**	**2017**
Greater London	115,411	105,297
East Midlands	46,367	51,410
South East	86,483	77,453
South West	52,085	41,310
East of England	29,908	32,206
North West	21,611	20,054
West Midlands	18,557	19,924
Yorkshire and The Humber	14,631	14,379
Wales	9,989	9,043
North East	5,553	5,534
Scotland	996	1,588
Total	**401,591**	**378,198**

The quality of the Group's retail mortgage book is reflected in the number and value of accounts in arrears with only 0.2% (2017: 0.3%) of loan balances being three months or more in arrears.

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

Loans fully secured on residential property (Continued)

The credit risk exposure by loan to value band is detailed below:

Group and Society **All figures £'000**	**Stage 1**	**Stage 2**	**Stage 3**	**2018 Total**	**2017 Total**
Under 50%	193,716	12,579	666	**206,961**	196,924
50% to 75%	172,865	11,419	0	**184,284**	175,401
75% to 85%	6,109	674	0	**6,783**	4,945
Over 85%	3,398	164	0	**3,562**	928
Total	**376,088**	**24,836**	**666**	**401,591**	**378,198**

The average loan to value of residential mortgages is 47% (2017: 46%); indexed using the House Price Index published by the Land Registry.

The following table sets out information about the overdue status of loans and advances to customers in Stages 1,2 and 3 for 2018 under IFRS 9:

Group & Society **All figures £'000**	**Stage 1**	**Stage 2**	**Stage 3**	**2018 Total**
Current	376,088	22,633	0	398,721
Past due up to 3 months	0	2,204	0	2,204
Past due over 3 months	0	0	666	666
Total	**376,088**	**24,836**	**666**	**401,591**

Loan commitments are considered to be in Stage 1 and have loan to values consistent with the existing portfolio of loans and advances.

The main factor for loans moving into arrears tends to be the condition of the general economic environment.

The table below provides information on retail loans by payment due status based on IAS 39 for 2017:

Group & Society **All figures £'000**	**2017 Total**	**2017 %**
Neither past due or impaired	365,938	97
Past due up to 3 months but not impaired	1,585	0
Not impaired	367,523	97
Not past due	9,695	3
Past due over 3 months and impaired	980	0
Impaired	10,675	3
Total	**378,198**	**100**

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

Loans fully secured on residential property (Continued)

The value of collateral held is detailed below:

Group & Society All figures £'000	Unindexed 2018	Indexed 2018
Stage 1	958,831	1,219,318
Stage 2	52,560	70,848
Stage 3	1,374	3,229
Total	**1,012,765**	**1,293,394**

Loans not past due but impaired are interest only mortgages where there is potential for the repayment strategy of the loan to fail.

Group & Society All figures £'000	Unindexed 2017	Indexed 2017
Neither past due or impaired	868,394	1,336,356
Past due but not impaired	3,433	6,457
Impaired	20,326	31,113
Total	**892,153**	**1,373,926**

The collateral consists of residential property. Collateral values are adjusted by the Land Registry House Price Index to derive the indexed valuation at 31 December. This Index takes into account regional data from the 12 standard planning regions of the UK. The Group uses the Index to update the property values of its residential and buy-to-let portfolios on a quarterly basis.

With collateral capped to the amount of outstanding debt, the value of collateral held against loans past due and in 'Stage 2' at 31 December is £2.2m against outstanding debt of £2.2m. In addition, the value of collateral held against loans past due and in 'Stage 3' at 31 December is £0.7m against outstanding debt of £0.7m.

With collateral capped to the amount of outstanding debt, the value of collateral held against loans 'Past due but not impaired' at 31 December 2017 was £1.6m against outstanding debt of £1.6m. In addition, the value of collateral held against 'Impaired' assets at 31 December 2017 was £1.0m against outstanding debt of £1.0m.

Mortgage indemnity insurance acts as additional security. It is taken out for all residential loans where the borrowing exceeds 75% of the value of the property at the point of application.

The status 'past due up to three months but not impaired' and 'past due over three months but not impaired' includes any asset where a payment due is received late or missed but no individual provision has been allocated. The amount included is the entire loan amount rather than just the overdue amount.

Possession balances represent those loans where the Group has taken ownership of the underlying security pending its sale. The Group has various forbearance options to support customers who may find themselves in financial difficulty. These include payment plans, term extensions and reduced payment concessions.

Forbearance

Temporary interest only concessions are offered to customers in financial difficulty on a temporary basis with formal periodic review. The concessions allow customers to reduce monthly payments to cover interest only, and, if made, the arrears status would not increase. Reduced payment concessions allow a customer to make an agreed underpayment for a specific period of time. The monthly underpaid amount accrues as arrears and agreement is reached at the end of the concession period on how the arrears will be repaid.

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

Loans fully secured on residential property (Continued)

Payment plans are agreed to enable customers to reduce their arrears balances by an agreed amount per month which is paid in addition to their standard monthly repayment.

The term of the mortgage is extended in order to reduce payments to a level which is affordable to the customer based on their current financial circumstances.

From the above list, only the suitable forbearance options will be offered to a customer when appropriate.

All forbearance arrangements are formally discussed with the customer and reviewed by management prior to acceptance of the forbearance arrangement. By offering customers in financial difficulty the option of forbearance the Society potentially exposes itself to an increased level of risk through prolonging the period of non-contractual payment and/or potentially placing the customer into a detrimental position at the end of the forbearance period.

Regular monitoring of the level and different types of forbearance activity are reported to the Board on a periodic basis. The Board monitors the level of arrears and forbearance cases. In addition all forbearance arrangements are reviewed and discussed with the customer on a regular basis to assess the ongoing potential risk to the Society and suitability of the arrangement for the customer.

The table below details the loan balances of forbearance cases:

Group and Society **All figures £'000**	**Stage 1**	**Stage 2**	**Stage 3**	**2018** **Total**	**2017**
Interest only concessions	0	293	0	293	196
Reduced payment concessions	0	134	47	181	131
Payment plans	0	227	95	323	312
Mortgage term extensions	0	3,467	0	3,467	3,640
Total	**0**	**4,121**	**143**	**4,263**	**4,279**

Other loans fully secured on land

The maximum credit risk exposure is detailed below:

Group and Society **All figures £'000**	**2018**	**2017**
Greater London	5,078	6,340
East Midlands	1	1
South East	1,813	2,529
South West	1,482	1,660
East of England	980	982
North West	354	354
West Midlands	78	119
Yorkshire and The Humber	354	400
North East	152	163
Total	**10,292**	**12,548**

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

Other loans fully secured on land (Continued)

The credit risk exposure by loan to value band is detailed below:

Group and Society All figures £'000	Stage 1	Stage 2	Stage 3	2018 Total	2017 Total
Under 50%	3,828	0	0	**3,828**	**4,030**
50% to 75%	5,958	506	0	**6,464**	**8,518**
Over 75%	0	0	0	**0**	**0**
Total	**9,786**	**506**	**0**	**10,292**	**12,548**

The average loan to value of other loans fully secured on land is 55% (2017: 56%).

The quality of the Group's mortgage book secured on commercial property is reflected in the number and value of accounts in arrears with £nil (2017: £nil) of loan balances being three months or more in arrears.

The main factor for loans moving into arrears tends to be the condition of the general economic environment. The table below provides information on commercial loans by payment due status:

The following table sets out information about the overdue status of loans and advances to customers in Stages 1,2 and 3 for 2018 under IFRS 9:

Group & Society All figures £'000	Stage 1	Stage 2	Stage 3	2018 Total
Current	9,786	506	0	**10,292**
Overdue > 30 days	0	0	0	**0**
Total	**9,786**	**506**	**0**	**10,292**

The table below provides information on commercial loans by payment due status based on IAS 39 for 2017:

Group & Society	2017 £'000
Neither past due or impaired	12,548
Not impaired	**12,548**
Total	**12,548**

Notes to the Annual Report and Accounts (continued)

CUSTOMER CREDIT RISK (CONTINUED)

Other loans fully secured on land (Continued)

The value of collateral held is detailed below:

Group & Society All figures £'000	Unindexed 2018	Indexed 2018
Stage 1	19,057	19,057
Stage 2	750	750
Stage 3	0	0
Total	**19,807**	**19,807**

Group & Society All figures £'000	Unindexed 2017	Indexed 2017
Neither past due or impaired	23,870	23,287
Total	**23,870**	**23,287**

The collateral consists of commercial property. Collateral is capped at the amount of outstanding exposure.

The status 'past due up to three months but not impaired' and 'past due over three months but not impaired' includes any asset where a payment due is received late or missed but no individual provision has been allocated. The amount included is the entire loan amount rather than just the overdue amount.

Possession balances represent those loans where the Group has taken ownership of the underlying security pending its sale. The Group has various forbearance options to support customers who may find themselves in financial difficulty. These include payment plans, capitalisations, term extensions and reduced payment concessions.

Forbearance

The forbearance policy for loans fully secured on land is the same as that for loans fully secured on residential property.

There was one mortgage in forbearance or impaired at 31 December 2018 (2017: £nil). Provisions of £55k are made for loans fully secured on land.

Group and Society All figures £'000	Stage 1	Stage 2	Stage 3	2018 Total	2017
Reduced payment concessions	0	506	0	506	**0**
Total	**0**	**506**	**0**	**506**	**0**

Provisions for loans fully secured on land are reported in Note 14.

Notes to the Annual Report and Accounts (continued)

32. LIQUIDITY RISK

The Group's policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding, to maintain public confidence in the solvency of the Group and to enable it to meet its financial obligations as they arise. This is achieved through maintaining a prudent level of liquid assets and through control of the growth of the business. A significant proportion of the Society's liquidity is held either at call or in the form of debt securities and treasury bills, which are capable of being sold at short notice to meet unexpected and severe adverse cash flows. Stress tests are undertaken to measure the Society's ability to meet such adverse flows, the results of which are reviewed by ALCO. The Board is confident that the Society will continue to be able to meet its future financial obligations as they arise.

The table below analyses the Group's assets and liabilities into relevant maturity groupings, based on the remaining period to contractual maturity at the statement of financial position date. This is not representative of the Group's management of liquidity. Loans and advances to customers rarely run their full course. The actual repayment profile is likely to be significantly different from that shown in the analysis. For example most mortgages have a contractual maturity of around 25 years but are generally repaid much sooner. The average life of a mortgage at the Group is c 2.5 years. Conversely, retail deposits repayable on demand generally remain on balance sheet much longer.

Group 2018 **All figures £'000**	**On demand**	**Not more than 3 months**	**More than 3 months but not more than a year**	**More than a year but not more than 5 years**	**More than 5 years**	**Total**
Cash and balances at central banks	48,681	0	0	0	0	48,681
Loans and advances to credit institutions	6,379	0	0	0	0	6,379
Derivative financial instruments	0	2	16	212	0	230
Loans and advances to customers	3,429	2,547	19,965	83,591	301,593	411,125
Non-financial assets	0	0	0	0	2,618	2,618
Total assets	**58,489**	**2,549**	**19,981**	**83,803**	**304,211**	**469,033**
Shares	157,594	131,692	46,906	4,054	0	340,246
Amounts owed to credit institutions	130	0	0	45,000	0	45,130
Amounts owed to other customers	7,219	33,668	0	0	0	40,887
Derivative financial instruments	0	0	1	96	0	97
Non-financial liabilities	0	0	0	0	2,596	2,596
Reserves	0	0	0	0	40,077	40,077
Total liabilities and reserves	**164,943**	**165,360**	**46,907**	**49,150**	**42,673**	**469,033**

Included in the Group balances were £1.2m of reserves held by the subsidiary company.

Notes to the Annual Report and Accounts (continued)

LIQUIDITY RISK (CONTINUED)

Group 2017 All figures £'000	On demand	Not more than 3 months	More than 3 months but not more than a year	More than a year but not more than 5 years	More than 5 years	Total
Cash and balances at central banks	25,485	0	0	0	0	25,485
Loans and advances to credit institutions	5,372	0	0	0	0	5,372
Derivative financial instruments	0	0	6	160	0	166
Loans and advances to customers	2,809	2,511	15,872	79,764	288,853	389,809
Non-financial assets	0	0	0	0	2,962	2,962
Total assets	**33,666**	**2,511**	**15,878**	**79,924**	**291,815**	**423,794**
Shares	161,374	133,025	14,024	11,042	0	319,465
Amounts owed to credit institutions	44	0	0	25,000	0	25,044
Amounts owed to other customers	8,864	31,158	0	0	0	40,022
Derivative financial instruments	0	3	9	104	0	116
Non-financial liabilities	0	0	0	0	2,635	2,635
Reserves	0	0	0	0	36,512	36,512
Total liabilities and reserves	**170,282**	**164,186**	**14,033**	**36,146**	**39,147**	**423,794**

Included in the balances of the Group were £1.2m of Reserves held by the subsidiary company.

The following is an analysis of the gross contractual cash flows payable under financial liabilities:

Group and Society 2018 All figures £'000	On demand	Not more than 3 months	More than 3 months but not more than a year	More than a year but not more than 5 years	More than 5 years	Total
Shares	157,594	131,938	47,366	4,159	0	341,057
Amounts owed to credit institutions	130	0	0	45,000	0	45,130
Amounts owed to other customers	7,219	33,723	0	0	0	40,942
Derivative financial instruments	0	0	1	96	0	97
Total financial liabilities	**164,943**	**165,661**	**47,367**	**49,255**	**0**	**427,226**

Notes to the Annual Report and Accounts (continued)

LIQUIDITY RISK (CONTINUED)

Group and Society 2017 All figures £'000	On demand	Not more than 3 months	More than 3 months but not more than a year	More than a year but not more than 5 years	More than 5 years	Total
Shares	161,374	133,253	14,092	11,486	0	320,205
Amounts owed to credit institutions	44	0	0	25,000	0	25,044
Amounts owed to other customers	8,864	31,210	0	0	0	40,074
Derivative financial instruments	0	3	9	104	0	116
Total financial liabilities	170,282	164,466	14,101	36,590	0	**385,439**

33. MARKET RISK

Market risk is the risk of changes to the Society's financial condition caused by market interest rates. The Society is exposed to market risk in the form of changes (or potential changes) in the general level of interest rates, changes in the relationship between short and long-term interest rates and divergence of interest rates for different balance sheet elements (basis risk).

The Society has adopted the 'Matched Plus' approach to interest rate risk, as agreed with the PRA, which aims to manage interest rate exposures to within Board agreed limits through the use of either a natural hedge or an interest rate derivative.

The management of interest rate risk is based, inter alia, on a full statement of financial position gap analysis. The statement of financial position is subjected to a number of stress tests. On a monthly basis, these stress tests include stressing interest rates by 2.5%, short term increases or decreases followed by longer term flattening of interest rates and gradual movements in interest rates. In addition management review interest rate basis risk; stressing the statement of financial position by both expected and a severe stress scenarios. Both sets of results are measured against the Board's appetite for risk. The Board has set a risk appetite for market risk measured in the stressed gap analysis of £1.5m of capital. The Board has set a risk appetite for basis risk based on minimum margins which are revised annually. These stress tests and their results are monitored by the ALCO and reported to the Board.

Notes to the Annual Report and Accounts (continued)

MARKET RISK (CONTINUED)

The tables below summarise the Group's exposure to interest rate risk. Included in the tables are Group assets and liabilities, including derivative financial instruments which are principally used to reduce exposure to interest rate risk, categorised by re-pricing date.

Group 2018 **All figures £'000**	**Not more than 3 months**	**More than 3 months but not more than a year**	**More than a year but not more than 5 years**	**Non-interest bearing**	**Total**
Cash and balances at central banks	48,481	0	0	200	48,681
Loans and advances to credit institutions	6,379	0	0	0	6,379
Derivative financial instruments	0	0	0	230	230
Loans and advances to customers	332,656	18,048	60,421	0	411,125
Non-financial assets	0	0	0	2,618	2,618
Total assets	**387,516**	**18,048**	**60,421**	**3,048**	**469,033**
Shares	314,124	2,075	23,000	1,047	340,246
Amounts owed to credit institutions	45,130	0	0	0	45,130
Amounts owed to other customers	40,729	0	0	158	40,887
Derivative financial instruments	0	0	0	97	97
Non-financial liabilities	0	0	0	2,596	2,596
Reserves	0	0	0	40,077	40,077
Total liabilities and reserves	**399,983**	**2,075**	**23,000**	**43,975**	**469,033**
Impact of derivative instruments	60,000	(7,000)	(53,000)	0	0
Interest rate sensitivity gap	**47,533**	**8,973**	**(15,579)**	**(40,927)**	**(0)**
Sensitivity to profit and reserves					
Parallel shift of + 2%	(141)	179	(187)	0	(149)
Parallel shift of - 2%	141	(179)	187	0	149

Notes to the Annual Report and Accounts (continued)

MARKET RISK (CONTINUED)

Group 2017 All figures £'000	Not more than 3 months	More than 3 months but not more than a year	More than a year but not more than 5 years	Non-interest bearing	Total
Cash and balances at central banks	25,255	0	0	230	25,485
Loans and advances to credit institutions	5,372	0	0	0	5,372
Derivative financial instruments	0	0	0	166	166
Loans and advances to customers	327,850	15,195	46,764	0	389,809
Non-financial assets	0	0	0	2,962	2,962
Total assets	**358,477**	**15,195**	**46,764**	3,358	423,794
Shares	306,421	999	10,975	1,070	319,465
Amounts owed to credit institutions	25,044	0	0	0	25,044
Amounts owed to other customers	39,853	0	0	169	40,022
Derivative financial instruments	0	0	0	116	116
Non-financial liabilities	0	0	0	2,635	2,635
Reserves	0	0	0	36,512	36,512
Total liabilities and reserves	**371,318**	**999**	**10,975**	**40,502**	**423,794**
Impact of derivative instruments	42,000	(10,500)	(31,500)	0	0
Interest rate sensitivity gap	**29,159**	**3,696**	**4,289**	**(37,144)**	**0**
Sensitivity to profit and reserves					
Parallel shift of + 2%	(104)	(44)	(96)	0	(244)
Parallel shift of - 2%	104	44	96	0	244

There is no material difference between the interest rate risk profile for the Group and that for the Society.

The Group is not exposed to foreign currency risk.

The Society does not have any financial assets or liabilities that are offset with the net amount presented in the statement of financial position as IAS 32 'Financial Instruments – Presentation' requires both an enforceable right to set off and the intention to settle on a net basis or to realise the asset and settle the liability simultaneously. Neither of these conditions are met by the Society.

All financial assets and liabilities are presented on a gross basis in the statement of financial position.

The Society and Group, at December 2018, have entered into Credit Support Annexes (CSAs) for its derivative instruments which provide for the exchange of collateral on a daily basis to mitigate net mark to market credit exposure. These are set to a minimum threshold of £250k.

As credit exposures are below the threshold agreed in the CSAs no collateral was provided against derivative financial instruments or repurchase agreements at 31 December 2018 (2017: £nil).

Notes to the Annual Report and Accounts (continued)

34. CAPITAL STRUCTURE

The Society's policy is to maintain a strong capital base to maintain member, creditor and market confidence and to sustain future development of the business. The formal ICAAP process (Internal Capital Adequacy Assessment Process) assists the Society with its management of capital. The business planning updates enable the board to monitor the Society's capital position to assess whether adequate capital is held to mitigate the risks it faces in the course of its business activities. The Society's actual and expected capital position is reviewed against stated risk appetite which aims to maintain capital at a specific level above its Internal Capital Guidance (ICG).

The Board manages the Society's capital and risk exposures to maintain capital in line with regulatory requirements. This is subjected to regular stress tests to ensure the Society maintains sufficient capital for future possible events.

The Group's capital requirements are set and monitored by the PRA. During 2018 the Society has complied with the new requirements included within the EU Capital Requirements Directive IV (Basel III).

There were no reported breaches of capital requirements during the year. There have been no material changes in the Society's management of capital during the year. At 31 December 2018 the Group had CET1 (Common Equity Tier 1) capital of £40m comprising of general reserves less intangible assets and other regulatory adjustments. The Group had no tier 2 capital, meaning that total regulatory capital was also £40m.

Under Basel III Pillar 3 the Society is required to publish further information regarding its capital position and exposures. The Society's Pillar 3 disclosures are available on our website www.mhbs.co.uk.

Lending and Business Decisions

The Society manually underwrites all lending decisions to enable it to make appropriate decisions based on an individual's circumstances. Once loan funds have been advanced detailed portfolio management information is used to review the ongoing risk profile of both the portfolios and individual customers. In addition, for residential and buy-to-let mortgages, property values are updated on a quarterly basis.

Pricing

Pricing models are utilised for all mortgage product launches. The models include expected loss estimates and capital utilisation enabling the calculation of a risk adjusted return on capital.

Counterparty risk

Wholesale lending is only carried out with approved counterparties in line with the Society's lending criteria and is subject to a range of limits. The limits are monitored daily to ensure the Society remains within risk appetite.

35. GUARANTEES AND FINANCIAL COMMITMENTS

The Society and Group have capital expenditure contracted for but not provided for in the accounts at 31 December 2018 £nil (2017:£3k).

The total of future minimum lease payments under non-cancellable operating leases at 31 December 2018 is £95k, expiring between one and five years (2017:£94k).

Notes to the Annual Report and Accounts (continued)

36. RELATED PARTY TRANSACTIONS

Key management personnel compensation

The directors of the Society are considered to be the only key management personnel as defined by IAS 24. Total compensation for key management personnel was as follows and a breakdown is disclosed on page 21 in the Directors' remuneration report.

Group and Society All figures £'000	2018	2017
Key management personnel compensation	**672**	632

Transactions with key management personnel and their close family members

The following transactions were undertaken through the normal course of business:

Group & Society	2018 £'000	2018 Number of people	2017 £'000	2017 Number of people
Deposits, share accounts and investments				
Net movement in the year	11		38	
Balance at 31 December	86	9	75	8

Key management personnel and members of close family received interest of less than £1k in total (2017: less than £1k in total) during the year.

Secured loans made to key management personnel and members of their close family would be on the same terms and conditions that are applicable to all other employees and members of Market Harborough Building Society.

Amounts deposited by key management personnel and members of their close family earn interest at the same rates and on the same terms and conditions as applicable to all other employees and members of Market Harborough Building Society.

Directors' loans and transactions

At 31 December 2018 there were no outstanding secured mortgage loans (2017: nil) to directors and their connected persons. A register is maintained at the Head Office of the Society which shows details of all loans, transactions and arrangements with directors and their connected persons. A statement of the appropriate details contained in the register, for the financial year ended 31 December 2018, will be available for inspection at the Head Office for a period of 15 days up to and including the annual general meeting.

Subsidiary Company

The Society directly holds 100% of the issued ordinary share capital of Market Harborough Mortgages Limited. The principal activity of the company is mortgage related finance. Its share capital is £1 (2015: £1). Its principal place of business is Welland House, The Square, Market Harborough, Leicestershire, LE16 7PD. It is registered in England and Wales. There have been no additions or disposals of investments during the year. Market Harborough Mortgages Limited became dormant from 1 January 2016. There were no transactions between the entities during the year.

37. CONTINGENT LIABILITIES

Contingent liabilities represent potential future obligations that at 31 December 2018 are not recognised in the statement of financial position because there is significant uncertainty at the date as to the requirement for the Group to make payments in respect of them.

The Society did not have any contingent liabilities at 31 December 2018.

Notes to the Annual Report and Accounts (continued)

38. COUNTRY BY COUNTRY REPORTING

Article 89 of the Capital Requirements Directive IV requires credit institutions and investments firms in the EU to disclose annually, specifying by Member State in which it has an establishment, the following information on a consolidated basis for the year: name, nature of activities, geographical location, turnover, number of employees, profit before tax, corporation tax paid and public subsidies received.

The principle activities of Market Harborough Building Society are provision of residential mortgages and retail savings products.

Market Harborough Building Society and its subsidiary operate only in the United Kingdom. Details of the Society's trading subsidiaries are disclosed in Note 15.

Average employee numbers are disclosed in Note 9.

Group **All figures £'000**	**2018**	**2017**
Turnover	11,116	10,162
Profit before tax	4,008	3,336
Corporation tax paid	667	611

Turnover consists of net interest income, net fees and commissions received or paid and other income.

No public subsidies were received by the Group.

Basis of preparation

The Country by Country information for the year ended 31 December 2018 has been prepared on the following basis:

The number of employees has been calculated as the average number of full and part-time employees, on a monthly basis, as disclosed in note 9.

Turnover represents total operating income as disclosed in the Group Income Statement. Total operating income comprises net interest income, fees and commissions receivable and payable and other income.

Pre-tax profit or loss represents the Group profit or loss before tax, as reported in the Group Income Statement.

Corporation tax paid represents the cash amount of corporation tax paid during the year, as disclosed in the Group Statement of Cash Flow.

No public subsidies were received during the year, however the Society is a participant of the Term Funding Scheme. Borrowings from the scheme are shown in note 28.

Statement of Directors' responsibilities in relation to the Country by Country Reporting (CBCR) Information

The Directors of the Society are responsible for preparing the CBCR Information for the year ended 31 December 2018 in accordance with the Capital Requirements (Country-by-Country Reporting) Regulations 2013. In preparing the CBCR Information, the Directors are responsible for:

- interpreting the requirements of the Capital Requirements (Country-by-Country Reporting) Regulations 2013;
- determining the acceptability of the basis of preparation set out above to the CBCR information;
- making judgements and estimates that are reasonable and prudent; and
- establishing such internal control as the Directors determine is necessary to enable the preparation of CBCR Information that is free from material misstatement, whether due to fraud or error.

39. TRANSITION TO IFRS 9

IFRS 9 – 'Financial Instruments'

This became effective from 1 January 2018.

IFRS 9 largely replaces the requirements of the previous financial instruments standard, IAS 39: 'Financial Instruments: Recognition and Measurement'. It addresses the areas of recognition, bases of valuation, income recognition methods, impairment and hedging for financial instruments and has become the standard governing the Group's accounting for Financial Assets and Liabilities. Only the rules relating to the Group's portfolio hedging arrangements will remain subject to IAS 39.

Notes to the Annual Report and Accounts (continued)

TRANSITION TO IFRS 9 (CONTINUED)

Many of the previous IAS 39 rules are repeated in broadly similar form in the new standard. In particular, the amortised cost basis of measurement and the related EIR method of income recognition remain largely unchanged. The greatest impact from the new standard is on impairment provisions, but the requirements addressing classification and measurement and hedging have also changed.

Impairment Implementation

The Group undertook a project commencing in 2017 to develop the modelling and analysis necessary to comply with IFRS 9. This project was led by the Finance Director and the proposed approach has been presented to, discussed with, and agreed by the Audit Committee. The areas of key judgements within the IFRS 9 provisions are:

- Future economic forecasts and the linkage to arrears levels.
- The weighting that should be given to the different economic forecasts.
- The extent to which the customer credit score can reduce before it is considered to constitute a material reduction in credit-worthiness.
- The degree of management override that should be applied to circumstances where a probability of default / exposure at default approach is unsuitable (such as older interest only borrowers).

All scenarios are based upon creating an expected loss through applying:

- A probability of default
- A loss given default. This is a function of the erosion of the underlying security.

The approach is to separately evaluate the incremental risks posed to the security value and to the customer's probability of default. Risk drivers are separately considered to establish how they will cumulatively impact the risk to the security or the probability of default.

The result of this evaluation is to allocate the loan into a high, medium or low category for both security and probability of default as well as a numeric value to use for the erosion of security and the probability of default that could be used for each loan.

The probability weighting for the four scenarios at the point of transition chosen were:

- Benign (neutral economic scenario) – 50%
- Base (allied to the Society's expectations in its Corporate Plan)– 25%
- Downturn (economic recession) – 24%
- Severe ('tail event' downturn) – 1%

Notes to the Annual Report and Accounts (continued)

TRANSITION TO IFRS 9 (CONTINUED)

Classification of financial assets and financial liabilities on 1 January 2018 of initial application of IFRS 9:

Group & Society 2018 **All figures £'000**	**IAS 39 carrying amount 31 December 2017**	**Remeasurement**	**IFRS 9 carrying amount 1 January 2018**
Financial Assets			
Cash and balances at central banks	25,485		25,485
Loans and advances to credit institutions	5,372		5,372
Derivative financial instruments	166		166
Loans and advances to customers	389,809	(260)	389,549
Total financial assets	**420,832**	**(260)**	**420,572**
Financial Liabilities			
Shares	319,465		319,465
Amounts owed to credit institutions	25,044		25,044
Amounts owed to other customers	40,022		40,022
Derivative financial instruments	116		116
Total financial liabilities	**384,647**	**0**	**384,647**

Note: All of the movement in the Loans and advances to customers relates to the movement in provisions.

Retained Earnings **All figures £'000**	**Group**	**Society**
Closing balance under IAS 39 at 31 December 2017	36,512	35,327
Impact of initial recognition of IFRS 9	260	260
Deferred tax element of initial recognition of IFRS 9	(50)	(50)
Opening balance under IFRS 9 at 1 January 2018	**36,722**	**35,537**

Annual Business Statement

1. STATUTORY RATIOS AND OTHER PERCENTAGES

Group	2018	Statutory limit
Lending limit		
Proportion of business assets not in the form of loans fully secured on residential property	2.7%	25%
Funding limit		
Proportion of shares and borrowings not in the form of shares held by individuals	20.2%	50%

The percentages are calculated in accordance with, and the statutory limits are those prescribed by, sections 6 and 7 of the Building Societies Act 1986 (as amended by the Building Societies Act 1997) and are based on the statement of financial position.

Business assets are the total assets of the Group as shown in the statement of financial position plus provisions for impairment, less tangible fixed assets and liquid assets.

Loans fully secured on residential property are the amount of principal owed by borrowers and interest accrued not yet payable. This is the amount shown in the statement of financial position plus provisions for bad and doubtful debts and interest in suspense, less unamortised premiums on the acquisition of loans.

2. OTHER PERCENTAGES

Group	2018	2017
As a percentage of shares and borrowings		
Gross capital	9.4%	9.5%
Free capital	9.2%	9.1%
Liquid assets	12.9%	8.0%
Liquid assets (including off balance sheet FLS funding)	17.8%	17.8%
As a percentage of mean total assets		
Profit after taxation	0.7%	0.6%
Management expenses (Group)	1.5%	1.6%
Management expenses (Society)	1.5%	1.6%
As a percentage of total assets at year end		
Return on assets	0.7%	0.6%

The above percentages have been calculated from the Group Annual Report and Accounts.

Definitions

'Gross capital' represents the general reserve.

'Free capital' represents the general reserve plus provisions for bad and doubtful debts less tangible fixed assets.

'Mean total assets' is the average of the 2018 and 2017 year-end total assets.

'Liquid assets' represents available liquidity on the Group's balance sheet.

'Liquid assets (including off balance sheet FLS funding)' represents both available liquidity on the Group's balance sheet and Treasury Bills borrowed under the Funding for Lending Scheme, which would have to be sold to convert to readily available liquidity.

Annual Business Statement (continued)

3. INFORMATION RELATING TO THE DIRECTORS

Director	Occupation / Professional Qualification	Other Directorships	Year of Birth	Date of Appointment
Nicholas Johnston	Chartered Accountant	Market Harborough Mortgages Ltd	1959	01-08-09
Jonathan Fox	Company Director	Fox 65 Racing Ltd	1965	01-09-15
Melanie Duke	Company Director, Corporate Treasurer & Chartered Accountant	Duke Treasury Consulting Ltd 2016 G1 Limited GC Holdings Ltd Willow Gardens Management Company Ltd	1964	01-01-10
Andrew Merrick	Chief Financial Officer & Chartered Accountant	Medico Legal Records Ltd Irwin Mitchell Secretaries Ltd IM Dee Ltd Berkeley Law Nominees Ltd Kensington Law Ltd Berkeley Law Trust Company Ltd Berkeley Law Ltd Berkeley Latam Ltd Berkeley Hurrell Ltd Ascent Performance Group Ltd IM Investments Holdings Ltd Debt Guard Ltd IMCO Investments Ltd Alexander Harris (Altrincham) Ltd IM Commercial Holdings Ltd IME Law Ltd MPH Solicitors Ltd Irwin Mitchell Holdings Ltd	1961	01-01-18
Michael Thomas	Company Director & Corporate Treasurer & Chartered Accountant	AST Language Services Ltd	1964	10-07-13

INFORMATION RELATING TO THE DIRECTORS (CONTINUED)

Director	Occupation / Professional Qualification	Other Directorships	Year of Birth	Date of Appointment
Mark Robinson	Chief Executive	Market Harborough Mortgages Ltd Market Harborough Building Society Charitable Foundation Market Harborough Cottage Hospital Portico Great War Memorial Project	1957	17-09-07
Nicholas Fielden	Finance Director	Market Harborough Mortgages Ltd	1965	09-12-13
Zoe Shapiro	Company Director		1969	01-02-16

The Chief Executive has a notice period of twelve months by the Society and six months by the executive, and the Finance Director has a notice period of 6 months by both the executive and the Society. The contract for Mark Robinson was entered into on 17 September 2007 and for Nicholas Fielden on 4 November 2013.

Documents may be served on any of the directors at the offices of KPMG LLP, 1 Snowhill, Show Hill Queensway, Birmingham B4 6GH. Correspondence should be marked "Private and Confidential" and quote reference MHBS/SC/CO.

4. OTHER SENIOR EXECUTIVES

Name	Occupation	Directorships
Stephen Barringer	Head of Mortgages and Savings	None
Michelle Pledger	Head of Risk	None
Elizabeth Souter	Financial Controller & Secretary	Uppingham Community College
Annie Cossar	Head of Operations	None

5. NEW ACTIVITIES

No new powers were exercised for the first time during the year.

Glossary

Term	Definition
Arrears	A customer is in arrears when they are behind in meeting their contractual obligations with the result that an outstanding loan payment is overdue. The value of the arrears is the value of any payments that have been missed.
Basel III	The Basel Committee on Banking Supervision issued the Basel III rules text in December 2010, which presents the details of strengthened global regulatory standards on bank capital adequacy and liquidity. Basel III became effective from 1 January 2014 through CRD IV.
Buy to let loans	Buy to let loans are those loans which are offered to customers buying residential property specifically to let out. Common Equity Tier 1 capital (CET1)
Contractual maturity	The date at which a loan or financial instrument expires, at which point all outstanding principal and interest has been paid.
Core Tier 1 capital	Core Tier 1 capital comprises general reserves, other reserves less intangible assets and other regulatory deductions.
Credit risk	This is the risk that a customer or counterparty fails to meet their contractual obligations.
Capital Requirements Directive (CRD IV)	CRD IV is the European legislation which came into force from 1 January 2014 to implement Basel III. It has revised the capital requirements framework and introduced liquidity requirements, which regulators use when supervising firms.
Debt securities	Assets representing certificates of indebtedness of credit institutions, public bodies or other undertakings excluding those issued by central banks.
Deferred tax asset	Corporation tax recoverable (or payable) in future periods resulting from temporary or timing differences, between the accounting value of assets and liabilities and the tax base of those assets and liabilities.
Defined benefit obligation	The present value of expected future payments required to settle the obligations of a defined benefit plan resulting from employee service.
Derivative financial instruments	A derivative financial instrument is a contract between two parties whose value is based on an underlying price or index rate it is linked to, such as interest rates, exchange rates of stock market indices. The Society uses derivative financial instruments to hedge its exposure to interest rates.
Expected credit loss (ECL)	Expected credit loss is a calculation of the present value of the amount expected to be lost on a financial asset over its expected life.
Effective interest rate method (EIR)	The method used to measure the carrying value of a financial asset or liability and to allocate associated interest income or expense over the relevant period. The calculation includes all fees and penalties paid and received between parties which are integral to the contract.
Fair value	Fair value is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Financial Conduct Authority (FCA)	The statutory body responsible for conduct of business regulation and supervision of UK authorised firms for 1 April 2013.

Glossary (continued)

Term	Definition
Financial Services Compensation Scheme	The UK's compensation fund of last resort for customers of authorised financial services firm. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the FCA is obliged to pay an annual levy, which goes towards its running costs and compensation payments.
Forbearance strategies	Strategies to support borrowers in financial difficulty, such as agreeing a temporary reduction in the monthly payment, extending mortgage terms and a conversion to an interest-only basis. The aim of forbearance strategies is to avoid repossession.
Free Capital	The aggregate of gross capital and provisions for collective impairment losses on loans and advances to customers less property, plant and equipment and intangible assets.
Funding Limit	Measures the proportion of shares and borrowings (excluding the fair value adjustment for hedged risk) not in the form of shares held by individuals. The calculation of the funding limit is explained in the Annual Business Statement.
General reserves	The accumulation of the Society's historic and current year profits which is the main component of Common Equity Tier 1 capital.
Gross capital	The aggregate of general reserves, available for sale reserves and subscribed capital.
Impaired loans	Loans where there is objective evidence that an impairment event has occurred, meaning that the Society does not expect to collect all the contractual cash flows or expect to collect them later than they are contractually due.
Individual liquidity adequacy assessment (ILAA)	The Society's own assessment of the liquidity resources it requires in order to remain within the risk tolerances it has set. This will include an evaluation of potential stresses based on multiple market environments.
Individually/collectively assessed impairment	Individual assessments are made of all mortgage loans where objective evidence indicates losses are likely or the property is in possession. A collective impairment provision is made against the remaining group of loans and advances where objective evidence indicates that it is likely that losses may be realised.
Interest rate risk	The risk of loss due to a change in market interest rates. Interest rate risk can have an impact on Society's mortgages and savings products.
Internal Capital Adequacy Assessment Process (ICAAP)	The Society's own assessment, as part of Basel II requirements, of the levels of capital that it needs to hold in respect of its regulatory capital requirements for risks it faces under a business as usual scenario including stress events.
Lending limit	Measures the proportion of business assets not in the form of loans fully secured on residential property.
Leverage ratio	Leverage ratio is defined as Tier 1 capital divided by the total exposures which includes on and off balance sheet items, with this ratio expressed as a percentage.
Liquid Assets	Total of cash in hand, loans and advances to credit institutions, and debt securities.
Liquidity risk	Liquidity risk is the risk that the Society is unable to meet its financial obligations as they fall due, or can only secure them at excessive cost. This risk arises from timing mismatches of cash inflows and outflows.
Loan to value (LTV)	LTV expresses the amount of a mortgage as a percentage of the value of the property.
Loans past due	Loans are past due when a loan payment that has not been made as of its due date.

Glossary (continued)

Term	Definition
Management expenses	The aggregate of administrative expenses, depreciation and amortisation. The management expense ratio is management expenses expressed as a percentage of mean total assets.
Market risk	The risk that movements in market risk factors, including foreign exchange rates, interest rates, credit spreads and customer-driven factors will create potential losses or decrease the value of the Society balance sheet.
Mean total assets	Represents the amount produced by halving the aggregate of total assets at the beginning and end of the financial year.
Member	A person who has a share investment or a mortgage loan with the Society.
Net interest income	The difference between interest receivable on assets and similar income and interest paid on liabilities and similar charges.
Operational risk	The risk of loss arising from inadequate or failed internal processes, people and systems, or from external events.
Renegotiated loans	Loans are classed as renegotiated where an agreement between a borrower and a lender has been made to modify the loan terms either as part of an on-going relationship or if the borrower is in financial difficulties. The renegotiated loan may no longer be treated as past due or impaired.
Risk appetite	The articulation of the level of risk that the Society is willing to accept (or not accept) in order to safeguard the interests of the Society's members whilst also achieving business objectives.
Risk weighted assets (RWA)	The value of assets, after adjustment, under the relevant Basel II capital rules to reflect the degree of risk they represent.
Residential loans	Loans that are loaned to individuals rather than institutions. Residential mortgage lending is secured against residential property.
Prudential Regulation Authority (PRA)	The statutory body responsible for the prudential supervision of banks, building societies, insurers and small number of significant investment firms in the UK from the 1 April 2013. The PRA is a subsidiary of the Bank of England.
Secured business lending (SBL)	Loans secured on commercial property which is only made available to Small and Medium sized Enterprises.
Shares	Funds deposited by a person in a retail savings account with the Society. Such funds are recorded as liabilities for the Society.
Shares and borrowings	The aggregate of shares, amounts owed to credit institutions, amounts owed to other customers.
Standardised approach	The basic method used to calculate capital requirements for credit risk under Basel II. In this approach the risk weighting used in the capital calculation are determined by specified percentages.
Tier 1 capital	A measure of financial strength as defined by the FSA. Comprises general reserves from retained profits and permanent interest bearing shares (PIBS), less intangible assets and other regulatory adjustments.
Tier 2 capital	Comprises the collective impairment allowance (for exposures treated on a Basel II Standardised basis), less certain regulatory deductions.
Tier 1 ratio	Tier 1 capital as a percentage of risk weighted assets.

Glossary (continued)

Term	Definition
Underlying profit	Profit before tax adjusted to exclude derivative fair value movements and the FSCS levy.
Wholesale funding	The total of amounts owed to credit institutions, amounts owed to other customers.

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