




# report & accounts **2007**

Yorkshire
BUILDING SOCIETY
With you one hundred percent

# Contents

# Chairman's report

## Ed Anderson

I am pleased to report that your Society again put in a strong operating performance in 2007. Despite the upheaval in UK and global financial markets, we achieved record levels of mortgage lending, a robust savings inflow and strong growth in our core operating profits.

Overall our well-balanced approach to business over many years leaves the Society very well placed in the current environment:

- our funding is overwhelmingly from individual savers rather than from the financial markets and our long-term commitment to providing value for money savings accounts is reflected in an increased level of new savings balances direct from our members;
- our retail funding is supported by a well regarded wholesale funding programme that allowed us to raise funding from the markets before the supply dried up and prices rose;
- our level of liquidity (i.e. cash and short-term investments) at 25% of shares and borrowings, is amongst the highest of the major banks and building societies and is well above the regulatory minimum;
- the quality of our mortgage book remains high and where we have moved into new areas of lending this has been done in a proportionate and cautious manner. We have not entered into areas such as unsecured, buy-to-let or commercial lending; and
- our capital position remains well above the minimum required by the Financial Services Authority.

### Profits

Our core operating profits grew strongly from £77m to £91m. This remains consistent with our goal of optimising rather than maximising profits and with our core purpose of delivering long-term value to our members. We can do this because we are a mutual and as such we are not driven by the short-term need to pay dividends to equity shareholders, or to meet stock market expectations.

This achievement has been supported by outstanding performance across a wide range of areas, from asset growth to operational efficiency and from service delivery to product development, of which more later.

However, market conditions have adversely affected the value of our portfolio of structured credit investments, which was purchased over a number of years. This portfolio consists of a number of higher yielding treasury investments with a book value of £135m at 31st December 2007. This represented less than 1% of our total assets and less than 3% of our total liquidity.

Movements in this portfolio reduced our pre-tax profits by £32m in fair value losses and a further

**"We remain committed to delivering long-term value to our members by offering them excellent products, exceptional service and by treating them fairly in all of our dealings with them."**


£7m in impairment provisions. A further £11m charge has been taken directly to reserves.

Other fair value volatility, which in 2006 boosted our profits by £14m, reduced profits by £11m in 2007. The negative figure in 2007 partly reflects the reversal of prior year movements and partly items that will themselves reverse in later years.

During 2007, we made £9m profits from the disposal of property and £2m on our shares in LINK, but we consider neither of these items to be part of our core performance. We have similarly excluded additional non-mortgage provisions when comparing our year on year core performance.

The combination of these items and the other factors mentioned above has reduced pre-tax profits to £55m from £78m in 2006.

| | 2007 | 2006 |
|---|---|---|
| | £m | £m |
| **Core operating profit** | **91.1** | **76.8** |
| Treasury investments: | | |
| losses from fair value volatility | (32.5) | (0.4) |
| impairment provisions | (6.9) | - |
| | (39.4) | (0.4) |
| Other fair value volatility | (11.1) | 14.0 |
| Other non-recurring items | 14.0 | (12.5) |
| Statutory profit before tax | **54.6** | **77.9** |

Overall our financial position remains extremely robust. We continue to have a very strong capital position and the combination of past prudence, cost efficiency and the strength of our funding position, means that we are well placed to deal with the current market conditions.

Your board firmly believes that the interests of current and future members continue to be best served by the Yorkshire remaining an independent mutual organisation. If nothing else, events surrounding Northern Rock plc have demonstrated the resilience of the building societies and the value of focusing on long-term member value, rather than short-term shareholder value.

## 2007 performance

The Chief Executive's report covers our 2007 performance in detail. The highlights are:

- our mortgage assets grew by 15% to over £15bn and total assets have now passed £20bn;
- our underlying retail savings balances have again grown strongly with retail inflow of nearly £650m in 2007;
- in the wholesale funding markets we are one of only two societies to have a Covered Bond programme in place and we have no major public wholesale issues that require re-financing until well into 2009;
- our operational efficiency again improved with the management expense ratio reducing from 69p per £100 of assets to only 63p per £100 of assets;

# Chairman's report

- member satisfaction remained very high, with 9 out of 10 members continuing to rate our service as good or excellent; and
- we opened three new branches together with further substantial investment in our Internet operations.

## Outlook and strategy

From the outset of the market turmoil in the second half of 2007, the Yorkshire's primary focus has been the financial security of the Society and its members. This has guided all of our decision making and will continue to do so as we look ahead. There are now undeniable signs of a slowdown and we have reacted accordingly. We have moderated our targets for 2008 and changed our mix of lending to ensure we minimise our exposure to those parts of the market that are most susceptible to a downturn. Whether or not we are heading for a full recession or for a more shallow and temporary dip remains unclear, but we have taken care to position ourselves so as to deal with either eventuality.

This does not mean that our core strategy has changed, rather that we have adapted to fit the changing climate. We remain committed to delivering long-term value to our members by offering them excellent products, exceptional service and treating them fairly in all of our dealings with them.

The Yorkshire is financially strong, with sound asset quality, a high level of efficiency and a strong track record in the delivery of value to members. The Society, its management and staff have responded extremely well to the turbulent market conditions of the second half of 2007 and we remain very well placed in the face of any difficult market conditions ahead.

## Your board

The board remains committed to following best practice in corporate governance and a detailed report on this is set out in pages 31 to 37.

Once again I would like to thank my fellow directors for their contributions in 2007 and I know that the senior management team welcome the value that they add through both their objectivity and the application of their considerable knowledge and experience.

2007 saw further changes to the board. Rob Jackson retired as Operations Director at the end of July having been with the Society for over 23 years. Rob was instrumental in the development of the Society's current operating systems. I wish to record the board's thanks to him and wish him well in his retirement.

**"The Yorkshire is financially strong, with sound asset quality, a high level of efficiency and a strong track record in the delivery of value to members."**

I would also like to thank Paul Lee and Frank Beckett, both of whom retired as non-executive directors at the end of December, for their invaluable contributions over the past decade, in particular Paul as Vice Chairman and Frank as Chair of the Audit Committee and a member of the Risk Committee.

In June 2007, Philip Johnson joined as a non-executive director and his experience as a partner in a major accounting firm will be a valuable asset to the Group. I am pleased that he has accepted the key role of Chair of the Group's Audit Committee.

## Our people

Finally, on behalf of the board I must pay tribute to the continued contribution of the Society's staff and senior executives. Once again they have demonstrated, at all levels and in all areas of the Group, exceptionally high levels of professionalism, enthusiasm and basic hard work. We are fortunate to have a team who genuinely believe in delivering value to our members and who are committed to the continued success of your Society.

**Ed Anderson**
Chairman

# Chief Executive's report

## Iain Cornish

The markets in which we operate remained buoyant for the first half of 2007 and the slowdown in the economy, that many anticipated, did not initially materialise. The second half of the year, however, saw UK banks and building societies facing some of the most difficult market conditions since the early 1990s. At that time it was due to the housing market, now it is due to a major disruption to the way that financial markets themselves operate, although there are also clear signs of a slowdown in the housing market and the wider economy.

Our response to these market and economic conditions has been prudent and above all, focused on protecting the interests of our members.

We fully expect 2008 to be a year of greater uncertainty than we have experienced for many years. However, the strength of our position means we are extremely confident of our ability to go on delivering long-term value and excellent service to our members.

### A strategy based on balance

For many years, the Group's strategy has been to deliver value to members through providing products that are good value over the long-term and so build sustainable relationships with them. This means that we take a balanced approach across the business, for example:

- we seek to make enough profit to be financially sustainable over the long-term whilst delivering value to our members on a continuous basis;
- we want to grow, but not so fast that it means taking excessive risks or that it impacts on the service we can provide to our members; and
- we want to control our costs as far as possible, but at the same time improve the quality and accessibility of the service we provide.

The effectiveness of this strategy and our strong historic positioning have allowed us to weather the events of 2007, which are still continuing, in robust shape.

### Our response to market disruption

Whilst the majority of our funding is raised directly from individual savers, we do participate in the wholesale markets on a limited basis to access different, longer-term and, at times cheaper, sources of funding.

The second half of 2007 saw a virtual closing down of these funding markets, which led to the much-publicised problems for Northern Rock plc, whose dependence on these markets was extreme.

**"...we came through 2007 with continued strong liquid asset and wholesale funding positions."**

The strength of our reputation in the financial markets meant that we were able to raise a good supply of wholesale funding and capital in late 2006 and early 2007 at very competitive rates – at a time when rates in general were relatively low. For example, in May 2007 we issued our second Covered Bond on the wholesale markets. This issue was heavily oversubscribed (itself testimony to how strongly the Society is viewed in these markets) and as a result, the issue was very well priced and provided us with a significant amount of good value funding for three years.

This meant that when the markets worsened in late 2007 and funding became more expensive, we did not need to chase large amounts of funding or be forced to reduce our holdings of liquidity. In fact, funding was still available to us and was taken where the price was right, as other institutions looked for a quality home for their excess cash. As a result, we came through 2007 with continued strong liquid asset and wholesale funding positions.

At the same time, we reacted immediately to changes in the mortgage and savings markets, withdrawing from some areas where we perceived that, because of the changes in the market, risks were becoming too high. This was important because, along with disruption in the wholesale markets, the second half of 2007 saw rapid changes in the retail markets. Lenders looked to withdraw from many parts of the mortgage market. Some, in particular those who had previously reduced their commitment to the retail savings markets, returned with, in our view, unsustainably priced savings offerings. By contrast, we made sure that we balanced the ability to remain competitive with the need to operate sustainably and fairly.

In common with many institutions, the market turmoil also had an impact on the value of a small element of our treasury instruments. We have taken a prudent approach to the year-end valuation, reducing their carrying amount by some £50m. Continuing market difficulties have caused a further £15m fall since the year-end. We continue to monitor the performance of these investments closely and will review our holdings of these assets when greater normality returns to the markets for them.

## A year of significant milestones and achievements

Despite this challenging market your Society achieved a number of significant milestones.

Our total assets grew to over £20bn. This growth was built on record gross mortgage lending of £4.7bn and lower levels of borrowers choosing to redeem their mortgages and move to other lenders.

As a result, our mortgage book grew by over 15%, the largest increase in over a decade, and now stands at over £15bn.

Our member savings balances also grew strongly. Our inflow of savings direct from customers was

# Chief Executive's report

almost £650m in 2007, leading to an increase in retail savings balances of over £1bn. This growth was based on continued provision of a wide range of products priced to deliver long-term value to our members rather than to attract volatile balances through short-term incentives.

Our drive for ever greater levels of efficiency continued to bear fruit. Our management expenses ratio improved sharply and ended the year at 63p per £100 of assets – our lowest ever level and down 10p in just two years. It remains one of the lowest of any high street lender but we intend to continue to drive it down even further, whilst ensuring that this does not threaten the quality of our service.

## Member value

We seek to deliver value to our members in the form of consistently attractive interest rates, excellent service and innovative products. As such, a key measure for us is what our members themselves think about the products and service we provide to them.

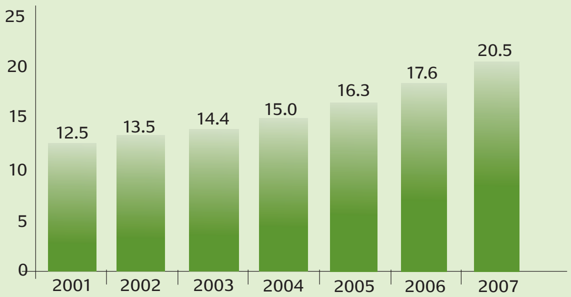
I am pleased to record that our regular customer satisfaction surveys continue to show that 9 out of 10 members would recommend us to their friends or family. At the same time our 'mystery shopper' exercises continue to show that we perform well against our competitors. Balancing this consistency of service with growth and improving our efficiency is always challenging, but we are committed to being one of the best organisations, of any description, that our members do business with.

Our mortgages and savings accounts have been consistently competitive. Last year we recorded over 950 appearances in 'best buy' tables, averaging over 18 mentions per week.

We also launched a number of new and improved products and services across the business. For example:

- three new branches were opened in 2007, in Chester, Oldham and Warrington reflecting our ongoing commitment to our branch network;

**Total assets (£bn)**

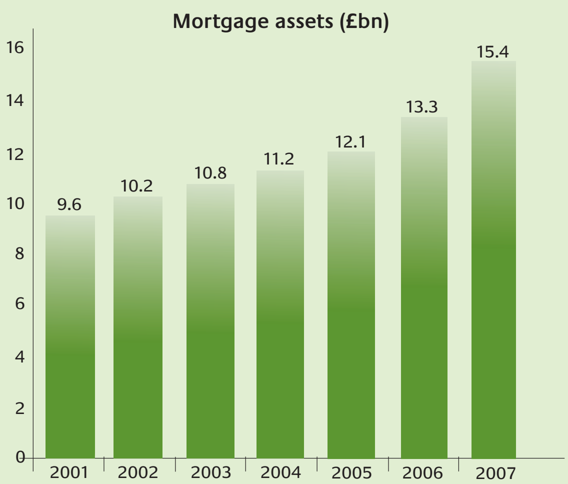


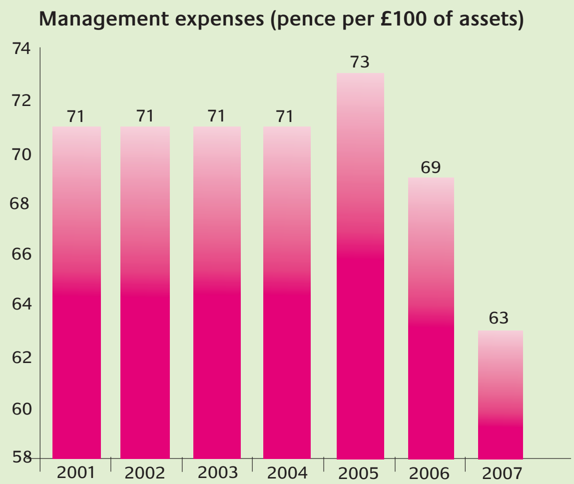

**Retail savings (£bn)**

- over 2,000 members a month are moving to our home insurance product, provided in partnership with Royal & SunAlliance, up 400% in four years and the product won a 5 star rating from Defaqto for the fourth year in a row;
- other new products and services in 2007 included the launch of our innovative and award winning e-conveyancer service, a foreign money transfer service in partnership with American Express and an insurance product designed for the over 50s;
- our existing products, meanwhile, continue to thrive, such as our Guaranteed Investment Account, offered through Credit Suisse, where sales rose by 300% in the year. An increasing number of our members are taking advantage of the opportunity to receive investment advice – income from Legal & General has risen by almost 40% in the last 3 years;
- our Corporate Business team has continued to cement its position as the leading provider of sharesave schemes in the UK with new clients including John Lewis Partnership, First Group and JJB; and
- underpinning this is a continued commitment to investing in our underlying systems and processes to support the services that we provide to members. 2007 has seen major developments take place in areas as diverse as our call handling systems (from our exclusively UK based call centres), risk management and product pricing, people management and facilities management processes.

These achievements are backed up by another set of industry awards won during 2007. These have been earned across a range of areas, but with a particular focus on service and innovation. They include:

- Most Innovative Application of Technology by a Bank or Building Society – ifs Financial Innovation Awards;
- Most Effective Delivery Channels Initiative for our e-conveyancer scheme – ifs Financial Innovation Awards;



# Chief Executive's report



- Innovator of the Year – Mortgage Finance Gazette;
- Service Excellence Award – Mortgage Introducer;
- Best Online Support award – Mortgage Edge;
- Best Lender for Existing Customers award – Legal & General;
- Best Service and Best Web Support awards – Mortgage Introducer;
- 5 Star Service award – Financial Adviser; and
- Gold Standard award – Mortgage Strategy Technology awards.

## Our business is underpinned by a strong balance sheet

Our achievement in delivering the required critical balance of growth, service and efficiency in 2007 was founded on the underlying strength of our balance sheet.

In the first half of the year we continued to expand our presence in the intermediary and credit repair mortgage markets, this was again done in a controlled manner. In particular, our portfolio of lending to borrowers with adverse credit histories is just 8% of total mortgages - well below the market norm. In response to market conditions, however, we have subsequently scaled back significantly in these areas. The Group has not entered into the unsecured personal, buy-to-let or commercial lending markets and so is not exposed to any potential downturn in these sectors in 2008.

Whilst our mortgage arrears have risen during 2007 this would be expected in the current environment. The levels remain extremely low – with just 0.3% of our mortgage loans more than 6 months in arrears and only 0.1% in possession.

Our balance sheet remains extremely strong and we are well positioned to deal with any continuation of the current market issues into 2008 and also any worsening of the housing market that may materialise.

## Our partnership with the community continues

We continue to be an active and responsible member of the communities in which we operate, evidenced by our levels of community support and fund raising across the country. Our staff are positively encouraged to get involved, with an entitlement of up to one day a year paid leave to take part in community activities. Since its inception in 1998 our Charitable Foundation has made 5,200 donations totalling over £2.5m, with around 80% of these resulting from member nominations.

"Over 2,000 members a month are moving to our home insurance product, provided in partnership with Royal & SunAlliance, up 400% in 4 years, and the product has won a 5 star rating from Defaqto for the fourth year in a row."

"...we want to grow, but not so fast that it means taking excessive risks or that it impacts on the service we can provide to our members."

The Society was also proud to achieve carbon neutral status in 2007, and we are working hard to reduce our carbon footprint further in all areas of our operations.

## Our people

As always, none of this would be possible without the commitment of our staff. 2007 has been a challenging year on many fronts, with high performance targets, continued efficiency challenges and turbulent markets. Once again our people have responded to the challenges with enthusiasm, expertise and resilience. Throughout this, high levels of engagement and job satisfaction remain:

- our levels of absenteeism are at their lowest for the last few years;
- 75% of our staff tell us, through our quarterly "Pulse" surveys, that they are satisfied with the Society as an employer; and
- 92% of our staff tell us that they would "go the extra mile at work when required".

I am immensely grateful to all of our staff for the efforts they put in on behalf of our members and I believe they can be proud of what they have achieved in 2007.

## 2008 promises to provide further challenges for all

Despite the uncertainties of the current environment we believe that the UK economy is fundamentally sound and resilient. In particular, we expect the labour market to remain relatively healthy and interest rates to remain low and this should protect the housing market from a major downturn.

Our business model of providing our members with long-term value through excellent products and services, our operational efficiency and our balanced approach to business is at the heart of everything we do. This means that we are in a good position from which to adapt our plans to any further change in market conditions.

**In summary, whilst some aspects of our results have been affected by the turmoil in the financial markets, 2007 has seen the Society deliver a core operating performance that is strong and ahead of plan. Our funding position remains balanced and healthy, our response to the current conditions has been prudent and, despite the uncertainty of the markets, we continue to face the future with great confidence.**

**Iain Cornish**
Chief Executive

# Working in society

The Society believes it is very important that it plays an active role in local communities where our members and staff live and work. As a responsible organisation we believe we should manage our impact on these communities, on the environment and on the people and businesses affected by, and benefiting from, our existence.

Based on feedback we receive from members and staff, our focus is on community involvement at a local level, through our policy of 'Working in society'.

## Charitable and community support

The Yorkshire Building Society Charitable Foundation, an independently controlled charity, continues to thrive having donated over £2.5m to 5,200 causes since 1998, with around 80% of these causes nominated by the Society's members and staff.

The Foundation donated over £340,000 to 1,350 causes (1,148 of which were suggested by members) across the UK in 2007. With the exception of the National Christmas Appeal, virtually all donations were below £2,000, to enable as many local causes as possible to benefit.

The following are examples of some of the causes the Foundation supported in 2007.

'Action For Kids' is a national charity which works with disabled children and young people and their parents and carers. It helps to transform young lives by removing barriers to independence and providing mobility equipment and support for families on low incomes with disabled children. The Foundation provided a grant of £870 to cover the cost of a large trike for a child suffering from a brain tumour, allowing the child to exercise and participate fully in family activities with increased freedom.

Andrew Peel, Corporate Fundraising Manager for 'Action for Kids' said, "We rely almost entirely on voluntary donations to fund our work and as demand for our services grows, every donation really does have an impact. The Foundation's donation will make a real difference to the life of a disabled young person and their family."

The Royal Blind Society supports blind or partially sighted people who are in charitable need. It assists the sight-impaired by providing cash grants for those on low incomes and a range of holidays and leisure opportunities. The Foundation's donation enabled the installation of essential specialist equipment for a hotel dedicated to providing leisure activities for the blind.

Philip Bush of the Royal Blind Society commented, "I was delighted to receive the most generous donation of £632 from the Charitable Foundation. The donation will be of great benefit to the many people who use our charity and will help us give them a better service. We are most grateful to you."

The Bradford Toy Library provides a free loan service of specialist toys to families across the Bradford region, who have children with special needs. The library also offers a 'sensory play area', which is free to use. In September, the Foundation donated £1,600 to the toy library, allowing them to buy specialist sensory equipment, including fibre optic toys and a backlit aquarium, which will assist the development of children with vision impairments and those who require auditory and tactile stimulation.

Feedback from the Member Panel and the Society's staff in 2007 confirmed that there was a strong desire to continue with our annual National Christmas Appeal. As a result of staff efforts and generous support from members we were delighted the Foundation was able to donate £110,000 to the chosen charity for 2007, Macmillan Cancer Support.

Nearly 70% of the Foundation's annual funding is provided by the Society's Small Change Big Difference™ scheme. Under this scheme, pence from interest on savings and mortgage accounts is


donated by account holders to the Foundation (maximum 99p per account, per year). Over 560,000 accounts now participate in the scheme.

Our Community Investment Fund supports smaller-scale local initiatives i.e. those that do not fall within the Charitable Foundation criteria such as support for swimming clubs and junior sports teams. In 2007, we made 288 grants from the fund, totalling over £78,000.

## Staff involvement

As well as financial support, we also believe in offering ‘hands-on’ support locally. Voluntary action in many forms has been part of the Society’s community focus for a number of years and all members of staff are entitled to take up to one day’s paid leave per year to help in the local community.

As a result of feedback from staff and the Member Panel, we launched our staff volunteers programme ‘Actionteering’ in 2007. Over 350 members of staff have already signed up, aiming to make a difference in the local community. ‘Actionteering’ can mean individual activities such as business mentoring, school governorships, helping a child to read or working with colleagues in the community on a team or individual basis. This initiative is focused on tackling issues in the community and the environment around us, working closely with community partners to try to ensure the maximum positive benefit for the time spent.

## Environmental commitment

In addition to community support, we also take our environmental impact very seriously and we were proud to achieve carbon neutral status from June 2007.

In October 2007, in a further effort to support our carbon neutral strategy, the Society transferred to green energy in our head office and branch premises. Green energy is energy obtained from renewable sources. Working with the Carbon Trust we have begun a carbon reduction programme aimed at reducing $CO^2$ produced by energy, waste, business travel and staff commuting. As a result of this programme, we set a series of targets aimed at significantly reducing our carbon footprint over the next three years by implementing a robust carbon management programme, including using energy from high efficiency or renewable sources and undertaking full energy audits.

We appreciate that it is not possible to eliminate all $CO^2$ completely, however what we cannot reduce directly we are offsetting by supporting projects in China, India and Turkey.

Recycling is another key area of focus. In 2007 we removed wastepaper bins in head office and replaced them with recycling hubs for paper, plastic bottles, aluminium cans, and even vending machine cups. We recycle as much as possible (including computers, furniture and mobile phones) and also purchase products made from recycled items for use throughout the organisation.

The environmental message is delivered across the Society and different types of initiatives have been introduced so that staff in all areas of the business can get involved and all are aware of their own contribution to the changing culture of the organisation.

# Non-executive directors



**Ed Anderson**, BSc, CPFA (age 57)
**Chairman**

Ed Anderson joined the board in 2003 and was appointed Chairman on 1 January 2007. He is a member of the Nominations, Remuneration and Risk Committees.

Ed is an accountant by training and has divided his career between airport management and local councils. He was the Managing Director of Leeds Bradford International Airport for 10 years until his retirement in September 2007 and was previously an executive director at Leeds City Council. Ed is Chairman, and a past President, of the Leeds Chamber of Commerce. He is also a member of the Council of the University of Leeds and is involved in various other local organisations.

**Richard Davey**, BA (age 59)
**Vice Chairman**

Richard Davey joined the board in 2005 and is a member of the Audit, Nominations and Risk Committees.

Richard has an investment banking background and was formerly Head of Investment Banking at NM Rothschild and Sons. He has extensive experience of the financial services sector having run Rothschild's Financial Services Group, working with a number of high street banks and insurers. Richard is Chairman of London Capital Group Holdings Plc and is also a non-executive director of Severn Trent Plc and Amlin Plc.

**Julie Baddeley**, MA (age 56)
**Non-executive Director**

Julie Baddeley joined the board in 2001 and is Chairman of the Remuneration Committee. She also, on behalf of the board, oversees the Society’s policy on ‘Treating Customers Fairly’.

Starting her career in employee relations, Julie is a management consultant. She was formerly an executive director at Woolwich Plc where she had responsibility for e-commerce, information technology and human resources. Julie is an Associate Fellow of the Saïd Business School, Oxford, and lectures on a range of management subjects. She also holds a number of directorships in the public and private sectors, including Greggs Plc and Computerland UK Plc.



Photographs from left to right: Ed Anderson, Richard Davey and Julie Baddeley




**Lynne Charlesworth**, BA, MBA (age 51)
**Non-executive Director**

Lynne Charlesworth joined the board in December 2006 and is a member of the Risk Committee. She is also a Trustee of the Society's Pension Scheme.

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

**Philip Johnson**, FCA (age 61)
**Non-executive Director**

Philip Johnson joined the board in June 2007 following his retirement as a partner at Deloitte & Touche LLP where he was Head of Audit Quality and Risk Management and Chairman of the Deloitte Audit Committee. Philip was appointed Chairman of the Society's Audit Committee on 1 January 2008.

During his 30 years with Deloitte, Philip specialised in providing advisory and assurance services to large corporate clients. He has considerable experience of financial services through leading some major investigations in the sector. Philip is Chairman of the influential Audit Working Party of the European Federation of Accountants and is also a member of the Audit Committee of the Wellcome Trust.

**David Paige**, BSc, FCA (age 56)
**Non-executive Director**

David Paige joined the board in December 2006 and is a member of the Audit and Risk Committees.

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

**Simon Turner**, BSc (age 56)
**Non-executive Director**

Simon Turner joined the board in October 2005 and is a member of the Audit and Remuneration Committees.

Simon has extensive experience in a large multi-national retail environment. He joined what was the Dixons Group (now DSG International Plc) in 1999, where he became the Managing Director of PC World in the UK, as well as managing all the computing businesses of the Group both in the UK and internationally. He is currently the Group Purchasing Director for DSG International Plc and is a member of their Group Executive Committee.

Photographs from left to right: Lynne Charlesworth, Philip Johnson, David Paige and Simon Turner

# Executive directors

**Iain Cornish**, BSc (age 47)
**Chief Executive**

Iain Cornish joined the Society in 1992 and has held a number of senior management positions with the Yorkshire prior to being appointed Chief Executive in July 2003. Iain is an economist and started his career in government followed by a move to the private sector.

Iain is a member of the Nominations and Risk Committees and a Trustee of the Society's Pension Scheme. He is a director of the Society's subsidiaries Accord Mortgages Ltd and Yorkshire Key Services Ltd. Iain is also Chairman of the Building Societies Association and a member of the Financial Services Practitioner Panel.

**Ian Bullock**, BSc, FIA (age 47)
**Sales and Marketing Director**

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

**Andy Caton**, BA (age 44)
**Corporate Development Director**

Andy Caton joined the Society in 1991 as an economist and was appointed to the General Management team in 1998. On 1 July 2004, he was appointed Corporate Development Director and is responsible for the Treasury, Corporate Affairs, Corporate Development and Corporate Business functions. Andy is also a director of Yorksafe Insurance Company Ltd and Yorkshire Guernsey Ltd, the Group's offshore deposit taking subsidiary.

**Andrew Gosling**, MA, FCA (age 52)
**Finance Director**

Andrew Gosling joined the Society as Finance Director in 2001. Prior to that he was a partner in the professional services firm Ernst & Young, where he was in charge of its financial services practice in the North of England and also led the firm's Building Societies Group. Andrew is responsible for the Group's Finance, Audit, Legal & Secretarial and Facilities functions. He is Chairman of Yorksafe Insurance Company Ltd, the Society's captive insurance subsidiary based in Guernsey, and is also a director of Yorkshire Guernsey Ltd.



Photographs left to right: Iain Cornish, Ian Bullock, Andy Caton and Andrew Gosling.

# General managers

**Robin Churchouse**, MA, ACA (age 42)
**General Manager Risk and Planning**

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

**Rachel Court**, BA (age 41)
**General Manager Human Resources and Customer Service**

Rachel Court was appointed to the General Management team in 2006 and is responsible for Human Resources as well as all aspects of customer service. She is also Chairman of Yorkshire Guernsey Ltd. Having joined the Society in 1991, Rachel has gained a broad experience across the Group starting in Mortgage Administration and Investment Services. She was then appointed Sales Director of Accord Mortgages Ltd before becoming the Society's Head of Mortgages, responsible for mortgage product development.

**David Henderson**, BSc (age 47)
**Chief Information Officer**

David Henderson joined the Society in August 2007 as Chief Information Officer, having responsibility for the Group's IT and Business Programme Delivery functions. He is also Chairman of the subsidiary Yorkshire Key Services Ltd which provides IT systems and solutions to other building societies. David started his career in the building society sector and prior to joining the Yorkshire he was Head of IT for a number of the retail business divisions at HBOS Plc.

Photographs from left to right: Robin Churchouse, Rachel Court and David Henderson.

The directors have pleasure in presenting their annual report, together with the Group Accounts and Annual Business Statement, for the year ended 31st December 2007.

## Business objectives and activities

The Group's purpose is to maximise long term benefits for a growing membership. This is achieved by the pursuit of two principal aims:

- to attract and retain as many members as possible who want long term benefits; and
- to continually improve the ability to deliver member benefits through:
  - a range of long term value products and services;
  - excellent service and communication through all distribution channels;
  - continued focus on cost effectiveness; and
  - maintaining a high level of financial security.

## Principal risks and uncertainties

The principal risks and uncertainties faced by the Group and our approach to managing them are set out on pages 23 to 30. In particular the Group has now moved on to the standardised approach under the Capital Requirements Directive (Basel II) and is in the process of implementing the changes required to comply with the Internal Ratings Based approach.

The disclosures required under Basel Pillar III will be published on the Society's website once the information is available.

## Business review

Key developments in the business of the Group and the Chief Executive's assessment of the future outlook are detailed on pages 2 to 11.

The Group uses various performance indicators to monitor its progress. The following sections look at key areas of the business and how the performance indicators for these areas have moved during the year.

**Financial performance**

Group profit before tax was £54.6 million (2006 – £77.9 million). This figure can be analysed into the following key areas:

| | **2007 £m** | 2006 £m | **2007 % of mean assets** | 2006 % of mean assets |
|---|---|---|---|---|
| Net interest income | **188.2** | 164.8 | **0.99** | 0.97 |
| Non-interest income | **40.9** | 32.4 | **0.22** | 0.19 |
| Volatility on assets held at fair value | **(32.5)** | (0.4) | **(0.17)** | – |
| Fair value volatility on derivatives and hedging | **(11.1)** | 14.0 | **(0.06)** | 0.08 |
| Net losses on available for sale assets | **(1.8)** | – | **(0.01)** | – |
| Total income | **183.7** | 210.8 | **0.97** | 1.24 |
| Management expenses | **(120.2)** | (116.9) | **(0.63)** | (0.69) |
| Operating profit before provisions | **63.5** | 93.9 | **0.34** | 0.55 |
| Provisions for impairment of mortgages | **(5.0)** | (3.5) | **(0.03)** | (0.02) |
| Provisions for impairment of debt securities | **(6.9)** | – | **(0.04)** | – |
| Provisions for other liabilities | **3.0** | (12.5) | **0.02** | (0.07) |
| Profit before tax | **54.6** | 77.9 | **0.29** | 0.46 |

The Group's underlying performance is strong as shown by the following analysis.

Non-interest income includes an amount of £9.0 million in relation to profits on the sale of property. Excluding this item non-interest income is in line with 2006 and our targets for 2007. These targets looked to consolidate this key area of our business and to continue the strong growth in income from our sales of insurance and investment products.

Volatility on assets held at fair value arises from fluctuations in the prices of certain investments, driven largely by recent market disruption particularly in relation to credit spreads and liquidity. Whether some of this item reverses in future depends on the extent to which credit markets recover from their recent turbulence.

Fair value volatility on derivatives and hedging results from changes in the value of certain financial instruments as a result of fluctuations in money market interest rates. This item is mainly timing differences which reverse over time.

Net losses on available for sale assets related to the disposal of certain financial instruments. In 2007 this figure includes £2.0 million in relation to the profit on disposal of shares in Link Interchange Network Ltd on its merger with Voca Ltd to form VocaLink Holdings Ltd.

The Group places great importance on cost control as long as this is not at the expense of the service we offer to our members. The continued success in this area has resulted in management expenses growth of just 2.8% in absolute terms which is a fall as a proportion of mean assets from 69p per £100 of assets to 63p. This reflects greatly enhanced efficiency across the Group in the last few years.

Provisions for impairment of mortgage loans are up slightly in line with the increasing expectation of a downturn in the housing market but its relatively low level reflects the quality of our mortgage book.

The provisions for impairment of debt securities relate to the fall in value of certain financial instruments following the recent market turbulence.

The £3.0 million release of provision for other liabilities relates principally to potential claims for compensation for mis-selling of endowment policies by our discontinued IFA operation. Current estimates are that provisions made in previous years were in excess of our actual liability.

After adjusting for items that are considered to be one-off in nature or the result of either timing differences or the recent market turbulence, the Group's core operating profit was as follows:

| | **2007 £m** | 2006 £m |
|---|---|---|
| Profit before tax: | **54.6** | 77.9 |
| Remove: | | |
| Net losses/(gains) from fair value volatility | **43.6** | (13.6) |
| Impairment of debt securities | **6.9** | – |
| Provisions for liabilities – (release)/charge | **(3.0)** | 12.5 |
| Profit on disposal of property | **(9.0)** | – |
| Gain on Link shares | **(2.0)** | – |
| Core operating profit | **91.1** | 76.8 |

### Liquidity

The Group's approach to managing liquidity risk is set out in the Risk Management Report on page 25. Liquidity has increased in absolute terms from £4.1 billion to £4.7 billion, maintaining its relationship to shares and borrowings at 25%.

### Capital

The Group's gross capital ratio was 6.31% (2006 – 7.16%) and free capital was 5.86% (2006 – 6.63%) – these ratios are defined in Section 2 of the Annual Business Statement on page 84.

The Group's principal measure to monitor the level of capital within the business (a key indicator of financial strength), is the solvency ratio.

Our solvency ratio (which is also the key capital ratio used by our regulator, the Financial Services Authority, to measure our capital strength) has fallen to 11.8% (2006 – 14.9%). This fall does not reflect any reduction in the underlying capital strength of the Group and is driven by two factors. Firstly, the rules governing the calculation were in transition in 2007, meaning that some of the capital held within the Society's subsidiaries was no longer included within the calculation, even though it is still available to the Group if needed. Further changes to the basis of calculation, which took effect on 1st January 2008, immediately increased the ratio back up to at least 13.5%. Secondly, the net fall to this level reflects the absorption of existing capital by our, planned, strong growth in 2007. Capital levels remain well above the Group's internal and prudential minima and reflect its continued capital strength.

**Covered Bonds**

In May 2007 the Society launched its second Covered Bonds programme which raised further wholesale funds of £1.0 billion. Further details are contained in Note 15 to the accounts.

**Business volumes**

As reflected in our business objectives set out above, a key area of focus for the Group is the volume of business achieved during the year. Our 2007 performance shows significant improvements on 2006. The following are the key elements monitored by the Group in this area:

| | **2007** | 2006 | **2007** | 2006 |
|---|---|---|---|---|
| | **£m** | £m | Estimated share of UK market | |
| Gross mortgage lending i.e. new loans | **4,735** | 3,979 | **1.3%** | 1.2% |
| Net mortgage lending i.e. after repayments of existing loans | **2,016** | 1,257 | **1.9%** | 1.1% |
| | | | % increase | |
| Mortgage balances excluding fair value adjustments and impairment provisions | **15,343** | 13,327 | **15.1** | 10.4 |

- our gross new mortgage lending of £4.7 billion was a record and represented an estimated 1.3% share of the UK market;
- repayments during the year (i.e. the difference between our gross and net lending measured as a percentage of opening mortgage balances) have decreased from 22.5% to 20.3%;
- 2007 saw our net lending increase by 60% to £2.0 billion, our best ever. This represented an estimated 1.9% share of the UK market; and
- overall our mortgage balances grew by 15.1%, a significant improvement on the rate of growth in 2006.

| | **2007** | 2006 | **2007** | 2006 |
|---|---|---|---|---|
| | **£m** | £m | Estimated share of building societies | |
| Net inflows into savings accounts | **649** | 791 | **4.0%** | 9.5% |

Our net inflow into savings accounts of £649 million represents a 46% increase on 2006's organic inflow (£345 million of 2006's inflow resulted from the acquisition of savings balances from other institutions) and is significantly ahead of our plan for the year and an estimated 4.0% of the building societies savings market.

**Assets**

At 31st December 2007 the total assets of the Group amounted to £20.5 billion, representing growth of 16.7% during the year, ahead of our 2007 target and a significant improvement on 2006 growth.

The main component of our assets remains mortgage loans, which are discussed above. The other key category is liquid assets, in the form of cash and authorised securities, which at 31st December 2007 stood at £4.7 billion (2006 – £4.1 billion) and represented 24.7% of shares, amounts owed to credit institutions and other customers and debt securities in issue (2006 – 25.1%).

**Asset quality – mortgage arrears**

During 2007 the Group's overall arrears position rose, in absolute and relative terms, in line with expectations. This increase was driven by the overall growth in our balance sheet, the general deterioration in retail arrears across the mortgage market and by the growth in our intermediary and credit repair portfolios. This latter factor reflects the higher risk nature of this borrowing, which in turn is reflected in how these products are priced (to achieve higher returns in exchange for higher risk) and in how they are monitored and managed.

The credit quality of our portfolio remains high, as demonstrated in particular by an arrears ratio for cases with payments three months or more in arrears of just 0.04%.

| Accounts with payments three months or more in arrears | 2007 | 2006 | 2007 % of mortgage accounts/balances | 2006 % of mortgage accounts/balances |
|---|---|---|---|---|
| Number of accounts | **1,873** | 1,327 | **1.08** | 0.81 |
| Balances outstanding on accounts | **£186.1m** | £106.6m | **1.21** | 0.80 |
| Amount of arrears included in balances | **£6.8m** | £3.8m | **0.04** | 0.03 |

The position on our more serious arrears cases, being those with payments twelve months or more in arrears, has deteriorated but remains at a very low level.

| Accounts with payments twelve months or more in arrears | 2007 | 2006 | 2007 % of mortgage accounts/balances | 2006 % of mortgage accounts/balances |
|---|---|---|---|---|
| Number of accounts | **175** | 93 | **0.10** | 0.06 |
| Balances outstanding on accounts | **£19.6m** | £8.7m | **0.13** | 0.07 |
| Amount of arrears included in balances | **£1.5m** | £0.7m | **0.01** | 0.01 |

Appropriate provisions have been made for potential losses on mortgages in accordance with the impairment policy set out in Note 1 to the accounts on page 50.

**Members and customers**

During 2007 our membership increased from 1.9 million to 2.0 million.

The Society uses a number of measures to track customer satisfaction. In particular, a customer satisfaction measure is maintained based on monthly surveys. During 2007 the percentage of customers rating the service they received as Excellent or Good remained stable at 90%.

## Staff

Our staff are key to our operations. Staff numbers and associated costs and ratios can be summarised as follows:

| | 2007 | 2006 |
|---|---|---|
| Staff costs (salaries and wages, social security costs and pension costs) | **£69.5m** | £69.4m |
| Number of staff employed (full and part time) | **2,364** | 2,337 |
| Number of staff employed (full time equivalent) | **2,114** | 2,092 |
| Per full time equivalent member of staff: | | |
| Total management expenses (£000) | **56.9** | 55.9 |
| Average total assets (£000) | **9,003** | 8,094 |

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

An equal opportunities policy is followed and the Group gives full consideration to applicants and staff who are disabled. The Group has recently had its Investor in People accreditation renewed.

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

## Directors

The names of the directors of the Society at 31st December 2007 are shown on pages 85 and 86 of the Annual Business Statement.

Rob Jackson, Operations Director, retired on 31st July 2007 and two non-executive directors, Frank Beckett and Paul Lee, retired on 31st December 2007. The board wishes to acknowledge their contribution to the continuing success of the Society.

At the 2008 Annual General Meeting (AGM), Julie Baddeley, Andy Caton and Andrew Gosling retire as directors in accordance with the Society's rules and the Building Societies Act 1986 and, being eligible, offer themselves for re-election. In addition, Ian Bullock and Philip Johnson, who were appointed to the board on 12th April 2007 and 1st June 2007 respectively, offer themselves for election.

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

## Charitable donations

In 2007 Yorkshire Building Society Charitable Foundation donated over £340,000 to 1,350 causes, of which 1,148 were suggested by members, maintaining the Foundation Trustees' desire to support causes across the UK with the assistance of member nominations. The funds were primarily raised through the 'Small Change, Big Difference' scheme. Further details can be found in the Working in Society Report on pages 12 and 13.

## Supplier payment policy

It is the general policy of the Group to pay supplier invoices on a weekly basis subject to internal authorisation control checks.

The creditor days were three days at 31st December 2007.

## Auditors

The re-appointment of KPMG Audit Plc as auditors of the Society is to be proposed at the AGM.

On behalf of the board

Ed Anderson
Chairman

3rd March 2008

## Introduction

The activities of financial institutions inevitably involve a degree of risk. The Group's risk management framework and governance structure is intended to provide appropriate and comprehensive monitoring, control and ongoing management of its major risks to ensure the security of its members' funds. The Group's ability to properly identify, measure, monitor and report risk is critical to its soundness and its ability to provide value to its membership.

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

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

The board recognises that risk in various forms arises naturally from the Group's primary provision of services to members and believes that its risk management philosophy should be based on:

- an awareness of all risk exposures and potential exposures;
- the formulation and quantification of views about the probable impact of such exposures; and
- the development and implementation of measures that contain the potential impact of such exposures within limits consistent with the achievement of the Group's primary business objectives.

The Group aims to identify the major sources of risk to its assets and operations and to deploy, in response to these, appropriate measures to control and monitor those risks. To this end the Group has developed a matrix of the key risks that it believes it faces, being those that, in the view of the board and senior management, represent the greatest threat to the Group's sustainability in terms of combined impact and likelihood. At an operational level, these principal risks and uncertainties can be considered in a number of categories, around which the Group has constructed its systems of monitoring and control. The individual risks, and the Group's response to them, are considered in more detail below within the context of the risk committees established to oversee them under delegated authority of the board. The categories are as follows:

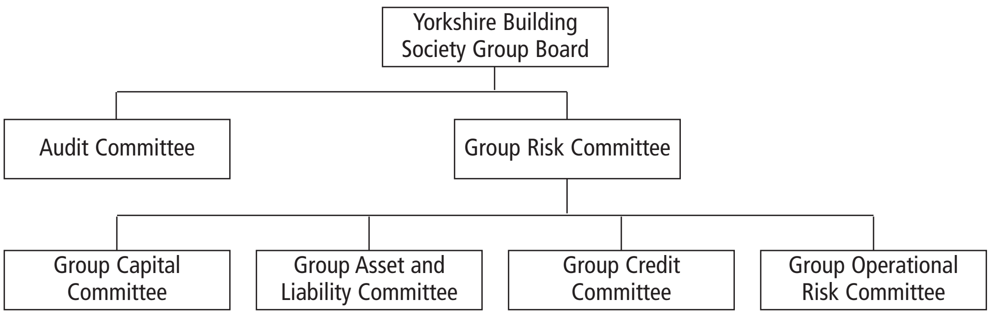
- credit risk – This risk arises from the Group's retail lending and wholesale investment activities, and is overseen by the Group Credit Committee. It is the risk that borrowers and wholesale counterparties fail to repay monies due to the Group;
- market risk – The Group's balance sheet and financial position is exposed to market risk through the normal course of the Group's business. Market risk arises from balance sheet positions that are exposed to changes in interest rates (or similar indices) and to the need to maintain adequate liquidity to meet the Group's cash flow requirements as they arise. This risk is overseen by the Group Asset and Liability Committee; and
- operational and regulatory risk – Overseen by the Group Operational Risk Committee, this risk arises from the possibility of loss or other damage caused by human or technical errors across the Group's operations and includes risks that relate to non-compliance with the statutory and regulatory requirements under which the Group operates.

The second half of 2007 saw material changes and uncertainties emerge within a number of the Group's areas of operation, and these mean that prioritisation of risk management (i.e. those areas that the board considers to be the most material at this time) has, quite rightly, changed. Whilst the Group continues to monitor the whole range of risks to which it is exposed, the principal risks and uncertainties at the end of 2007 can be broadly summarised as follow:

- the wholesale financial markets remain in a state of flux, impacting on the Group's wholesale funding programmes and its liquidity investment strategy; and
- the UK housing market appears to be entering a downturn, although the length and depth of this downturn remains unclear, and so the Group's exposure to potential retail credit losses is heightened.

The prevalence of fraud within the UK retail financial services markets remains high, and it is possible that a tightening housing market and general economic slow down will increase the pressures in this area. Whilst the Group is not exposed to the higher risk areas of the market (including buy-to-let mortgage lending and unsecured personal lending) it nonetheless remains vigilant in looking to minimise the level of fraudulent activity to which it is inevitably exposed.

**Group Risk Committee (GRC)**
The Group Risk Committee has been established by the board to oversee the Group's risk governance framework and to provide an entity-wide perspective on all risk matters. It comprises non-executive directors and senior executives and is chaired by the Chief Executive. It is responsible for establishing appropriate risk management committees as detailed below. Its terms of reference include monitoring of key risks indicators, direction of risk management and the improvement of the Group's risk management processes, in particular those associated with the project to implement the changes to capital regulation under the Capital Requirements Directive (Basel Pillar II). Further details of the membership and responsibilities of the committee can be found on page 35 of the Corporate governance report.




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

This includes:

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

Capital and capital ratios are detailed in Note 30.

### Group Asset and Liability Committee (GALCO)

#### Liquidity risk

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

The Group's liquidity policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding so as to ensure the ability of the Group to meet its financial obligations. This is achieved through maintaining a prudent level of liquid assets, through appropriate wholesale funding facilities and through the management of the growth of the business.

It is considered prudent to hold, as a minimum level of Prudential Liquidity, the amount that the Group estimates would be needed to see it through a range of different stress scenarios. These scenarios are modelled to ensure that the Group's liquidity is sufficient to meet its cash flow needs under any one scenario should it arise. The scenarios include ones driven by both Group specific and general market events, and anticipate both severe retail savings outflows and the unavailability of wholesale funding. They are constructed on various timescales as far out as six months.

A liquidity cash flow projection under various stress scenarios is produced on a daily basis. The assumptions incorporated in the Liquidity cash flow projection model are reviewed by GALCO on at least an annual basis.

The second half of 2007 saw unprecedented issues in both the wholesale markets in the UK and the wider global financial markets. Whilst the majority of the Group's funding is in the form of retail savings balances from its members, which performed extremely well through this period, the Group was nonetheless affected by the overall market conditions because it has an involvement in these wholesale markets in terms of both its funding and its liquid asset investment programmes. The level of liquidity risk faced by the Group therefore increased, though due to market issues rather than Group specific issues. The Group responded appropriately to the market conditions, which saw a virtual close down of all but a very limited number of wholesale funding markets, through a combination of modified wholesale funding activity, careful management of existing liquidity, reviews of its exposures to, and exposure limits for, a wide range of wholesale counterparties and enhanced monitoring and analysis of its overall liquidity position.

The Group's wholesale funding activities are undertaken through a broadly based programme, in terms of the type of funding instruments used, the nature and size of institutions dealt with and the maturity of funding tranches. This meant that the Group was able to continue to raise wholesale funding throughout the second half of 2007, focusing on those parts of the market that remained open and resisting the temptation to overpay for its funding. At the same time the frequency with which its liquidity was reviewed by senior management was increased, with weekly reviews of both the market conditions and the Group's own projected funding and liquidity positions. Although already prudent compared to best practice, the Group's liquidity stress tests were reviewed and enhanced in a number of ways, and we continue to keep them under review as market conditions develop. The Group also reviewed its existing exposures to and exposure limits for a wide range of counterparties with whom we invest liquid assets. Action was taken in a number of cases to reduce our existing or potential exposures, including suspension of limits for a number of institutions. This heightened level of monitoring continues into 2008.

Detail of actual exposures is contained in Note 37 on pages 77 and 78.

#### Market risk

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

The Group has a formal structure for managing its market risks including established risk limits, reporting lines, mandates and other control procedures. This structure is reviewed regularly by GALCO, which is responsible for managing and controlling the balance sheet exposures of the Group. GALCO meets at least monthly and the board receives monthly summaries of risk positions and GALCO activity.

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

The Group's principal source of market risk is interest rate risk and it focuses on four main measures for managing this:

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

More details of these risk management measures can be found in Note 35 to the accounts on page 76.

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

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

#### Currency risk

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

Detail of actual exposures is contained in Note 36.

#### Other risks

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

### Group Credit Committee

Credit risk is the potential risk of financial loss arising from the failure of a customer or counterparty to settle their financial and contractual obligations as they fall due. The Group has in place a comprehensive set of controls and limits to monitor and govern the amount of such risk accepted. Credit risk is monitored on an ongoing basis within Group Risk and the Group Credit Committee meets monthly to oversee risk management in this area.

**Retail credit risk**

The most significant retail credit risk that the Group is exposed to relates to its core business of providing loans secured on residential property. Given the collateral on these loans and growth of UK house prices, all but a small number of these loans are considered to be adequately covered by the value of the underlying security. The Group does suffer a small number of losses in the normal course of its lending activity, which are closely monitored by the committee against what are considered acceptable levels. The Group lends to households across the UK and does not consider there to be any significant concentration of credit risks in any particular part of the UK.

The Group's mortgage lending is conducted, and hence is monitored and managed, within three key portfolios. The largest two, accounting for 93% of balances, are 'prime' lending to borrowers with a good credit history. These consist of lending by the Society (through its branches or via the internet) and by its subsidiary Accord Mortgages Ltd (through financial intermediaries ). The third portfolio is 'credit repair' lending (made via intermediaries and managed within Accord) to borrowers with poorer credit histories who the Group aims to help restore their creditworthiness and ideally, in time, offer a prime mortgage. Clearly the credit risk associated with this latter portfolio is higher than for our two prime portfolios, particularly at a time when the housing market appears to be entering a downturn. The Group is well aware of this risk disparity, and differentiates its lending criteria and its monitoring and management processes and techniques accordingly.

Retail credit exposures are managed in accordance with the board approved Group Lending Policy and through the use of credit scoring systems that factor in the profile of the borrower, the nature of the loan, environmental conditions and the collateral that may be provided as security for the loan. These scoring systems, and the way they are used within the initial lending process, are varied to suit the different risks and profiles of the Group's three loan portfolios. Actual and forecast retail exposures are monitored and managed against policy limits by the Group Credit Committee. In particular the committee monitors arrears, loan to value ratios, expected losses and scorecard performance.

The monitoring of retail credit risk is tailored to our different loan portfolios and to the economic and housing market conditions that are in place at any given time. The current focus is strongly on the possibility of a housing downturn and therefore on identifying, and seeking to help and manage, those borrowers where the exposure to such a downturn is greatest. This is particularly important with some of our credit repair lending where borrowers have had previous problems and so are inherently more likely to suffer in any housing or economic downturn. This risk is reflected in the granularity of monitoring, the degree of pro-active help and, if needs be, the intensity of arrears management applied to these loans. However, the nature of these loans was recognised by the Group when they were entered into and so is reflected both in the rates (and other terms) in place and in the overall exposure limits.

Detail of actual exposures is contained in Note 38 on pages 79 and 80.

**Wholesale credit risk**

In addition to the ownership of the Group Lending Policy, the Group Credit Committee takes primary responsibility for the task of assessing and monitoring wholesale counterparty creditworthiness and conducting credit research and analysis. It does this by reviewing the Group's exposures and through setting limits to individual counterparties based on its internal ratings methodology. Limits are also set against the aggregate exposure to equally rated institutions and to all institutions based in any one country.

The board recognises that it is not possible to limit the Group's exposure just to institutions with the very highest credit ratings. Nevertheless it considers that the Group's approach (outlined above) is prudent and is designed to minimise the risk of losses.

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

- this portfolio, which has been maintained at less than 5% of the Group's total liquidity, is not treated as part of Prudential Liquidity;
- the Group will only invest where the deal manager has a proven track record in the type of instrument in question;
- a separate management structure is in place to monitor the performance of the investments and any changes to those investments are considered by the Group Credit Committee;
- all investments are assessed financially over their full term to maturity and limits put in place on the maximum weighted average life of the portfolio;
- sensitivity analyses are undertaken monthly on all investments to assess their vulnerability to changes in credit spreads; and
- limits are in place covering asset and instrument types, counterparty and credit rating exposures.

The board has itself monitored the size, constitution and performance of this portfolio and any investments in new types of instruments have involved board approval. The board is satisfied that the Group has had the personnel and systems in place to adequately control these investments. At present there are no plans to increase the size of the portfolio.

The events of late 2007 have, as reported elsewhere, materially impacted the value of these structured credit investments, principally through the illiquid state of the market but also, in a limited number of cases, through underlying credit issues. The Group was aware that the value of these investments could be impacted by a liquidity shortage but, in common with nearly all institutions and regulatory authorities, it did not foresee the extent of the liquidity issues that arose in 2007. The Group's response to these events has been to further increase its levels of performance monitoring, in particular if any individual investments have displayed signs of stress, including frequent liaison with investment managers. At the same time it has looked, where available, at all alternatives for the future structure of individual investments and has adopted a prudent approach to their valuation and treatment within the Group's financial statements.

Detail of actual exposures is contained in Note 37 on page 78.

**Group Operational Risk Committee**

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

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

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

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

The Group measures its operational risks based on both numerical and qualitative assessments of the risks it faces. The measures help to determine the level of control required to manage such risk within the overall risk profile of the organisation.

The Group aims to maintain a sound system of internal control that provides reasonable, but not absolute, assurance that it will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances that may be reasonably foreseen. The focus is adapted to current conditions. For example, recent years have seen the development of more refined fraud and financial crime strategies and controls in response to increasing levels of such activity in the financial services market.

**The Capital Requirements Directive (Basel II)**

The Group is in the process of implementing the changes to its overall risk management processes required for complying with the Basel II capital requirements regime. These changes will further enhance the Group's processes. Many of these changes were in place and in the process of being embedded at the year end. The Group has adopted the standardised approach as at 31st December 2007 and is in the process of applying to the Financial Services Authority for approval to adopt the Internal Ratings Based (IRB) approach in certain areas. The Group has also, as required, completed its Internal Capital Adequacy Assessment Process (ICAAP) and submitted this to the Financial Services Authority for approval. Meanwhile, the Group is committed to implementing the practical benefits of Basel II in parallel with, and as a further enhancement to, its existing risk management processes.

On behalf of the board

Ed Anderson
Chairman

3rd March 2008

# Corporate governance report

The board is accountable to the Society's members for the conduct of the Society's business. To ensure that the board manages the Society in a prudent and effective manner, it is committed to complying with best practice in corporate governance.

The board does this through adherence to the principles and provisions of the Combined Code issued by the Financial Reporting Council (the Code), which applies to listed companies, to the extent that they are relevant to a building society. Indeed, in the interest of transparency, the Financial Services Authority (FSA) encourages each building society to explain in its Annual Report and Accounts whether, and to what extent, it adheres to the Code.

The objective of this report is to communicate the key elements of the Group's governance structure and relate this to the principles in the Code. The board considers that it complies with all relevant aspects of the Code unless the contrary is stated within this report.

**The board**

The board applies principles of good governance by adopting the following procedures:

- the board holds ten board meetings each year. In addition, it held two sessions in 2007 for a detailed review of the Society's strategy. The attendance record of each director at board meetings and relevant board committee meetings is set out on page 37;
- the non-executive directors meet without the executive directors present at least twice a year;
- the board's principal role is to focus on the Society's strategy and ensure that the necessary resources are in place for the Group to meet its objectives and that financial and internal controls and systems of risk management are robust. In particular, its role is to provide general direction to the organisation and to safeguard the interest of members;
- the board maintains a schedule of reserved matters in order to ensure that it exercises control over the Group's affairs. These include, amongst other things, approval of the annual results and strategic aims of the Group as well as approval of policies and matters which must be approved by the board under legislation and the Society's Rules. The board is also responsible for the recruitment and terms of employment of the General Management team, which is made up of the executive directors and other General Managers. Details of all the General Managers can be found on pages 16 and 17;
- other matters are delegated to the General Management team or to other specified members of staff or committees, including the board committees referred to on pages 33 to 35 and the Group Asset and Liability Committee;
- all directors have access to independent professional advice if required and have the benefit of appropriate liability insurance cover at the Society's expense; and
- the size and composition of the board is kept under review to ensure that there is adequate succession planning for executive and non-executive directors and that there are the optimum skills and experience represented on the board for the direction of the Group's activities.

**Appointments to the board and re-elections**

The appointment of new directors is considered by the Nominations Committee (see page 34), which makes recommendations to the board. All directors are subject to election by members at the Annual General Meeting (AGM) following their appointment. In addition, all directors must receive approval from the FSA as Approved Persons in order to fulfil their controlled function as a director.

Under the Society's Rules, directors have to submit themselves for re-election at least once every three years. Non-executive directors are usually expected to serve for two full three-year terms following their first election to the board (subject to the board reviewing their performance prior to any proposal for re-election), and may be asked to serve for a further term of up to three years, as appropriate.

At the 2008 AGM, members will be asked to re-elect Julie Baddeley, non-executive director, Andy Caton, Corporate Development Director, and Andrew Gosling, Finance Director. The board has confirmed that the performance of these directors continues to be effective and that they continue to show commitment to their role.

During 2007, the following appointments were made to the board which will be voted on by members at the 2008 AGM:

- Ian Bullock was appointed Sales and Marketing Director on 12th April 2007. He was previously General Manager Sales and Marketing; and
- Philip Johnson was appointed as a non-executive director on 1st June 2007. Mr Johnson was identified as a successful candidate during a recruitment process that took place during the latter part of 2006 but he was unable to take up the appointment until 1st June 2007 following his retirement as a partner at Deloitte & Touche LLP.

On 31st July 2007 Rob Jackson, Operations Director, retired as an executive director. The board approved the appointment of David Henderson as Chief Information Officer with effect from 8th August 2007 to take over Mr Jackson's role as the General Manager in charge of the IT function. Other aspects of Mr Jackson's role were transferred to other members of the General Management team.

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

**Chairman and Chief Executive**

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

The Chairman is responsible for leadership of the board and for ensuring that the board acts effectively. The Chief Executive has overall responsibility for managing the Society and its subsidiaries and for implementing the strategies and policies agreed by the board.

**Board balance and independence**

As at the date of this report, the board consists of four executive directors and seven non-executive directors.

In the opinion of the board, each non-executive director, including the Chairman, is independent in character and judgement.

Paul Lee, non-executive director (who retired on 31st December 2007), is a partner in Addleshaw Goddard, a firm of solicitors, which provides certain legal services to the Society. Despite this connection, the board considered Mr Lee to be independent and that his partnership status with Addleshaw Goddard did not interfere with the exercise of his independent judgement for the following reasons:

- Mr Lee did not personally undertake any legal work on behalf of the Group;
- Addleshaw Goddard is a major commercial legal firm locally and nationally and is the leading national firm for specialist building society work;
- the Society instructed Addleshaw Goddard before Mr Lee was appointed to the board;
- the Society undertakes periodic reviews of the solicitors it uses and Mr Lee's membership of the Society's board has no bearing on this review, and
- a schedule of fees paid to Addleshaw Goddard in 2007 has been submitted to the FSA. A copy is available to members on request from the Group Secretary.

The Vice Chairman is the Society's Senior Independent Director.

**Information and professional development**

To ensure that the board functions effectively, all directors receive accurate, timely and clear information. It is the responsibility of the Chairman to ensure that the information requirements of the board are periodically reviewed. In March 2007 the board undertook a review of the information provided to it and, as a result, certain changes were made to the content and style of reporting to the board to ensure that the board papers continue to provide adequate and relevant information and focus on key strategic issues.

The Chairman also ensures that, on appointment, non-executive directors receive a comprehensive tailored induction programme on the Group's business and regulatory environment. All non-executive directors update their skills, knowledge and familiarity with the Group through regular internal presentations by senior managers and through relevant external and internal courses. Individual training requirements for non-executive directors are discussed during the performance evaluation process (see below). Non-executive directors are encouraged to contact individual members of the senior management team to discuss any queries that they may have.

All directors have access to the advice and services of the Group Secretary who is responsible for ensuring that board procedures are complied with and for advising the board, through the Chairman, on governance matters.

**Performance evaluation**

The Group has a formal performance evaluation system for all members of staff including the executive directors. The Chief Executive appraises the executive directors on their performance and the Chairman undertakes an appraisal of the Chief Executive.

A performance evaluation system for non-executive directors, including the Chairman, has been in place since 2003. In 2007, this took the format of an appraisal of each individual director by other members of the board and the General Management team through the completion of an anonymous questionnaire. The Chairman and Chief Executive reviewed the output of all questionnaires and used these as a basis for an evaluation interview with each non-executive director. The Vice Chairman and Chief Executive undertook the evaluation interview for the Chairman. This procedure identifies any individual and board training requirements and provides the evidence to the board as to whether to recommend to members that a director should be re-elected.

In 2007 internal performance evaluations of the board, the Audit Committee, the Remuneration Committee and the Risk Committee were carried out in order to review the effectiveness of how the board and the board committees operate. The board evaluation was undertaken through the means of a questionnaire, which asked all directors and General Managers to appraise a range of factors relating to the make-up and operation of the board. The process for each of the committees referred to above was either through a questionnaire or a general discussion by the relevant committee members.

The relevant results were reviewed by the board and each committee and any appropriate improvement was identified for action. The results of the evaluation of the Risk Committee were reviewed in early 2008.

**Board committees**

The board has established a number of committees which have their own terms of reference. Details of the board committees are set out below.

The terms of reference of the Audit Committee, the Nominations Committee, the Remuneration Committee and the Risk Committee are available on request from the Group Secretary or on the Society's website at www.ybs.co.uk/committees.

**Audit Committee**

The members of the committee are:

Frank Beckett, non-executive director (committee Chairman. Retired 31st December 2007)
Richard Davey, Society Vice Chairman
David Paige, non-executive director (appointed 24th January 2007)
Philip Johnson, non-executive director (appointed 27th June 2007 and committee Chairman from 1st January 2008)
Simon Turner, non-executive director

All members of the committee have relevant audit committee experience and Frank Beckett, Richard Davey, Philip Johnson and David Paige have recent relevant financial experience.

The responsibilities of the committee are in line with the provisions of the Smith Guidance on Audit Committees. The main function of the committee is to assist the board in fulfilling its oversight responsibilities, specifically the ongoing review, monitoring and assessment of:

- the integrity of the financial statements, any formal announcements relating to financial performance and significant financial reporting judgements contained in them;
- the effectiveness of the system of internal control processes;
- the internal and external audit processes;
- compliance with applicable laws and regulations;
- the Society's ethical and business standards;
- the appointment, re-appointment and removal of external auditors; and
- the policy on the use of the external auditors for non-audit work.

During 2007 the committee met four times in the execution of its responsibilities and considered reports on:

- the system of internal control;
- the integrity of financial statements;
- new accounting policies and application of existing policies;
- the activities of internal and external auditors;
- the effectiveness of the Group Internal Audit function;
- the performance of the external auditor; and
- the effectiveness of the committee.

The reports were provided by the independent Group Internal Audit function, the Group Finance function and the external auditors.

The committee considers that it has met its responsibilities and performed its duties with appropriate levels of care and expertise during 2007.

**Chairman's Committee**
The committee is made up of the Chairman, the Vice Chairman and the executive directors.

The committee's main function is to decide on any item that requires attention before the following board meeting except for specific issues that have to be determined by the full board.

**Nominations Committee**
The committee is made up of the Chairman, the Vice Chairman and the Chief Executive.

The committee is responsible for nominating candidates for the position of non-executive director, taking into account the balance of skills, knowledge and experience on the board, and for making appropriate recommendations to the board.

During 2007 a vacancy for a new non-executive director was advertised in national and local press to enable the vacancy to be brought to the attention of as wide a number of members as possible. In addition, an independent specialist agency was used to assist in the recruitment and search process.

**Remuneration Committee**
The members of the committee are:

Julie Baddeley, non-executive director (committee Chairman)
Ed Anderson, Society Chairman
Simon Turner, non-executive director

The committee is responsible for considering and approving the remuneration of the executive directors and other General Managers. Further details of the committee, the remuneration policy and directors' service contracts can be found in the Directors' Remuneration Report on pages 38 to 41. The contract in respect of Rob Jackson, Operations Director, who retired on 31st July 2007, pre-dated the Society's policy for one year notice periods for new executive director appointments and also the Code provision that notice periods should be set at one year or less. Mr. Jackson's contract was terminable by the Society on two years' notice or by the payment of an amount equivalent to two years' remuneration.

Whilst the Code states that the committee should set the remuneration of the Chairman, the board believes that it is more appropriate for the remuneration of the Chairman to be set and reviewed in the same manner as that used to determine the remuneration for all other non-executive directors. It is therefore dealt with by the board and not by the Remuneration Committee.

**Group Risk Committee**

The members of the committee are:

Iain Cornish, Chief Executive (committee Chairman)
Frank Beckett, non-executive director (retired 31st December 2007)
Andy Caton, Corporate Development Director
Lynne Charlesworth, non-executive director (appointed 24th January 2007)
Robin Churchouse, General Manager Risk and Planning
Richard Davey, Society Vice Chairman
Andrew Gosling, Finance Director
David Paige, non-executive director (appointed 24th January 2007)

On 23rd January 2008 Ed Anderson, Chairman and Rachel Court, General Manager Human Resources and Customer Service, were appointed members of the committee.

The Group Risk Committee has delegated responsibility for the more detailed ownership of the Group's risk appetite, risk monitoring and capital management framework.

The committee's primary responsibilities are:

- establishing methods for measuring risk appetite and positions;
- recommending for board approval the Group risk management policies, standards and limits;
- monitoring on-going risk positions and issues, in particular for compliance with Group risk management policies, standards and limits;
- the annual review and approval of the Group's Basel II/ICAAP reviews and validations, on recommendation from the Group Capital Committee;
- reviewing the Group's current and proposed activities against its risk appetite and capital budgets; and
- establishing and monitoring appropriate sub-committees and associated governance structures.

The Group Risk Committee has established a number of sub-committees with day-to-day responsibility for risk management oversight. Some of these committees have been in place for a number of years, others were established in 2006 following a review of the Group's risk management structures. All of the sub-committees meet at least quarterly and are chaired by an executive director or a General Manager. At 31st December 2007 the sub-committees were as follows:

- Group Asset and Liability Committee;
- Group Credit Committee;
- Group Capital Committee; and
- Group Operational Risk Committee.

Further details of the Group's approach to risk management can be found in the Risk Management Report on pages 23 to 30.

**System of internal controls**

The Society recognises the importance of a sound system of internal control in the achievement of its objectives and the safeguarding of member and Society assets. Internal control facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists in compliance with applicable law and regulations.

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

The Group Internal Audit function provided independent assurance to the board on the effectiveness of the system of internal control through the Audit Committee. The information received and considered by the committee provided reasonable assurance that during 2007 there were no material breaches of control or regulatory standards and that, overall, the Society maintained an adequate system of internal control that met the principles of the Code and the supplementary Turnbull guidance.

Further details of actual risk management practices are provided in the Risk Management Report on pages 23 to 30.

**Auditors**

The Society has a policy on the use of the external auditor for non-audit work which is implemented by the Audit Committee. The purpose of this policy is to ensure the continued independence and objectivity of the external auditor. The external auditor, KPMG Audit Plc, undertook a number of non-audit related assignments for the Group during 2007. These were conducted within the limits set out in the policy and are considered to be consistent with the professional and ethical standards expected of the external auditor in this regard.

**Relations with members**

The Society's members are made up of its investors (except deposit account holders) and borrowers. The majority of its customers are therefore its members and the Society encourages feedback from them on any aspect of the Society's activities.

This feedback takes various forms, including member 'Question Time' meetings and `Meet the Chief Executive' events which give members the opportunity to meet and ask questions of the Chief Executive, the senior management team and local branch staff. The Members' Forum was established in 2005 and continued to meet in 2007. It is currently made up of 17 members who are drawn from a cross section of the Society's membership. The aim is to debate and obtain views on specific relevant issues.

The Society operates a Member Panel, consisting of more than 10,000 members, who are invited to complete surveys on a variety of topical issues. In addition, a monthly customer satisfaction survey is undertaken, the results of which are a key performance indicator, which is monitored by the board on a monthly basis.

**AGM**

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

All members who are eligible to vote at the AGM receive a proxy voting form, which includes a 'vote withheld' option, and a pre-paid reply envelope to encourage them to exercise their vote through the appointment of a proxy if the member cannot attend and vote at the meeting. Since the 2006 AGM, to make it as easy as possible for such members to participate, they have also been able to appoint a proxy online.

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

**Board and Committee Membership and Attendance Record 2007**

Set out below are details of the directors during 2007 and their attendance record at board meetings and relevant board committee meetings in the year. The figure in brackets indicates the number of meetings that the director was eligible to attend during 2007.

| Director | Board Meetings | Board Committees: Audit | Chairman's (note 1) | Nominations | Remuneration | Risk |
|---|---|---|---|---|---|---|
| **Ed Anderson** Chairman | 10(10) | – | 2(2) | 1(1) | 7(7) | – |
| **Julie Baddeley** Non-executive Director | 9(10) | – | – | – | 7(7) | – |
| **Frank Beckett** Non-executive Director (note 2) | 10(10) | 4(4) | – | – | – | 6(6) |
| **Ian Bullock** Sales & Marketing Director (note 3) | 7(7) | – | 0(0) | – | – | – |
| **Andy Caton** Corporate Development Director | 10(10) | – | 2(2) | – | – | 5(6) |
| **Lynne Charlesworth** Non-executive Director | 10(10) | – | – | – | – | 5(5) |
| **Iain Cornish** Chief Executive | 10(10) | – | 2(2) | 1(1) | – | 5(6) |
| **Richard Davey** Vice Chairman | 9(10) | 4(4) | 2(2) | 1(1) | – | 6(6) |
| **Andrew Gosling** Finance Director | 9(10) | – | 2(2) | – | – | 5(6) |
| **Rob Jackson** Operations Director (note 4) | 6(6) | – | 2(2) | – | – | 3(3) |
| **Philip Johnson** Non-executive Director (note 5) | 6(6) | 2(2) | – | – | – | – |
| **Paul Lee** Non-executive Director (note 2) | 8(10) | – | – | – | – | – |
| **David Paige** Non-executive Director | 9(10) | 4(4) | – | – | – | 4(5) |
| **Simon Turner** Non-executive Director | 8(10) | 3(4) | – | – | 6(7) | – |

**Notes:**

1. In addition to the two Chairman's Committee meetings, the Committee considered business on a further five occasions using the written resolution procedure under the Society's Rules.
2. Retired as a director on 31st December 2007.
3. Appointed a director on 12th April 2007.
4. Retired as a director on 31st July 2007.
5. Appointed a director on 1st June 2007.

On behalf of the board

Ed Anderson
Chairman

3rd March 2008

# Directors' remuneration report

**Introduction**
This report:

- explains to members the policy for the remuneration of executive and non-executive directors;
- voluntarily addresses the statutory disclosure requirements for listed companies in relation to directors' remuneration that are considered relevant to a building society; and
- includes a table showing each director's remuneration for the year ended 31st December 2007.

A summary of this report will be sent to all members eligible to vote at the 2008 Annual General Meeting and, once again, members will have the opportunity to vote on the report.

**Remuneration Committee**
The committee is responsible for determining, on behalf of the board, the overall remuneration policy for all staff and, in particular, the policy and the level of remuneration of the executive directors and other senior managers. The full terms of reference of the committee can be found at www.ybs.co.uk/committees.

The committee normally meets four times a year with additional meetings if required. It takes independent external professional advice, as appropriate, and monitors comparative remuneration packages within the financial sector.

With effect from 1st January 2007 the composition of the committee was changed from being made up of all the non-executive directors to three such directors. These are Ed Anderson (Chairman of the Society), Julie Baddeley (Chairman of the committee) and Simon Turner.

The Society's Chief Executive and the General Manager Human Resources and Customer Service present proposals and supporting evidence as and when required and attend meetings at the committee's request.

**Remuneration policy for non-executive directors**
The committee does not set the remuneration of the non-executive directors. Instead, their remuneration, including that of the Society's Chairman, is reviewed on an annual basis by the executive directors and the General Manager Human Resources and Customer Service, using data from other building societies.

A recommendation is made to the full board, which determines any change in the remuneration of non-executive directors, which takes effect from 1st July. Additional fees (details of which are given on page 41) are paid to those non-executive directors who undertake additional duties and responsibilities, including directorships of subsidiary boards and membership of certain board committees.

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

**Remuneration policy for executive directors**
The overall policy is that:

- the remuneration of executive directors (together with that of other General Managers) should be competitive with those of other comparable organisations in the financial sector so as to attract and retain high calibre individuals with the relevant experience;
- a significant part of the remuneration of executive directors should be based on the Society's financial and service performance (including customer satisfaction) and individual performance using pre-determined targets to motivate and reward successful business and personal performance which is in the interests of current and future members;
- personal reviews of the executive directors are carried out at least annually to assess their performance in meeting individual and strategic objectives. These are reflected in pay reviews which take effect from 1st May each year; and
- no executive director should be involved in deciding his or her remuneration.

The various elements of the policy are set out below.

**(a) Basic salary**

Basic pay for all employees (including executive directors) will be market related thus ensuring a competitive salary that fairly reflects the market rate, skill, experience and expertise for the role. Individual development and progression is reflected through the annual salary and personal review processes.

The committee considers external data from independent national salary surveys of the financial sector and a comparator group of financial institutions to ensure salaries remain competitive. Independent reward specialists carry out an overall review of remuneration, generally once every three years. The last review was undertaken in 2007 by Hays Plc, which has no other connection with the Society. The review concluded that the basic pay of the executive directors was in line with the market median position, but that overall packages including performance pay were lower than those offered by competitors.

**(b) Performance pay**

In 2007 the executive directors participated in a non-pensionable performance incentive scheme, the elements of which reflected the Society's key measures of mortgage asset growth, underlying profitability, cost control, growth in other income and customer satisfaction (a scheme with similar characteristics is in place for all other staff). In addition, executive directors (together with other senior managers) had an element of their performance pay based on the achievement of personal objectives.

These measures are set to provide challenging objectives giving the executive directors an incentive to perform at the highest level in a manner which is consistent with the interests of members. There was no minimum amount of performance pay and the maximum amount, as a percentage of basic salary, was 40% for executive directors with 50% for the Chief Executive. A similar scheme will operate in 2008, but with the maximum amount payable being raised to 50% for executive directors and 60% for the Chief Executive to bring their remuneration in line with market practice.

The remuneration review undertaken by Hays Plc in 2007 showed that the Society's overall reward package for executive directors was significantly less than those within other similar organisations due to the absence of any long-term bonus scheme. As a mutual building society, the Society does not issue shares on the Stock Exchange. As a result, unlike executive directors of listed companies, the executive directors cannot participate in Share Option Schemes or Share Incentive Plans. The development of a long-term incentive scheme which is suitable for a mutual organisation is under consideration for implementation in 2009.

**(c) Benefits**

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

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

The executive directors are either members of the contributory defined benefit section or the defined contribution section of the Society's pension scheme. The defined benefit section of the scheme is designed to provide a pension of up to two-thirds of final pensionable salary on retirement (based on the number of years service). The pension scheme also provides for dependents' pensions and a lump sum of four times basic salary on death in service.

**Service contracts**

All the current executive directors, with the exception of Ian Bullock, have rolling contracts that can be terminated by either party on one year's notice or by the payment by the Society of an amount equivalent to one year's remuneration. Ian Bullock has a rolling contract which can be terminated by the Society on one year's notice or by him on six months' notice.

Rob Jackson retired as an executive director on 31st July 2007. His service contract predated the Combined Code provision that notice periods should be set at one year or less and it was terminable by the Society on two years' notice and by Mr Jackson on one year's notice.

# Directors' remuneration report

## continued

Unless notice to terminate is given by any party, the contracts for all executive directors continue automatically to the age of 60.

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

**Executive directors' remuneration**

| | Salary £000 | Performance pay £000 | Taxable benefits £000 | Increase in accrued pension £000 | Society's contribution to pension scheme* £000 | Total £000 |
|---|---|---|---|---|---|---|
| **Executive directors** | | | | | | |
| **2007** | | | | | | |
| Ian Bullock (appointed 12.04.07) | **155** | **61** | **8** | **–** | **16** | **240** |
| Andy Caton | **213** | **80** | **–** | **8** | **–** | **301** |
| Iain Cornish | **308** | **140** | **14** | **17** | **–** | **479** |
| Andrew Gosling | **233** | **88** | **–** | **9** | **–** | **330** |
| Rob Jackson (retired 31.07.07) | **126** | **47** | **2** | **2** | **–** | **177** |
| | **1,035** | **416** | **24** | **36** | **16** | **1,527** |
| **2006** | | | | | | |
| Andy Caton | 201 | 85 | 1 | 6 | – | 293 |
| Iain Cornish | 292 | 136 | 14 | 16 | – | 458 |
| Andrew Gosling | 225 | 92 | 1 | 8 | – | 326 |
| Rob Jackson | 206 | 87 | 9 | 4 | – | 306 |
| | 924 | 400 | 25 | 34 | – | 1,383 |

*Defined contribution pension scheme.

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

Rob Jackson retired on 31st July 2007. He did not receive any additional remuneration or benefits (including pension benefits) as a result of his retirement.

**Executive directors' pension benefits (defined benefit section) in 2007**

| | Contributions from directors £000 | Increase in accrued pension £000 | Accrued pension as at 31st December 2007 £000 | Transfer value of accrued benefits as at 1st January 2007 £000 | Transfer value of accrued benefits as at 31st December 2007 £000 | Movement in transfer value less directors' contributions £000 |
|---|---|---|---|---|---|---|
| Andy Caton | **16** | **8** | **65** | **595** | **687** | **76** |
| Iain Cornish | **24** | **17** | **158** | **1,601** | **1,827** | **202** |
| Andrew Gosling | **18** | **9** | **50** | **569** | **712** | **125** |
| Rob Jackson (retired 31.07.07) | **10** | **2** | **138** | **2,393** | **2,745** | **342** |
| | **68** | **36** | **411** | **5,158** | **5,971** | **745** |

Ian Bullock, who was appointed a director on 12th April 2007, is a member of the defined contribution section of the pension scheme and he is therefore not included in the above table.

**Non-executive directors' fees**

| | Fees | | Subsidiary/committee fees (note 1) | | Total | |
|---|---|---|---|---|---|---|
| | **2007 £000** | 2006 £000 | **2007 £000** | 2006 £000 | **2007 £000** | 2006 £000 |
| Ed Anderson (Chairman from 01.01.07) | **72** | 39 | **6** | 5 | **78** | 44 |
| Julie Baddeley | **35** | 33 | **10** | 5 | **45** | 38 |
| Frank Beckett | **35** | 33 | **18** | 18 | **53** | 51 |
| Colette Bowe (retired 31.12.06) | **–** | 33 | **–** | 10 | **–** | 43 |
| Lynne Charlesworth (note 2) | **35** | – | **4** | – | **39** | – |
| Richard Davey (Vice Chairman from 01.01.07) | **46** | 33 | **13** | 11 | **59** | 44 |
| Philip Johnson (appointed 01.06.07) | **20** | – | **3** | – | **23** | – |
| Paul Lee (Vice Chairman to 30.06.06) | **35** | 39 | **–** | 5 | **35** | 44 |
| David Paige (note 2) | **35** | – | **9** | – | **44** | – |
| Christopher Sheridan (retired 31.12.06) | **–** | 68 | **–** | – | **–** | 68 |
| Sue Tinson (retired 26.04.06) | **–** | 10 | **–** | – | **–** | 10 |
| Simon Turner | **35** | 33 | **8** | 5 | **43** | 38 |
| | **348** | 321 | **71** | 59 | **419** | 380 |

**Notes:**

1. The subsidiary/committee fees consist of:
   - £5,000 per annum for membership of boards of the subsidiaries Accord Mortgages Limited (Ed Anderson who resigned from that board on 31st July 2007) and Yorkshire Investment Services Limited (Richard Davey who resigned from that board on 31st July 2007);
   - £5,000 per annum for membership of each of the Audit Committee and the Group Risk Committee and £3,500 per annum for membership of the Remuneration Committee. In addition, the Chairman of the Audit Committee (Frank Beckett) received an additional £7,500 per annum and the Chairman of the Remuneration Committee (Julie Baddeley) received an additional £1,500 per annum. Membership of these committees is set out in the Corporate Governance Report on pages 33 to 35; and
   - £5,000 per annum for the 'Treating Customers Fairly' oversight role (Julie Baddeley).
2. Lynne Charlesworth and David Paige were appointed directors on 31st December 2006 but received no remuneration in 2006.
3. The above table excludes VAT which is payable in respect of certain non-executive directors' fees.

On behalf of the board

Julie Baddeley

Chairman of the Remuneration Committee

3rd March 2008

# Statement of directors' responsibilities

**Directors' responsibilities in respect of the Annual Report and Accounts**
The directors are responsible for preparing the Annual Report and Accounts including the Annual Business Statement, Directors' Report and the Annual Accounts in accordance with applicable law and regulations.

The Building Societies Act (the Act) requires the directors to prepare Group and Society Annual Accounts for each financial year. Under that law they are required to prepare the Group Annual Accounts in accordance with IFRS as adopted by the EU and applicable law and have elected to prepare the Society Annual Accounts on the same basis.

The Group and Society Annual Accounts are required by law and IFRS 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 these Annual Accounts, the directors are required to:

- select suitable accounting policies and apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRS as adopted by the EU; and
- prepare the Annual Accounts on the going concern basis, unless it is inappropriate to presume that the Group and the Society will continue in business.

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

**Directors' responsibilities for accounting records and internal control**
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; and
- 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 Services Authority under the Financial Services and Markets Act 2000.

The directors 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 financial statements may differ from legislation in other jurisdictions.

On behalf of the board

Ed Anderson
Chairman

3rd March 2008

# Independent auditors' report

## to the members of Yorkshire Building Society

We have audited the group and society annual accounts of Yorkshire Building Society for the year ended 31st December 2007 which comprise the Group and Society Income Statements, the Group and Society Statements of Recognised Income and Expense, the Group and Society Balance Sheets, the Group and Society Cash Flow Statements and the related notes. These annual accounts have been prepared under the accounting policies set out therein.

We have examined the Annual Business Statement (other than the details of directors and officers upon which we are not required to report) and the Directors' Report.

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

**Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the Report and Accounts including the Directors' Report, the Annual Business Statement and the annual accounts in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 42.

Our responsibility is to audit the annual accounts in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). We are also responsible for examining the Annual Business Statement (other than the details of directors and officers) and for reading the information in the Directors' Report and assessing whether it is consistent with the accounting records and the annual accounts.

We report to you our opinion as to whether the annual accounts give a true and fair view and are properly prepared in accordance with the Building Societies Act 1986, regulations made under it and, as regards the group annual accounts, Article 4 of the IAS Regulation. In addition, we report to you our opinion as to whether certain information in the Annual Business Statement gives a true representation of the matters in respect of which it is given, whether the information in the Directors' Report is consistent with the accounting records and the annual accounts and whether 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 made under it. The information given in the Directors' Report includes that specific information given in the Chief Executive's Report that is cross referred from the Business Review section of the Directors' Report. It also includes that specific information given in the Risk Management Report that is cross referred from the Principal Risks And Uncertainities section of the Directors' Report.

We also report to you if, in our opinion, the annual accounts are not in agreement with the accounting records or if we have not received all the information and explanations that we require for our audit.

We read the other information contained in the Annual Report and Accounts accompanying the annual accounts, the Annual Business Statement and the Directors' Report and consider whether it is consistent with the audited annual accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the annual accounts, Annual Business Statement and Directors' Report. Our responsibilities do not extend to any other information.

**Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the annual accounts and the Annual Business Statement. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the annual accounts, and of whether the accounting policies are appropriate to the group's and society's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the annual accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the annual accounts.

**Opinion**

In our opinion:

- the annual accounts give a true and fair view, in accordance with IFRS as adopted by the EU, of the state of the affairs of the group and of the society as at 31st December 2007 and of the income and expenditure of the group and of the society for the year then ended;
- 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;
- the information given in the Directors' Report is consistent with the accounting records and the annual accounts; and
- the annual accounts, the Annual Business Statement and the Directors' Report have each been prepared in accordance with the applicable requirements of the Building Societies Act 1986, regulations made under it and, as regards the group annual accounts, Article 4 of the IAS Regulation.

KPMG Audit Plc
Chartered Accountants
Registered Auditor

Leeds
3rd March 2008

# Income statements

## for the year ended 31st December 2007

| | NOTES | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|---|
| Interest receivable and similar income | 3 | **1,136.7** | 875.0 | **1,151.3** | 829.4 |
| Interest payable and similar charges | 4 | **(948.5)** | (710.2) | **(1,031.3)** | (721.8) |
| **Net interest income** | | **188.2** | 164.8 | **120.0** | 107.6 |
| Fees and commissions receivable | | **34.2** | 32.3 | **30.1** | 28.9 |
| Fees and commissions payable | | **(7.1)** | (6.6) | **(4.6)** | (4.4) |
| **Net fee and commission income** | | **27.1** | 25.7 | **25.5** | 24.5 |
| Income from investments in subsidiaries | 5 | **–** | – | **2.5** | 15.1 |
| Net (losses)/gains from fair value volatility on financial instruments | 6 | **(43.6)** | 13.6 | **(47.4)** | 19.0 |
| Net losses arising on realisation of available for sale assets | | **(1.8)** | – | **(1.3)** | – |
| Other operating income | | **13.8** | 6.7 | **27.8** | 16.4 |
| **Total income** | | **183.7** | 210.8 | **127.1** | 182.6 |
| Administrative expenses | 7 | **(110.5)** | (107.4) | **(110.1)** | (106.5) |
| Depreciation and amortisation | | **(9.7)** | (9.5) | **(7.7)** | (6.6) |
| **Operating profit before provisions** | | **63.5** | 93.9 | **9.3** | 69.5 |
| Impairment of loans and advances to customers | 9 | **(5.0)** | (3.5) | **2.3** | (0.1) |
| Impairment of debt securities | 9 | **(6.9)** | – | **(6.9)** | – |
| Provisions for liabilities | 26 | **3.0** | (12.5) | **3.0** | (12.3) |
| **Profit before tax** | | **54.6** | 77.9 | **7.7** | 57.1 |
| Tax expense | 11 | **(15.4)** | (24.2) | **(1.5)** | (18.4) |
| **Net profit** | | **39.2** | 53.7 | **6.2** | 38.7 |

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

The notes on pages 48 to 83 form part of these accounts.

# Statements of recognised income and expense

## for the year ended 31st December 2007

| | NOTES | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|---|
| Available for sale investments: | | | | | |
| Valuation losses taken to equity | | **(24.6)** | (18.4) | **(23.5)** | (17.7) |
| Amounts released | | **7.4** | 0.3 | **7.0** | 0.3 |
| Cash flow hedges: | | | | | |
| (Losses)/gains taken to equity | | **(8.6)** | 5.6 | **(8.6)** | 5.6 |
| Amounts released | | **0.5** | (2.8) | **0.5** | (2.8) |
| Actuarial gain on retirement benefit obligations | 25 | **33.8** | 22.0 | **33.8** | 22.0 |
| Tax on items taken directly to or transferred from equity | 11 | **(5.0)** | (1.0) | **(5.2)** | (1.2) |
| **Net income not recognised directly in the income statement** | | **3.5** | 5.7 | **4.0** | 6.2 |
| **Net profit** | | **39.2** | 53.7 | **6.2** | 38.7 |
| **Total recognised income and expense for the year** | | **42.7** | 59.4 | **10.2** | 44.9 |

Total recognised income and expense for the year is attributable to members.

The notes on pages 48 to 83 form part of these accounts.

# Balance sheets

## as at 31st December 2007

| ASSETS | NOTES | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|---|
| Liquid assets | | | | | |
| Cash in hand and balances with the Bank of England | 12 | **434.9** | 36.2 | **434.9** | 36.2 |
| Loans and advances to credit institutions | 13 | **756.8** | 167.8 | **732.2** | 20.2 |
| Debt securities | 14 | **3,530.2** | 3,868.0 | **3,184.5** | 3,481.6 |
| Loans and advances to customers | | | | | |
| Loans secured on residential property | 15 | **15,357.8** | 13,263.6 | **9,324.5** | 8,840.5 |
| Other loans | 15 | **4.2** | 5.4 | **4.2** | 5.4 |
| Derivative financial instruments | 33 | **294.9** | 95.4 | **132.3** | 95.7 |
| Investments | 10 | **2.1** | 0.1 | **9,217.9** | 6,261.0 |
| Intangible assets | 16 | **8.1** | 11.4 | **7.5** | 10.5 |
| Investment properties | 17 | **6.3** | 6.7 | **6.0** | 6.6 |
| Property, plant and equipment | 18 | **80.2** | 78.2 | **60.3** | 56.7 |
| Deferred tax assets | 19 | **6.7** | 17.5 | **4.8** | 14.9 |
| Retirement benefit surplus | 25 | **8.0** | – | **8.0** | – |
| Other assets | 20 | **8.1** | 15.3 | **19.8** | 32.6 |
| **Total assets** | | **20,498.3** | 17,565.6 | **23,136.9** | 18,861.9 |
| LIABILITIES | | | | | |
| Shares | 21 | **12,448.2** | 11,286.3 | **12,448.2** | 11,286.3 |
| Amounts owed to credit institutions | 22 | **249.4** | 72.5 | **1,410.0** | 1,244.5 |
| Other deposits | 23 | **2,423.5** | 1,596.4 | **4,103.8** | 1,855.6 |
| Debt securities in issue | 24 | **3,967.4** | 3,262.0 | **3,967.4** | 3,262.0 |
| Derivative financial instruments | 33 | **94.0** | 42.0 | **94.0** | 43.7 |
| Current tax liabilities | | **12.5** | 27.1 | **10.6** | 21.3 |
| Deferred tax liabilities | 19 | **40.6** | 30.6 | **7.7** | 9.6 |
| Retirement benefit obligations | 25 | **–** | 30.7 | **–** | 30.7 |
| Other liabilities | 26 | **58.0** | 56.5 | **55.6** | 54.3 |
| Subordinated liabilities | 27 | **105.0** | 105.3 | **105.0** | 130.3 |
| Subscribed capital | 28 | **146.0** | 145.2 | **146.0** | 145.2 |
| | | **19,544.6** | 16,654.6 | **22,348.3** | 18,083.5 |
| Total equity attributable to members | 29 | **953.7** | 911.0 | **788.6** | 778.4 |
| **Total liabilities** | | **20,498.3** | 17,565.6 | **23,136.9** | 18,861.9 |

The accounts on pages 44 to 83 were approved by the board of directors on 3rd March 2008 and were signed on its behalf by:

| | |
|---|---|
| Ed Anderson | Chairman |
| Richard Davey | Vice Chairman |
| Iain Cornish | Chief Executive |

The notes on pages 48 to 83 form part of these accounts.

# Cash flow statements

## for the year ended 31st December 2007

| | NOTES | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|---|
| **Cash flows from operating activities:** | | | | | |
| Operating profit before provisions | | **63.5** | 93.9 | **9.3** | 69.5 |
| Working capital adjustments | 41 | **22.6** | 4.9 | **27.4** | 6.9 |
| Net increase in operating assets | 41 | **(2,091.5)** | (1,143.6) | **(3,267.7)** | (2,627.7) |
| Net increase in operating liabilities | 41 | **2,165.9** | 631.2 | **3,575.6** | 2,070.6 |
| **Net cash flows from operating activities** | | **160.5** | (413.6) | **344.6** | (480.7) |
| **Cash flows from investing activities:** | | | | | |
| Purchase of property, plant and equipment and intangible assets | | **(8.9)** | (7.6) | **(8.7)** | (7.4) |
| Proceeds from sale of property, plant and equipment | | **10.0** | – | **10.0** | – |
| Purchase of debt securities | | **(8,176.7)** | (6,439.3) | **(7,652.6)** | (6,319.9) |
| Proceeds from sale and redemption of debt securities | | **8,692.1** | 6,057.7 | **8,079.7** | 5,943.0 |
| **Net cash flows from investing activities** | | **516.5** | (389.2) | **428.4** | (384.3) |
| **Cash flows from financing activities:** | | | | | |
| Proceeds from issue of covered bonds | | **1,023.5** | 1,005.6 | **1,023.5** | 1,005.6 |
| Redemption of securities | | **(3,342.1)** | (3,838.7) | **(3,342.1)** | (3,838.7) |
| Issue of securities | | **2,859.9** | 3,304.2 | **2,859.9** | 3,304.2 |
| Proceeds from issue of subscribed capital | | **0.8** | 145.2 | **0.8** | (3.3) |
| Proceeds from redemption of subordinated capital | | **(0.3)** | (3.3) | **(25.3)** | 145.2 |
| Interest paid on subordinated liabilities and subscribed capital | | **(15.1)** | (14.2) | **(16.5)** | (15.6) |
| **Net cash flows from financing activities** | | **526.7** | 598.8 | **500.3** | 597.4 |
| Taxation paid | | **(14.3)** | (13.9) | **(9.2)** | (17.4) |
| **Net increase/(decrease) in cash and cash equivalents** | | **1,189.4** | (217.9) | **1,264.1** | (285.0) |
| Opening balance | | **792.9** | 1,010.8 | **645.2** | 930.2 |
| **Total closing cash and cash equivalents** | | **1,982.3** | 792.9 | **1,909.3** | 645.2 |
| **Cash and cash equivalents:** | | | | | |
| Cash and balances with central banks | | **434.9** | 36.2 | **434.9** | 36.2 |
| Loans and advances to banks | | **756.8** | 167.8 | **732.2** | 20.2 |
| Debt securities | | **790.6** | 588.9 | **742.2** | 588.8 |
| | | **1,982.3** | 792.9 | **1,909.3** | 645.2 |

The cash flow has been prepared in compliance with International Accounting Standard 7 'Cash Flow Statements' and has been presented under the indirect method. Previously the statement had been prepared under the direct method.

For the purposes of the cash flow statement, cash and cash equivalents comprises cash and other financial instruments with original maturities of less than three months.

The notes on pages 48 to 83 form part of these accounts.

INTRODUCTION

**Basis of preparation**

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) in issue that have been endorsed by the EU and are effective at 31st December 2007 and with those parts of the Building Societies (Accounts and Related Provisions) Regulations applicable to societies reporting under IFRS.

Disclosed below are new standards and interpretations, which have been adopted during the year. These have had the following effect on the results presented:

- International Accounting Standard 1: Presentation of Financial Statements – Capital Disclosures (IAS 1). This has introduced the requirement to disclose information about the Group's capital; and
- IFRS 7, 'Financial Instruments: Disclosures'. This standard, revises and combines the disclosure requirements of IAS 32 Financial instruments: Disclosure and presentation, and IAS 30: 'Disclosures in the financial statements of banks and similar financial institutions', into one standard.

The directors have not adopted IAS 1, Presentation of Financial Statements (2007) or IFRS 8, Operating Segments, which although endorsed by the EU are not currently mandatory.

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

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

## 1. SIGNIFICANT ACCOUNTING POLICIES

**Basis of consolidation**

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

**Tax**

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

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

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

The following temporary differences are not provided for: the initial recognition of assets or liabilities that affect neither accounting nor taxable profit and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. Deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which temporary differences can be utilised.

**Joint ventures**

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

**Investment properties, property, plant and equipment**

**Investment properties**

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

**Property, plant and equipment**

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

**Subsequent costs**

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

## 1. SIGNIFICANT ACCOUNTING POLICIES (continued)

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

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

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

### Intangible assets

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

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

### Leases
The leases entered into by the Group are operating leases. Operating lease rentals are expensed to the income statement on a straight line basis over the period of the lease agreement.

### Employee benefits – Pension obligations

**Defined contribution plans**
Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement as incurred.

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

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

The cash flow statements have been prepared using the indirect method.

### Foreign currency
Assets and liabilities denominated in foreign currencies are translated into sterling at the appropriate rates of exchange prevailing at the year end date and exchange differences are dealt with in the income statement as they arise. All income and expense is translated into sterling at the rate of exchange at the day of receipt or payment.

### Financial assets
The Group classifies its financial assets into the following categories:

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

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

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

**Held to maturity**
The Group does not currently classify any of its financial assets as held to maturity.

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

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

**Derecognition of financial assets and liabilities**
Financial assets are only derecognised when the contractual rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership. The Group has not derecognised the loans securing its issue of covered bonds because substantially all the risks and rewards are retained.

Financial liabilities are only derecognised when the obligation is discharged, cancelled or has expired.

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

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

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

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

**Impairment losses on debt instruments held as available for sale**
At each balance sheet date the Group assesses whether or not there is objective evidence that individual available for sale debt instruments are impaired.

In determining whether there is any objective evidence of impairment the Group takes into account a number of factors including:

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

1. SIGNIFICANT ACCOUNTING POLICIES (continued)

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

Where the Group determines that there is objective evidence of impairment or that trigger events exist at the balance sheet date, then the cumulative loss that had been recognised directly in reserves is removed from reserves and recognised in the income statement.

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

**Derivative financial instruments and hedge accounting**

**Derivative financial instruments**

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

**Embedded derivatives**

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

**Hedging**

All derivatives entered into by the Group are for the purposes of providing an economic hedge. Full details of hedging strategies are contained in Note 33 on page 72. Hedge accounting is an optional treatment but the specific rules and conditions in IAS 39 have to be complied with before it can be applied. The Group has classified the majority of its derivatives as fair value and cash flow hedges in order to reduce volatility in the income statement.

**Fair value hedges**

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

**Cash flow hedges**

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

**Interest income and expense**

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

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

## 2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

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

### Pensions

The Group operates a defined benefit pension scheme. Significant judgements (on areas such as future interest and inflation rates, membership levels and mortality rates) have to be exercised in estimating the value of the assets and liabilities of the scheme, and hence of its net surplus/deficit. These are outlined in Note 25. The impact of a 0.1% increase in the rate used to discount the future value of the liabilities would be to reduce the present value of the liabilities by £5.8 million. The impact of a one year increase in each of the quoted life expectances at age 60 would be to increase the present value of the liabilities by £7.1 million.

### Effective interest rate

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

### Impairment of financial assets

The creation of impairment provisions for a portfolio of mortgage loans is inherently uncertain and requires the exercise of a significant degree of judgement. Provisions are calculated using historic default and loss experience, but require judgement to be exercised in predicting future economic conditions (e.g. interest rates and house price inflation) and customer behaviour (e.g. default rates). The most critical estimate is of the population of loans where some impairment has occurred. A 10% increase would result in an increase of £0.9 million in the level of provision required. A 10% increase in the loss given default rate would increase provisions by £1.9 million.

### Fair value of financial assets

The Group holds a small number of structured debt investments that contain embedded derivatives. There is no market in either these embedded features or the host instrument so the entire instrument is measured at fair value and changes in fair value are recognised in the income statement. The fair value is recorded at net asset value as determined by the manager of the investment. In one instance the Group has received a firm proposal to restructure the investment and in this case the fair value has been estimated using details of the reconstruction. It is recognised that a range of values could be attributed to this restructuring and that the fair value could lie in a range of £2 million above or below this estimate.

## 3. INTEREST RECEIVABLE AND SIMILAR INCOME

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| On assets held at amortised cost | | | | |
| Loans fully secured on residential property | **800.2** | 650.5 | **489.2** | 438.3 |
| Connected undertakings | **–** | – | **348.4** | 190.8 |
| Other loans | **0.4** | 0.5 | **0.4** | 0.5 |
| Other liquid assets/cash and short term funds | **36.9** | 18.0 | **35.0** | 15.1 |
| On available for sale securities | **218.0** | 164.8 | **199.1** | 149.4 |
| On financial instruments held at fair value through the income statement | | | | |
| Derivatives | **76.3** | 35.3 | **76.3** | 35.3 |
| Other assets | **4.9** | 5.9 | **2.9** | – |
| Total interest receivable | **1,136.7** | 875.0 | **1,151.3** | 829.4 |

## 4. INTEREST PAYABLE AND SIMILAR CHARGES

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| On liabilities held at amortised cost | | | | |
| Shares held by individuals | **560.3** | 433.1 | **560.3** | 433.1 |
| Deposits from banks | **19.5** | 19.7 | **19.5** | 19.7 |
| Deposits from other financial institutions | **16.8** | 11.2 | **16.8** | 11.2 |
| Deposits from connected undertakings | **–** | – | **76.9** | 57.5 |
| Other deposits | **92.0** | 70.1 | **29.1** | 16.2 |
| Certificates of deposit | **23.5** | 10.8 | **23.5** | 10.8 |
| Other debt securities | **164.8** | 121.2 | **164.8** | 121.2 |
| Subordinated liabilities | **6.5** | 7.6 | **7.9** | 9.0 |
| Subscribed capital | **8.6** | 6.6 | **8.6** | 6.6 |
| Other interest payable | **0.8** | 0.6 | **0.8** | 0.6 |
| On financial instruments held at fair value through the income statement | | | | |
| Deposits from connected undertakings | **–** | – | **68.5** | 7.1 |
| Derivatives | **55.7** | 29.3 | **54.6** | 28.8 |
| Total interest payable | **948.5** | 710.2 | **1,031.3** | 721.8 |

## 5. INCOME FROM INVESTMENTS IN SUBSIDIARIES

This income arises from dividends declared and payable to the Society by its subsidiary Yorksafe Insurance Company Ltd.

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

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Assets held at fair value | **(24.2)** | – | **(23.6)** | – |
| Embedded derivatives | **(8.3)** | (0.4) | **(8.3)** | – |
| Derivatives and hedging | **(11.1)** | 14.0 | **(15.5)** | 19.0 |
| Net (losses)/gains from fair value volatility on financial instruments | **(43.6)** | 13.6 | **(47.4)** | 19.0 |

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

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

The derivative and hedging category relates to ineffectiveness in hedge accounting relationships and changes in value of derivatives that are not in such relationships despite being effective as economic hedges. The main element (£9.7 million) relates to interest rate basis swaps that are not in hedging relationships. These swaps were contracted early in 2007 in order to reduce the risks associated with money market interest rates. The £9.7 million charge in 2007 is expected to reverse in 2008 and 2009. This exposure is discussed further in Note 35 on page 76. Ineffectiveness on cash flow hedging is an immaterial amount.

## 7. ADMINISTRATIVE EXPENSES

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Staff costs | | | | |
| Salaries and wages | **59.5** | 57.4 | **58.7** | 56.9 |
| Social security costs | **5.4** | 5.3 | **5.4** | 5.3 |
| Pension costs – defined benefit plans (see Note 25) | **2.9** | 5.2 | **2.9** | 5.2 |
| Other post retirement benefits (see Note 25) | **1.7** | 1.5 | **1.7** | 1.5 |
| Staff costs capitalised – computer systems enhancements | **–** | (0.2) | **–** | (0.2) |
| Operating lease rentals | **–** | – | **2.5** | 2.5 |
| Other expenses | **41.0** | 38.2 | **38.9** | 35.3 |
| | **110.5** | 107.4 | **110.1** | 106.5 |

The Society "Operating lease rentals" category, above, relates to rental payments paid by the Society to subsidiary companies in the Group which own properties and equipment.

**Remuneration of auditors and their associates**

Included in other expenses above are the following:

| | Group 2007 £000 | Group 2006 £000 | Society 2007 £000 | Society 2006 £000 |
|---|---|---|---|---|
| Statutory audit work | **175** | 164 | **122** | 114 |
| Tax advice | **–** | 75 | **–** | 75 |
| Regulatory review | **–** | 25 | **–** | 25 |
| Other advice | **162** | 41 | **135** | 41 |
| | **337** | 305 | **257** | 255 |

The above figures, relating to auditors remuneration, exclude value added tax.

**Staff numbers**

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

| | 2007 Full time | 2007 Part time | 2006 Full time | 2006 Part time |
|---|---|---|---|---|
| Building Society | | | | |
| Central administration | **1,100** | **267** | 1,118 | 246 |
| Branches | **729** | **250** | 704 | 251 |
| Subsidiaries' offices | **17** | **1** | 17 | 1 |
| | **1,846** | **518** | 1,839 | 498 |

## 8. REMUNERATION OF AND TRANSACTIONS WITH DIRECTORS

Total directors' remuneration amounted to £1,946,000 (2006 – £1,763,000).

Full details of directors' remuneration, bonuses and pensions are given in the Directors' Remuneration report on pages 38 to 41. In addition, past directors' pensions in respect of services as directors (closed scheme) amounted to £37,000 (2006 – £53,000).

None of the directors had an interest in shares in, or debentures of, any associated body of the Society at any time during the financial year. Details of transactions with directors and loans held by directors and connected persons are disclosed in Note 40.

A register is maintained at the Head Office of the Society, containing details of loans, transactions and arrangements between the Society and its directors and connected persons. A statement of the appropriate details for 2007 will be available for inspection at the Head Office for a period of fifteen days up to and including the Annual General Meeting.

## 9. IMPAIRMENT

| Loans and advances to customers | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| At 1st January | | | | |
| Collective | **10.7** | 9.0 | **3.4** | 3.2 |
| Individual | **4.5** | 2.7 | **0.7** | 0.7 |
| | **15.2** | 11.7 | **4.1** | 3.9 |
| Amounts written off during the year | | | | |
| Collective | **–** | – | **–** | – |
| Individual | **(1.5)** | (0.2) | **(0.3)** | – |
| | **(1.5)** | (0.2) | **(0.3)** | – |
| Impairment adjustment for the year | | | | |
| Collective | **(1.9)** | 1.7 | **(2.5)** | 0.2 |
| Individual | **7.0** | 2.0 | **0.3** | – |
| | **5.1** | 3.7 | **(2.2)** | 0.2 |
| At 31st December | | | | |
| Collective | **8.8** | 10.7 | **0.9** | 3.4 |
| Individual | **10.0** | 4.5 | **0.7** | 0.7 |
| | **18.8** | 15.2 | **1.6** | 4.1 |
| The charge for the year comprises: | | | | |
| Impairment adjustment for loans and advances | **5.1** | 3.7 | **(2.2)** | 0.2 |
| Recoveries relating to amounts previously written off loans and advances | **(0.1)** | (0.2) | **(0.1)** | (0.1) |
| Net provision charge/(credit) for the year | **5.0** | 3.5 | **(2.3)** | 0.1 |

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

| Debt Securities | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| At 1st January | **–** | – | **–** | – |
| Individual impairment adjustment for the year | **6.9** | – | **6.9** | – |
| At 31st December | **6.9** | – | **6.9** | – |

Provisions for impairment of debt securities relate to cash collateralised debt obligations

## 10. INVESTMENTS

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Equities | **2.0** | – | **2.0** | – |
| Joint ventures | **0.1** | 0.1 | **–** | – |
| Subsidiaries | **–** | – | **9,215.9** | 6,261.0 |
| | **2.1** | 0.1 | **9,217.9** | 6,261.0 |

**Investment in equities**

At 31st December 2006 the Group had a shareholding in LINK Interchange Network Ltd that had an immaterial value. During the year these shares were disposed of and shares in VocaLink Holdings Limited were acquired. Both of these investments were in connection with the Group's operation of cash machines.

10. INVESTMENTS (continued)

**Investment in joint venture**

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

| | 2007 £m | 2006 £m |
|---|---|---|
| Share of joint ventures | | |
| Gross assets | **0.3** | 0.4 |
| Gross liabilities | **(0.2)** | (0.3) |
| | **0.1** | 0.1 |

**Investment in subsidiaries**

| **Society** | Shares £m | Loans £m | Total £m |
|---|---|---|---|
| Cost | | | |
| At 1st January 2007 | **294.8** | **5,966.7** | **6,261.5** |
| Additions | **–** | **4,183.0** | **4,183.0** |
| Repayments | **–** | **(1,228.1)** | **(1,228.1)** |
| At 31st December 2007 | **294.8** | **8,921.6** | **9,216.4** |
| Impairment losses | | | |
| At 1st January 2007 | **(0.5)** | **–** | **(0.5)** |
| Provided in year | **–** | **–** | **–** |
| At 31st December 2007 | **(0.5)** | **–** | **(0.5)** |
| Net book value | | | |
| At 31st December 2007 | **294.3** | **8,921.6** | **9,215.9** |
| Cost | | | |
| At 1st January 2006 | 294.8 | 3,452.6 | 3,747.4 |
| Additions | – | 2,519.4 | 2,519.4 |
| Repayments | – | (5.3) | (5.3) |
| At 31st December 2006 | 294.8 | 5,966.7 | 6,261.5 |
| Impairment losses | | | |
| At 1st January 2006 | (0.5) | – | (0.5) |
| Provided in year | – | – | – |
| At 31st December 2006 | (0.5) | – | (0.5) |
| Net book value | | | |
| At 31st December 2006 | 294.3 | 5,966.7 | 6,261.0 |

Included within Shares is an investment of £60.0 million (2006 – £60.0 million) in Yorkshire Guernsey Ltd which is a credit institution.

## 10. INVESTMENTS (continued)

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

| | Principal activity |
|---|---|
| Accord Mortgages Ltd | Mortgage lending |
| YBS Properties Ltd | Property holding |
| YBS Properties (Edinburgh) Ltd | Property holding |
| Yorkshire Building Society Covered Bonds LLP | Mortgage acquisition and guarantor of covered bonds |
| Yorkshire Key Services Ltd | Computer services |
| Yorkshire Key Services (No. 2) Ltd | Retail deposit services |
| Yorkshire Guernsey Ltd | Deposit taking |
| Yorksafe Insurance Company Ltd | Insurance |
| YBS Investments (No. 1) Ltd | Investments |
| YBS Investments (No. 2) Ltd | Investments |
| Yorkshire Investment Services Ltd | Investments |
| YBS Properties (York) Ltd | Non-trading |
| Yorkshire Building Society Estate Agents Ltd | Non-trading |
| Yorkshire Computer Services Ltd | Non-trading |

Yorkshire Key Services (No. 2) Ltd is wholly-owned by Yorkshire Key Services Ltd.

YBS Investments (No. 2) Ltd is wholly-owned by Yorkshire Investment Services Ltd.

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

All the companies are wholly owned except for Yorksafe Insurance Company Ltd and Yorkshire Building Society Covered Bonds LLP. The Society's interests in these companies are, in substance, no different than if they were 100% held subsidiary undertakings and consequently they are consolidated in the Group accounts.

## 11. TAX EXPENSE

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Current tax: | | | | |
| UK corporation tax at 30% (2006 – 30%) | **5.2** | 20.3 | **5.2** | 19.1 |
| Corporation tax – adjustment in respect of prior periods | **0.4** | 8.5 | **0.3** | 8.0 |
| Overseas tax | **1.0** | 0.9 | **–** | – |
| Total Current tax | **6.6** | 29.7 | **5.5** | 27.1 |
| Deferred tax (Note 19): | | | | |
| Current year | **9.0** | 2.6 | **(3.9)** | (1.0) |
| Adjustment in respect of prior periods | **(0.2)** | (8.1) | **(0.1)** | (7.7) |
| Total tax expense in income statement | **15.4** | 24.2 | **1.5** | 18.4 |

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

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Profit before tax | **54.6** | 77.9 | **7.7** | 57.1 |
| Tax calculated at a tax rate of 30% (2006 – 30%) | **16.4** | 23.4 | **2.3** | 17.2 |
| Effects of: | | | | |
| Lower tax rate on overseas earnings | **(2.0)** | (0.7) | **–** | – |
| Income not subject to tax | **(1.3)** | – | **(1.3)** | – |
| Expenses not deductible for tax purposes | **3.7** | 1.1 | **0.5** | 0.9 |
| Adjustment to tax charge in respect of previous periods | **0.2** | 0.4 | **0.2** | 0.3 |
| Prospective change in deferred tax rate | **(1.6)** | – | **(0.2)** | – |
| Total tax expense in income statement | **15.4** | 24.2 | **1.5** | 18.4 |

## 11. TAX EXPENSE (continued)

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Tax expense/(credit) recognised directly in equity: | | | | |
| Tax on available for sale securities | **(5.1)** | (5.6) | **(4.9)** | (5.4) |
| Tax on pension costs | **(2.1)** | (2.1) | **(2.1)** | (2.1) |
| Deferred tax on pension costs | **12.3** | 8.7 | **12.3** | 8.7 |
| Prospective change in deferred tax rate | **(0.1)** | – | **(0.1)** | – |
| | **5.0** | 1.0 | **5.2** | 1.2 |

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

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Cash in hand | **15.0** | 15.5 | **15.0** | 15.5 |
| Cash ratio deposit with the Bank of England | **21.2** | 18.4 | **21.2** | 18.4 |
| Other deposits with the Bank of England | **398.7** | 2.3 | **398.7** | 2.3 |
| | **434.9** | 36.2 | **434.9** | 36.2 |

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

## 13. LOANS AND ADVANCES TO CREDIT INSTITUTIONS

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Loans and advances to banks | **601.5** | 164.8 | **576.9** | 17.2 |
| Loans and advances to other credit institutions | **155.3** | 3.0 | **155.3** | 3.0 |
| | **756.8** | 167.8 | **732.2** | 20.2 |

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

## 14. DEBT SECURITIES

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Debt securities issued by: | | | | |
| Public bodies | **267.2** | 268.6 | **267.2** | 234.9 |
| Other borrowers | **3,263.0** | 3,599.4 | **2,917.3** | 3,246.7 |
| | **3,530.2** | 3,868.0 | **3,184.5** | 3,481.6 |
| Analysis by type: | | | | |
| Listed on a recognised investment exchange | **2,495.3** | 2,359.8 | **2,424.4** | 2,067.0 |
| Unlisted | **1,034.9** | 1,508.2 | **760.1** | 1,414.6 |
| | **3,530.2** | 3,868.0 | **3,184.5** | 3,481.6 |

Debt securities of £2.3 billion (2006 – £2.0 billion) are due in over one year.

14. DEBT SECURITIES (continued)

| | Group | | Society | |
|---|---|---|---|---|
| | Available for sale £m | Held at fair value through the income statement £m | Available for sale £m | Held at fair value through the income statement £m |
| Movements in debt securities during the year are analysed as follows: | | | | |
| At 1st January 2007 | **3,774.3** | **93.7** | **3,481.6** | **–** |
| Additions | **8,956.9** | **10.3** | **8,309.5** | **85.3** |
| Disposals | **(9,253.0)** | **(40.5)** | **(8,656.9)** | **(23.5)** |
| Exchange translation | **42.9** | **1.4** | **43.1** | **2.5** |
| Other changes in value | **(22.9)** | **(32.9)** | **(24.8)** | **(32.3)** |
| At 31st December 2007 | **3,498.2** | **32.0** | **3,152.5** | **32.0** |
| Movements in debt securities during the year are analysed as follows: | | | | |
| At 1st January 2006 | 3,352.1 | 100.6 | 3,070.4 | – |
| Additions | 7,028.2 | – | 6,908.7 | – |
| Disposals | (6,526.5) | – | (6,421.7) | – |
| Exchange translation | (61.2) | (6.7) | (58.0) | – |
| Other changes in value | (18.3) | (0.2) | (17.8) | – |
| At 31st December 2006 | 3,774.3 | 93.7 | 3,481.6 | – |

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

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

Debt securities of £2.3 billion (2006 – 2.0 billion) are due in over one year.

15. LOANS AND ADVANCES TO CUSTOMERS

| | Group | | Society | |
|---|---|---|---|---|
| | **2007 £m** | 2006 £m | **2007 £m** | 2006 £m |
| Loans and advances to customers comprise: | | | | |
| Loans fully secured on residential property | **15,267.6** | 13,202.1 | **9,277.0** | 8,885.0 |
| Other loans secured on residential property | **71.6** | 119.9 | **11.6** | 6.0 |
| Fair value hedging adjustments | **37.4** | (43.2) | **37.5** | (46.4) |
| Allowances for impairment | **(18.8)** | (15.2) | **(1.6)** | (4.1) |
| Loans secured on residential property | **15,357.8** | 13,263.6 | **9,324.5** | 8,840.5 |
| Loans fully secured on land | **4.2** | 5.4 | **4.2** | 5.4 |

Loans and advances to customers are held at amortised cost with interest and associated costs being recognised in the interest receivable and similar income line of the income statement on an effective interest rate basis. Amounts totalling £15.0 billion (2006 – £12.9 billion) are due in over one year.

**Covered Bonds**

Loans and advances to customers include £2.6 billion (2006 – £1.4 billion) for both the Group and Society which have been transferred from the Society to Yorkshire Building Society Covered Bonds LLP, a Limited Liability Partnership which is consolidated by the Group. The loans secure £2.2 billion (2006 – £1.0 billion) of covered bonds issued by the Society. The covered bonds are included in debt securities in issue (see Note 24). The loans are retained on the Society's balance sheet as the Society substantially retains the risks and rewards relating to the loans.

## 16. INTANGIBLE ASSETS

| | Software £m | Other £m | Total £m |
|---|---|---|---|
| **Group** | | | |
| Cost | | | |
| At 1st January 2007 | **42.6** | **1.5** | **44.1** |
| Additions | **1.8** | **–** | **1.8** |
| Disposals | **(0.3)** | **–** | **(0.3)** |
| Transfers | **(2.3)** | **–** | **(2.3)** |
| At 31st December 2007 | **41.8** | **1.5** | **43.3** |
| Depreciation | | | |
| At 1st January 2007 | **32.7** | **–** | **32.7** |
| Charged in year | **2.9** | **0.3** | **3.2** |
| Disposals | **(0.3)** | **–** | **(0.3)** |
| Transfers | **(0.4)** | **–** | **(0.4)** |
| At 31st December 2007 | **34.9** | **0.3** | **35.2** |
| Net book value | | | |
| At 31st December 2007 | **6.9** | **1.2** | **8.1** |
| Cost | | | |
| At 1st January 2006 | 39.4 | – | 39.4 |
| Additions | 3.4 | 1.5 | 4.9 |
| Disposals | (0.2) | – | (0.2) |
| At 31st December 2006 | 42.6 | 1.5 | 44.1 |
| Depreciation | | | |
| At 1st January 2006 | 29.9 | – | 29.9 |
| Charged in year | 3.0 | – | 3.0 |
| Disposals | (0.2) | – | (0.2) |
| At 31st December 2006 | 32.7 | – | 32.7 |
| Net book value | | | |
| At 31st December 2006 | 9.9 | 1.5 | 11.4 |

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

Other intangible assets consist of an amount paid for the transfer of the administration of a number of employee sharesave schemes to the Society.

Depreciation is provided to write off the cost less the estimated residual value of intangible assets by equal instalments over their estimated useful economic lives of between three and five years.

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

## 16. INTANGIBLE ASSETS (continued)

| | Software £m | Other £m | Total £m |
|---|---|---|---|
| **Society** | | | |
| Cost | | | |
| At 1st January 2007 | **28.7** | **1.5** | **30.2** |
| Additions | **1.8** | **–** | **1.8** |
| Disposals | **(0.3)** | **–** | **(0.3)** |
| Transfers | **(2.3)** | **–** | **(2.3)** |
| At 31st December 2007 | **27.9** | **1.5** | **29.4** |
| Depreciation | | | |
| At 1st January 2007 | **19.7** | **–** | **19.7** |
| Charged in year | **2.6** | **0.3** | **2.9** |
| Disposals | **(0.3)** | **–** | **(0.3)** |
| Transfers | **(0.4)** | **–** | **(0.4)** |
| At 31st December 2007 | **21.6** | **0.3** | **21.9** |
| Net book value | | | |
| At 31st December 2007 | **6.3** | **1.2** | **7.5** |
| Cost | | | |
| At 1st January 2006 | 25.5 | – | 25.5 |
| Additions | 3.4 | 1.5 | 4.9 |
| Disposals | (0.2) | – | (0.2) |
| At 31st December 2006 | 28.7 | 1.5 | 30.2 |
| Depreciation | | | |
| At 1st January 2006 | 17.3 | – | 17.3 |
| Charged in year | 2.6 | – | 2.6 |
| Disposals | (0.2) | – | (0.2) |
| At 31st December 2006 | 19.7 | – | 19.7 |
| Net book value | | | |
| At 31st December 2006 | 9.0 | 1.5 | 10.5 |

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

| 17. INVESTMENT PROPERTIES | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Cost | | | | |
| At 1st January | **8.1** | 8.0 | **7.8** | 7.7 |
| Additions | **0.2** | 0.2 | **0.2** | 0.2 |
| Disposals | **(0.6)** | (0.1) | **(0.6)** | (0.1) |
| Transfers | **(0.1)** | – | **(0.1)** | – |
| At 31st December | **7.6** | 8.1 | **7.3** | 7.8 |
| Depreciation | | | | |
| At 1st January | **1.4** | 1.1 | **1.2** | 1.0 |
| Charged in year | **0.1** | 0.3 | **0.1** | 0.2 |
| Disposals | **(0.2)** | – | **–** | – |
| Transfers | **–** | – | **–** | – |
| At 31st December | **1.3** | 1.4 | **1.3** | 1.2 |
| Net book value | | | | |
| At 31st December | **6.3** | 6.7 | **6.0** | 6.6 |
| Fair value | | | | |
| At 31st December | **11.4** | 16.5 | **11.0** | 16.2 |

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

Investment properties are generally flats and offices, ancillary to branch premises and not used by the Group.

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

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

The fair value of the Group's investment properties at 31st December 2007 has been arrived at on the basis of a valuation carried out by the Group's Estates Manager.

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

## 18. PROPERTY, PLANT AND EQUIPMENT

| | Land and Buildings £m | Equipment Fixtures, Fittings and Vehicles £m | Total £m |
|---|---|---|---|
| **Group** | | | |
| Cost | | | |
| At 1st January 2007 | **77.2** | **68.3** | **145.5** |
| Additions | **4.5** | **2.4** | **6.9** |
| Disposals | **(0.6)** | **(0.5)** | **(1.1)** |
| Transfers | **0.1** | **2.3** | **2.4** |
| At 31st December 2007 | **81.2** | **72.5** | **153.7** |
| Depreciation | | | |
| At 1st January 2007 | **14.3** | **53.0** | **67.3** |
| Charged in year | **1.5** | **4.9** | **6.4** |
| Disposals | **(0.1)** | **(0.5)** | **(0.6)** |
| Transfers | **(0.2)** | **0.6** | **0.4** |
| At 31st December 2007 | **15.5** | **58.0** | **73.5** |
| Net book value | | | |
| At 31st December 2007 | **65.7** | **14.5** | **80.2** |
| Cost | | | |
| At 1st January 2006 | 78.2 | 66.4 | 144.6 |
| Additions | 1.0 | 1.5 | 2.5 |
| Disposals | (0.2) | (1.4) | (1.6) |
| Transfers | (1.8) | 1.8 | – |
| At 31st December 2006 | 77.2 | 68.3 | 145.5 |
| Depreciation | | | |
| At 1st January 2006 | 12.4 | 50.2 | 62.6 |
| Charged in year | 1.9 | 4.3 | 6.2 |
| Disposals | – | (1.5) | (1.5) |
| At 31st December 2006 | 14.3 | 53.0 | 67.3 |
| Net book value | | | |
| At 31st December 2006 | 62.9 | 15.3 | 78.2 |

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

## 18. PROPERTY, PLANT AND EQUIPMENT (continued)

| | Land and Buildings £m | Equipment Fixtures, Fittings and Vehicles £m | Total £m |
|---|---|---|---|
| **Society** | | | |
| Cost | | | |
| At 1st January 2007 | **55.4** | **22.5** | **77.9** |
| Additions | **4.3** | **2.3** | **6.6** |
| Disposals | **(0.5)** | **(0.5)** | **(1.0)** |
| Transfers | **0.1** | **2.3** | **2.4** |
| At 31st December 2007 | **59.3** | **26.6** | **85.9** |
| Depreciation | | | |
| At 1st January 2007 | **11.6** | **9.6** | **21.2** |
| Charged in year | **1.2** | **3.4** | **4.6** |
| Disposals | **(0.1)** | **(0.5)** | **(0.6)** |
| Transfers | **(0.2)** | **0.6** | **0.4** |
| At 31st December 2007 | **12.5** | **13.1** | **25.6** |
| Net book value | | | |
| At 31st December 2007 | **46.8** | **13.5** | **60.3** |
| Cost | | | |
| At 1st January 2006 | 56.4 | 20.6 | 77.0 |
| Additions | 1.0 | 1.3 | 2.3 |
| Disposals | (0.2) | (1.2) | (1.4) |
| Transfers | (1.8) | 1.8 | – |
| At 31st December 2006 | 55.4 | 22.5 | 77.9 |
| Depreciation | | | |
| At 1st January 2006 | 10.1 | 8.8 | 18.9 |
| Charged in year | 1.5 | 2.2 | 3.7 |
| Disposals | – | (1.4) | (1.4) |
| At 31st December 2006 | 11.6 | 9.6 | 21.2 |
| Net book value | | | |
| At 31st December 2006 | 43.8 | 12.9 | 56.7 |

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

## 19. DEFERRED TAX ASSETS AND LIABILITIES

| | Group | | Society | |
|---|---|---|---|---|
| | **2007 £m** | 2006 £m | **2007 £m** | 2006 £m |
| The movement on the deferred tax liability/(asset) is as follows: | | | | |
| At 1st January | **13.1** | 9.9 | **(5.3)** | (5.3) |
| Income statement charge/(credit) | **8.8** | (5.5) | **(4.0)** | (8.7) |
| Tax expense recognised directly in equity | **12.0** | 8.7 | **12.2** | 8.7 |
| At 31st December | **33.9** | 13.1 | **2.9** | (5.3) |
| Deferred tax assets and liabilities are attributable to the following items: | | | | |
| **Deferred tax assets** | | | | |
| Pensions and other post retirement benefits | **–** | 11.5 | **–** | 11.5 |
| Provision for loan impairment | **1.4** | 1.6 | **0.9** | 1.1 |
| Other provisions | **5.0** | 4.4 | **2.3** | 2.3 |
| Other temporary differences | **0.3** | – | **1.6** | – |
| | **6.7** | 17.5 | **4.8** | 14.9 |
| **Deferred tax liabilities** | | | | |
| Pensions and other post retirement benefits | **1.2** | – | **1.2** | – |
| Accelerated tax depreciation | **1.4** | 1.7 | **1.1** | 1.3 |
| Overseas dividends | **–** | 4.1 | **–** | 4.1 |
| Implementation of IAS 39 – mortgages and hedging | **6.1** | 5.8 | **4.9** | 4.2 |
| Overseas operations | **30.9** | 18.5 | **–** | – |
| Other temporary differences | **1.0** | 0.5 | **0.5** | – |
| | **40.6** | 30.6 | **7.7** | 9.6 |

## 19. DEFERRED TAX ASSETS AND LIABILITIES (continued)

The deferred tax charge/(credit) in the income statement comprises the following temporary differences:

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | £m | £m |
| Accelerated tax depreciation | **(0.3)** | 0.2 | **(0.2)** | 0.2 |
| Pensions and other post retirement benefits | **0.5** | (0.2) | **0.5** | (0.2) |
| Overseas dividends | **(4.1)** | 0.5 | **(4.1)** | 0.5 |
| Other provisions | **(0.6)** | – | **–** | 0.5 |
| Overseas operations | **12.4** | 4.8 | **–** | – |
| Other temporary differences | **0.9** | (10.8) | **(0.2)** | (9.7) |
| | **8.8** | (5.5) | **(4.0)** | (8.7) |

Deferred tax has not been provided on unremitted earnings of overseas subsidiaries of £100.7 million (2006 – £105.3 million) as there is no requirement or expectation that these earnings will be distributed in the foreseeable future.

## 20. OTHER ASSETS

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Prepayments and accrued income | **4.4** | 3.7 | **4.6** | 4.1 |
| Due from subsidiary undertakings | **–** | – | **12.4** | 24.0 |
| Other assets | **3.7** | 11.6 | **2.8** | 4.5 |
| | **8.1** | 15.3 | **19.8** | 32.6 |

## 21. SHARES

| | | | | |
|---|---|---|---|---|
| Shares comprising balances held by individuals | **12,446.9** | 11,283.0 | **12,446.9** | 11,283.0 |
| Fair value hedging adjustments | **1.3** | 3.3 | **1.3** | 3.3 |
| | **12,448.2** | 11,286.3 | **12,448.2** | 11,286.3 |

## 22. AMOUNTS OWED TO CREDIT INSTITUTIONS

| | | | | |
|---|---|---|---|---|
| Amounts owed to: | | | | |
| Banks | **214.7** | 72.4 | **214.7** | 72.4 |
| Group companies | **–** | – | **1,160.6** | 1,172.0 |
| Other credit institutions | **34.7** | – | **34.7** | – |
| Fair value hedging adjustments | **–** | 0.1 | **–** | 0.1 |
| | **249.4** | 72.5 | **1,410.0** | 1,244.5 |

Amounts due to Group companies comprise balances due to the Society's offshore deposit-taking subsidiary Yorkshire Guernsey Ltd.

## 23. OTHER DEPOSITS

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Amounts owed to: | | | | |
| Group companies | **–** | – | **2,846.0** | 1,442.7 |
| Other customers | **2,423.5** | 1,596.4 | **1,257.8** | 412.9 |
| | **2,423.5** | 1,596.4 | **4,103.8** | 1,855.6 |

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

## 24. DEBT SECURITIES IN ISSUE

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Commercial paper | **24.9** | 507.3 | **24.9** | 507.3 |
| Certificates of deposit | **757.0** | 170.5 | **757.0** | 170.5 |
| Fixed rate notes | **2,310.1** | 1,094.2 | **2,310.1** | 1,094.2 |
| Floating rate notes | **900.9** | 1,485.6 | **900.9** | 1,485.6 |
| Fair value hedging adjustment | **(25.5)** | 4.4 | **(25.5)** | 4.4 |
| | **3,967.4** | 3,262.0 | **3,967.4** | 3,262.0 |

Debt securities in issue include £2.2 billion (2006 – £1.0 billion), for both Group and Society, of covered bonds secured on certain loans and advances to customers.

## 25. RETIREMENT BENEFIT OBLIGATIONS

The Group operates one main employee benefit scheme (the Scheme), the costs of which are borne by the Society, with both defined benefit and defined contribution sections. This Scheme has been accounted for under International Accounting Standard 19 'Employee benefits' (IAS 19) which requires disclosure of certain information about the Scheme as set out below.

In addition, the Group operates unfunded defined benefit pension schemes for certain current and former members of staff. These schemes have also been accounted for under IAS 19 and the relevant disclosures have been aggregated with those of the main employee benefits scheme.

**Defined contribution post-employment benefits**
In addition to the defined benefit section (see below) the Group operates a defined contribution section of the main scheme for new employees and for existing employees who are not members of the defined benefit section. The expense recognised for the defined contribution section is £1.7 million (2006 – £1.5 million).

**Defined benefit post-employment benefits**
The Group operates a funded defined benefit section of the main scheme for certain employees, providing benefits based on final salary. The assets of this section are held in a separate trustee-administered fund. Contributions to the defined benefit section are assessed in accordance with the advice of an independent qualified actuary using the projected unit method. The defined benefit section was closed to new employees in 2000.

The Group's policy for recognising actuarial gains and losses is to recognise them immediately on the balance sheet through the statement of recognised income and expense.

The overall costs of the Scheme have been recognised, within administrative expenses, in the Group's accounts according to IAS 19.

| **Summary of assumptions** | 31st Dec 2007 % | 31st Dec 2006 % | 31st Dec 2005 % | 31st Dec 2004 % | 31st Dec 2003 % |
|---|---|---|---|---|---|
| Inflation rate | **3.4** | 3.0 | 2.8 | 2.7 | 2.8 |
| Discount rate | **5.8** | 5.1 | 4.7 | 5.3 | 5.5 |
| Expected return on assets | **6.4** | 7.0 | 6.7 | 7.1 | 6.9 |
| Rate of increase in pay | **4.9** | 4.5 | 4.3 | 4.2 | 4.8 |
| Rate of increase of pensions in payment* | | | | | |
| Service before 1st January 2000 | **3.6** | 3.7 | 3.5 | 3.5 | 3.0 |
| Service after 31st December 1999 | **3.4** | 3.0 | 2.8 | 2.7 | 2.8 |
| Rate of increase for deferred pensioners* | **3.4** | 3.0 | 2.8 | 2.7 | 2.8 |

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

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

## 25. RETIREMENT BENEFIT OBLIGATIONS (continued)

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

| | 2007 Years | 2006 Years |
|---|---|---|
| Male pensioner | **24.7** | 24.7 |
| Female pensioner | **27.7** | 27.7 |
| Male non-pensioner | **25.6** | 25.6 |
| Female non-pensioner | **28.6** | 28.6 |

**Categories of assets**

| | 31st Dec 2007 % | 31st Dec 2006 % | 31st Dec 2005 % | 31st Dec 2004 % | 31st Dec 2003 % |
|---|---|---|---|---|---|
| Equities | **44** | 66 | 66 | 73 | 81 |
| Bonds | **50** | 30 | 28 | 21 | 11 |
| Cash and other | **6** | 4 | 6 | 6 | 8 |
| | **100** | 100 | 100 | 100 | 100 |

| **Reconciliation of funded status** | £m | £m | £m | £m | £m |
|---|---|---|---|---|---|
| Present value of defined benefit obligation | **(262.7)** | (286.3) | (285.0) | (228.1) | (204.0) |
| Assets at fair value | **270.7** | 255.6 | 229.4 | 180.1 | 162.7 |
| Funded status/Defined benefit asset/(liability) | **8.0** | (30.7) | (55.6) | (48.0) | (41.3) |

| **Statement of recognised income and expense (SORIE)** | 2007 £m | 2006 £m | 2005 £m | 2004 £m |
|---|---|---|---|---|
| Actuarial gain/(loss) recognised in SORIE | **33.8** | 22.0 | (21.4) | (4.5) |
| Cumulative actuarial losses recognised at 1st January | **(3.9)** | (25.9) | (4.5) | – |
| Cumulative actuarial gains/(losses) recognised at 31st December | **29.9** | (3.9) | (25.9) | (4.5) |
| **Experience gain and losses** | | | | |
| Experience gain/(loss) on defined benefit obligation | **38.0** | 14.6 | (43.1) | (10.9) |
| Experience (loss)/gain on assets | **(4.2)** | 7.4 | 21.7 | 6.4 |
| Actuarial gain/(loss) recognised in SORIE | **33.8** | 22.0 | (21.4) | (4.5) |

| **Components of pension expense as shown in the income statement** | 2007 £m | 2006 £m |
|---|---|---|
| Service cost | **6.2** | 7.2 |
| Interest cost | **14.4** | 13.3 |
| Expected return on assets | **(17.7)** | (15.3) |
| Total pension expense | **2.9** | 5.2 |

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

| **Reconciliation of present value of defined benefit obligation** | | |
|---|---|---|
| Present value of defined benefit obligation at 1st January | **286.3** | 285.0 |
| Defined benefit service cost | **6.2** | 7.2 |
| Interest cost | **14.4** | 13.3 |
| Defined benefit employee contributions | **1.6** | 1.7 |
| Actuarial gain | **(38.0)** | (14.6) |
| Defined benefit actual benefits paid | **(7.8)** | (6.3) |
| Present value of defined benefit obligation at 31st December | **262.7** | 286.3 |

## 25. RETIREMENT BENEFIT OBLIGATIONS (continued)

| Movement in defined benefit fair value of assets | 2007 £m | 2006 £m |
|---|---|---|
| Fair value of assets at 1st January | **255.6** | 229.4 |
| Expected return on assets | **17.7** | 15.3 |
| Actuarial (loss)/gain on assets | **(4.2)** | 7.4 |
| Defined benefit actual company contributions | **7.8** | 8.1 |
| Defined benefit employee contributions | **1.6** | 1.7 |
| Defined benefit actual benefits paid | **(7.8)** | (6.3) |
| Fair value of plan assets at 31st December | **270.7** | 255.6 |

None of the assets were invested in the Group's own financial instruments (2006 – £nil) or property (2006 – £nil).

**Estimated contributions in 2008**

| | 2008 £m |
|---|---|
| Society contributions | 7.6 |
| Employee contributions | 1.5 |
| Total contributions | 9.1 |

## 26. OTHER LIABILITIES

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Accruals and deferred income | **15.6** | 14.9 | **13.9** | 13.1 |
| Income tax deducted at source | **36.1** | 28.8 | **36.1** | 28.8 |
| Provisions for regulatory and other liabilities | **4.6** | 12.0 | **4.3** | 11.6 |
| Other | **1.7** | 0.8 | **1.3** | 0.8 |
| | **58.0** | 56.5 | **55.6** | 54.3 |

Movements in Provisions for regulatory and other liabilities, principally relating to previous sales of endowment policies, during the year were as follows:

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| At 1st January | **12.0** | 6.6 | **11.6** | 6.4 |
| Amounts utilised during the year | **(4.4)** | (7.1) | **(4.3)** | (7.1) |
| Provision (release)/charge during the year | **(3.0)** | 12.5 | **(3.0)** | 12.3 |
| At 31st December | **4.6** | 12.0 | **4.3** | 11.6 |

It is anticipated that the majority of claims relating to these provisions will be cleared within the next two years.

## 27. SUBORDINATED LIABILITIES

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| 6% Subordinated Bonds 2019 | **25.8** | 25.7 | **25.8** | 25.7 |
| 11⅜% Subordinated Bonds 2022 | **25.3** | 25.3 | **25.3** | 25.3 |
| 6⅝% Subordinated Bonds 2024 | **51.5** | 51.5 | **51.5** | 51.5 |
| Floating Rate Subordinated Notes 2012 | **–** | – | **–** | 25.0 |
| Fair value hedging adjustments | **2.4** | 2.8 | **2.4** | 2.8 |
| | **105.0** | 105.3 | **105.0** | 130.3 |

Interest on the Floating Rate Notes is payable at rates linked to the London Interbank Offered Rate (LIBOR). All subordinated liabilities are denominated in sterling. The notes are repayable at the dates stated or earlier at the option of the Society and with the prior consent of the Financial Services Authority under the following conditions:

- redemption of all (but not some only) of the 6% Notes at par on 7th May 2014 after giving not less than fifteen nor more than thirty days' notice to the holders. In the event the Society does not redeem the notes on 7th May 2014 the fixed rate of interest will become the aggregate of 2.03% and the then current five year benchmark Gilt rate; and
- redemption of all (but not some only) of the 11⅜% Notes at par on 27th November 2017 after giving not less than thirty nor more than sixty days' notice to the holders. In the event the Society does not redeem the notes on 27th November 2017 the fixed rate of interest will become the greater of 11⅜% and an aggregate of 3.10% and the then current five year benchmark Gilt rate.

The rights of repayment of the holders of subordinated debt are subordinated to the claims of all depositors, creditors and members holding shares in the Society, as regards the principal of their shares and interest due on them.

Included within the Society's subordinated liabilities for 2006 was £25.0 million due to Yorkshire Guernsey Ltd, the Society's offshore deposit taking subsidiary. The Society exercised the option to redeem all of these floating rate notes on 21st March 2007.

## 28. SUBSCRIBED CAPITAL

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| 5.649% Permanent Interest Bearing Shares | **150.9** | 150.8 | **150.9** | 150.8 |
| Fair value hedging adjustments | **(4.9)** | (5.6) | **(4.9)** | (5.6) |
| | **146.0** | 145.2 | **146.0** | 145.2 |

All Permanent Interest Bearing Shares (PIBS) are unsecured and denominated in Sterling. Interest is payable half yearly on the 5.649% PIBS on 27th March and 27th September. PIBS are repayable at the option of the Society, in whole, in March 2019 or any interest payment date thereafter.

Repayment requires the prior consent of the Financial Services Authority, if the PIBS are not repaid on a call date the interest rate is reset at a margin to the then prevailing LIBOR rate. They are deferred shares of the Society and the rights of repayment of the holders of PIBS are subordinated to the claims of all depositors, creditors, members holding shares in the Society and holders of subordinated debt, as regards the principal of their shares and interest due on them. The interest rate risk arising from the issuance of fixed rate PIBS has been mitigated through the use of interest rate swaps.

## 29. TOTAL EQUITY ATTRIBUTABLE TO MEMBERS

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| General reserve | **995.8** | 933.1 | **830.0** | 800.3 |
| Hedging reserve | **(10.0)** | (1.9) | **(10.0)** | (1.9) |
| Available for sale reserve | **(32.1)** | (20.2) | **(31.4)** | (20.0) |
| Total equity attributable to members | **953.7** | 911.0 | **788.6** | 778.4 |

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

## 30. CAPITAL MANAGEMENT

More detail of capital management strategies can be found in the Risk Management Report on page 24.

| | Group | |
|---|---|---|
| | **2007** | 2006 |
| | **£m** | £m |
| **Tier 1** | | |
| General reserve | **995.8** | 933.1 |
| Subscribed capital (note a) | **146.0** | 150.8 |
| Pension fund adjustments (note b) | **(13.8)** | 15.5 |
| Intangible fixed assets | **(8.1)** | (11.4) |
| Deductions from Tier 1 capital (note c) | **(57.5)** | – |
| | **1,062.4** | 1,088.0 |
| **Tier 2** | | |
| Subordinated liabilities | **105.0** | 105.3 |
| Collective allowances for impairment | **8.8** | 10.7 |
| Deductions from Tier 2 capital (note c) | **(57.5)** | – |
| | **56.3** | 116.0 |
| Other deductions (note c) | **1.0** | – |
| **Total capital** | **1,119.7** | 1,204.0 |

| | **2007** | 2006 |
|---|---|---|
| | **£bn** | £bn |
| Risk weighted assets | **9.5** | 8.1 |
| Tier 1 ratio (%) | **11.2%** | 13.5% |
| Solvency ratio (%) | **11.8%** | 14.9% |

The above ratios, deductions and definitions are in accordance with Financial Services Authority (FSA) guidelines.

The reduction in the capital ratios during 2007 is driven by a combination of strong asset growth and the rules governing calculation of the ratios being in transition. Further changes to the basis of calculation, which took effect on 1st January 2008, immediately increased the ratio back up to at least 13.5%. At all times capital has been significantly in excess of that required by the FSA.

Throughout the year the Group Capital Committee has kept the Group's capital position under review as well as considering the current market conditions for capital issuance and has seen no benefit to the Group in issuing further capital in 2007.

**Notes:**

a. For 2007, subscribed capital includes any fair value adjustments arising from micro hedging and adjustments for unamortised premiums and discounts that are included in the consolidated balance sheet. For 2006, these adjustments are excluded. This change in treatment reflects a change in the calculation of regulatory capital effective from 1st January 2007, as part of the migration to Basel II.

b. The regulatory capital rules allow the pension fund deficit to be added back to regulatory capital and a deduction taken instead for an estimate of the additional contributions to be made in the next five years, less associated deferred tax.

c. For 2007, certain deductions from capital are required. As in note a, this change in treatment is part of the migration to Basel II.

## 31. FINANCIAL COMMITMENTS

| | Group 2007 £m | Group 2006 £m | Society 2007 £m | Society 2006 £m |
|---|---|---|---|---|
| Committed undrawn standby facilities | **7.5** | 9.5 | **7.5** | 9.5 |

The Society has an obligation under the Building Societies Act 1986 to discharge the liabilities incurred up to 11th June 1996 of all subsidiaries in so far as those subsidiaries are unable to discharge the liabilities out of their own assets. The Society has given undertakings whereby it has agreed to discharge the liabilities incurred after 11th June 1996 by certain of its subsidiaries, including Yorkshire Guernsey Ltd, in the event that these subsidiaries may be unable to discharge them out of their own assets. The Society accounts for these guarantees in accordance with IFRS 4 'Insurance Contracts'.

Capital commitments contracted for at 31st December 2007, but for which no provision has been made in the accounts, amounted to £0.5 million (Society £0.5 million), (2006 – Group £0.1 million and Society £nil).

The Group is not in default on any of its financial liabilities or commitments.

## 32. FINANCIAL INSTRUMENTS

The table below summarises the main financial instruments, their significant terms and conditions and the accounting treatment adopted.

| Financial instrument | Significant terms and conditions | Accounting treatment |
|---|---|---|
| Cash in hand and balances with the Bank of England | Short term cash balances in branches<br>Statutory deposits, primarily non interest bearing | Amortised cost |
| Loans and advances to credit institutions | Short term<br>Fixed and variable interest rates | Amortised cost* |
| Debt securities | Short, medium and long term<br>Fixed and variable interest rates | Generally held at fair value as available for sale assets<br>Certain investments are held at fair value through the income statement. Detail is given in Note 14 |
| Loans fully secured on residential property | Loan period is typically up to 25 years<br>A variety of mortgage products offering fixed and variable interest rates | Amortised cost* |
| Derivative financial instruments | Primarily medium term<br>Value derived from underlying price, rate or index | Fair value through income statement |
| Intercompany deposit from Covered Bond Limited Liability Partnership | Long term<br>Fixed and variable interest rates | Fair value through income statement |
| Investments | Investment in subsidiary companies | Amortised cost |
| Shares | Deposits made by individuals<br>Varying withdrawal notice periods<br>Fixed and variable interest rates | Amortised cost* |
| Amounts owed to credit institutions and other customers | Primarily short term Time Deposits<br>Fixed and variable interest rates | Amortised cost* |
| Debt securities in issue | Short and medium term<br>Fixed and variable interest rates | Amortised cost* |
| Subordinated liabilities | Long term<br>Fixed and variable interest rates | Amortised cost* |
| Subscribed capital | Long term<br>Fixed interest rates | Amortised cost* |

* Except where hedge accounting allows a fair value adjustment to be made.

## 33. DERIVATIVE FINANCIAL INSTRUMENTS

Instruments used for the management of market risk include derivative financial instruments (derivatives), which are contracts or agreements whose value is derived from one or more underlying price, rate or index inherent in the contract or agreement, such as interest rates, exchange rates or stock market indices.

Derivatives are only used by the Group in accordance with the Building Societies Act 1986. This means that such instruments are not used in trading activity or for speculative purposes and accordingly they are only used to reduce the risk of loss on core assets or liabilities arising from changes in interest rates, currency rates or other factors of a prescribed description.

The principal derivatives used in balance sheet risk management are interest rate swaps, interest rate options, cross currency interest rate swaps, forward rate agreements, futures contracts and foreign exchange contracts. These are used to hedge Group balance sheet exposures arising from fixed rate mortgage lending and savings products, funding and investment activities.

The following table describes the significant activities undertaken by the Group, the related risks associated with such activities and the type of derivatives which are typically used in managing such risks. Such risks may alternatively be managed using on-balance sheet instruments as part of the Group's integrated approach to risk management.

| Activity | Risk | Type of hedge |
|---|---|---|
| Management of the investment of reserves and other net non-interest bearing liabilities | Sensitivity to changes in interest rates | Interest rate swaps |
| Fixed rate savings products and fixed rate funding | Sensitivity to changes in interest rates | Interest rate swaps, options, forward rate agreements and futures |
| Fixed rate mortgage lending and fixed rate investments | Sensitivity to changes in interest rates | Interest rate swaps, options, forward rate agreements and futures |
| Equity linked investment products | Sensitivity to changes in equity indices | Equity linked interest rate swaps |
| Investment and funding in foreign currencies | Sensitivity to changes in foreign exchange rates | Cross-currency interest rate swaps and foreign exchange contracts |

The Group's objective is to manage risk within its risk tolerance irrespective of the accounting treatment.

Those derivative products which are combinations of more basic derivatives are used only in circumstances where the underlying position being hedged contains the same risk features. In such cases the derivatives used will be designed to match the risks of the underlying asset or liability and therefore to hedge the associated market risk.

Certain financial instruments (including some retail products) contain features that are similar to derivatives. In the majority of such cases, the Group manages the associated risks by entering into derivative contracts that match these features.

Whilst all derivatives have been entered into for hedging purposes, only certain ones have been designated as such for accounting purposes. In some cases a natural offset can be achieved without applying the requirements of IAS 39. The Group only designates hedges where a high degree of effectiveness can be achieved.

Fair value hedges are designated where interest rate swaps are used to minimise the variability in the fair value of fixed interest financial instruments (mainly fixed rate mortgages).

Cash flow hedges are designated where interest rate swaps are used to convert the interest rate variability on short term financial instruments into fixed rates.

## 33. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

The following tables summarise the notional and fair value of all derivative financial instruments held at the year end and the hedging designations in place at that date.

**Group**
**At 31st December 2007**

| | Contract/notional amount £m | Fair values Assets £m | Fair values Liabilities £m |
|---|---|---|---|
| Interest rate swaps designated as fair value hedges | 8,766.8 | 50.5 | (49.6) |
| Interest rate swaps designated as cash flow hedges | 1,990.1 | 36.6 | (13.6) |
| Cross currency interest swaps designated as fair value hedges | 2,198.3 | 174.0 | – |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | 8,132.8 | 30.8 | (26.8) |
| Cross currency interest rate swaps | 448.9 | 7.8 | (6.4) |
| Equity linked interest rate swaps | 6.7 | 4.1 | – |
| Forward foreign exchange | 424.7 | – | (16.8) |
| Interest rate options | 45.0 | 0.1 | – |
| Collateral received | – | (9.0) | – |
| Collateral pledged | – | – | 19.2 |
| **Total derivatives held for hedging** | 22,013.3 | 294.9 | (94.0) |

**Society**
**At 31st December 2007**

| | Contract/notional amount £m | Fair values Assets £m | Fair values Liabilities £m |
|---|---|---|---|
| Interest rate swaps designated as fair value hedges | 8,766.8 | 50.5 | (49.6) |
| Interest rate swaps designated as cash flow hedges | 1,990.1 | 36.6 | (13.6) |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | 10,769.3 | 42.2 | (26.8) |
| Cross currency interest rate swaps | 448.9 | 7.8 | (6.4) |
| Equity linked interest rate swaps | 6.7 | 4.1 | – |
| Forward foreign exchange | 424.7 | – | (16.8) |
| Interest rate options | 45.0 | 0.1 | – |
| Collateral received | – | (9.0) | – |
| Collateral pledged | – | – | 19.2 |
| **Total derivatives held for hedging** | 22,451.5 | 132.3 | (94.0) |

## 33. DERIVATIVE FINANCIAL INSTRUMENTS (continued)

**Group**
**At 31st December 2006**

| | Contract/notional amount | Fair values Assets | Fair values Liabilities |
|---|---|---|---|
| | £m | £m | £m |
| Interest rate swaps designated as fair value hedges | 7,689.3 | 88.2 | (5.9) |
| Interest rate swaps designated as cash flow hedges | 1,913.6 | 15.9 | (5.2) |
| Cross currency interest swaps designated as fair value hedges | 1,010.3 | – | (1.2) |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | 1,292.1 | 11.6 | (2.5) |
| Cross currency interest rate swaps | 984.2 | 4.7 | (28.9) |
| Equity linked interest rate swaps | 16.7 | 4.0 | – |
| Forward foreign exchange | 283.8 | 0.1 | (1.7) |
| Interest rate options | 20.0 | – | – |
| Interest rate futures | 50.0 | – | – |
| Collateral received | – | (29.1) | – |
| Collateral pledged | – | – | 3.4 |
| **Total derivatives held for hedging** | 13,260.0 | 95.4 | (42.0) |

**Society**
**At 31st December 2006**

| | Contract/notional amount | Fair values Assets | Fair values Liabilities |
|---|---|---|---|
| Interest rate swaps designated as fair value hedges | 7,689.3 | 88.2 | (5.9) |
| Interest rate swaps designated as cash flow hedges | 1,913.6 | 15.9 | (5.2) |
| Derivatives not designated as hedges: | | | |
| Interest rate swaps | 2,704.3 | 11.6 | (5.4) |
| Cross currency interest rate swaps | 984.2 | 4.7 | (28.9) |
| Equity linked interest rate swaps | 16.7 | 4.0 | – |
| Forward foreign exchange | 417.2 | 0.4 | (1.7) |
| Interest rate options | 20.0 | – | – |
| Interest rate futures | 50.0 | – | – |
| Collateral received | – | (29.1) | – |
| Collateral pledged | – | – | 3.4 |
| **Total derivatives held for hedging** | 13,795.3 | 95.7 | (43.7) |

The Group has in place a number of ISDA (International Swaps and Derivatives Association) master agreements where collateral is passed between parties to mitigate the market contingent counterparty risk inherent in outstanding derivative positions.

## 34. LIQUIDITY RISK

Liquidity risk is an intrinsic part of the Group's business as long term mortgages are funded by short term retail customer balances. Most mortgages have a contractual maturity date of around 25 years but in practice are frequently repaid early; currently the estimated average life of a mortgage is approximately five years. Conversely experience shows that retail deposits, nominally repayable on demand or with short notice periods, actually remain with the Society for relatively long periods. It is this inherent mismatch in the maturity profiles of retail assets and liabilities that creates liquidity risk.

The Group's liquidity management policy is designed to ensure maintenance of adequate investments in liquid assets to cover statutory, regulatory and operational requirements. The primary function of liquidity is the provision of sufficient assets in realisable form to ensure the Group is able to meet its liabilities as they arise and to absorb potential cash flow requirements created by the maturity mismatches referred to above. The policy is further designed to delegate liquidity management, within limits and a structure established by the board, as well as to monitor the composition of liquidity in line with risk management objectives and to optimise returns on liquidity investments insofar as these are consistent with other operational objectives.

The Group's liquidity management is focused in two areas:

- limits are established by the board that govern the quantity, quality (counterparty creditworthiness), marketability and returns from the Group's portfolio of liquidity investments. The portfolio is managed by the Treasury function, monitored by the Risk function and overseen by the Group Asset and Liability Committee under a series of delegated authorities; and
- the Group conducts a series of daily stress tests that are designed to ensure that its liquidity is sufficient to meet its cash flow needs under any one of a number of adverse scenarios should they arise. The scenarios include ones caused by both Group specific and general market events, and incorporate both severe retail savings outflows and the unavailability of wholesale funding. They are constructed on various timescales as far out as six months.

All liquidity risk in subsidiary companies is eliminated by the use of appropriate inter-company loans and deposits. The tables below show contractual cash flows for all financial liabilities including interest payments. Further details of liquidity management are contained within the Risk Management Report on pages 23 to 30.

| Group | Repayable on demand and up to one year £m | In more than one year but not more than five years £m | Over five years £m | Total £m |
|---|---|---|---|---|
| **As at 31st December 2007** | | | | |
| Shares | **11,966.5** | **615.6** | **–** | **12,582.1** |
| Amounts owed to credit institutions | **216.7** | **7.5** | **37.6** | **261.8** |
| Other deposits | **2,410.8** | **45.6** | **–** | **2,456.4** |
| Debt securities in issue | **1,031.4** | **3,356.1** | **–** | **4,387.5** |
| Subordinated liabilities | **7.5** | **30.1** | **177.2** | **214.8** |
| Subscribed capital* | **8.4** | **33.9** | **42.4** | **84.7** |
| Operating lease payments | **3.9** | **12.7** | **16.1** | **32.7** |
| Derivative financial liabilities | **(7.9)** | **89.4** | **16.8** | **98.3** |
| **Total** | **15,637.3** | **4,190.9** | **290.1** | **20,118.3** |

| Group | Repayable on demand and up to one year £m | In more than one year but not more than five years £m | Over five years £m | Total £m |
|---|---|---|---|---|
| **As at 31st December 2006** | | | | |
| Shares | 10,708.4 | 685.6 | – | 11,394.0 |
| Amounts owed to credit institutions | 40.2 | 5.4 | 35.7 | 81.3 |
| Other deposits | 1,548.9 | 59.9 | – | 1,608.8 |
| Debt securities in issue | 1,395.8 | 2,203.2 | 10.3 | 3,609.3 |
| Subordinated liabilities | 7.5 | 30.2 | 184.7 | 222.4 |
| Subscribed capital* | 8.4 | 33.9 | 42.4 | 84.7 |
| Operating lease payments | 3.5 | 11.7 | 14.8 | 30.0 |
| Derivative financial liabilities | (21.5) | 22.8 | 1.7 | 3.0 |
| **Total** | 13,691.2 | 3,052.7 | 289.6 | 17,033.5 |

* Interest payments on subscribed capital are £8.4 million per year. The liquidity table includes these for ten years.

## 35. MARKET RISK

### Value at Risk (VaR)

VaR is a risk management tool which evaluates the potential losses that may be incurred as a result of movements in market conditions over a specified holding period and to a given level of confidence. The model used is based on a 10 day holding period and a 99% confidence level.

The VaR model calculates potential movements in market prices by reference to market data from the last 90 days, and incorporates underlying risk factors based on historic interest rate volatilities and correlations.

VaR for the Treasury portfolios is calculated and reported on a daily basis and for the Group balance sheet on a monthly basis. A quarterly back test of the VaR model is performed to test the validity of the assumptions and parameters within the model.

A number of limitations should be considered in relation to the VaR model:

- historic data is not necessarily a good guide to future events;
- the model, by definition, does not capture the potential losses outside the 99% confidence level, particularly those events that are extreme in nature; and
- VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

VaR measures below are based upon full balance sheet positions including the investment of the Group's free reserves.

### Balance sheet structure analysis (Basis risk)

An analysis of interest bearing items by rate type is performed to illustrate key areas of structural mismatch. It identifies mismatches between administered rates, fixed rates and other rates including those linked to Bank Base Rate and LIBOR. The effect of LIBOR mismatches within the balance sheet is measured as the impact on net interest income (for a 12 month rolling period) of an isolated increase in LIBOR of one basis point (0.01%).

### Basis point value sensitivity

This measure calculates the change in value of the assets and liabilities resulting from a one basis point parallel shift in interest rates. Within the Treasury portfolio this is calculated and reported on a daily basis separately for each currency and at the full balance sheet level on a monthly basis.

### Repricing gap analysis

An analysis of repricing dates is performed, primarily for the avoidance of repricing risk concentrations, i.e. to prevent the situation where too great a proportion of the Group's assets and liabilities see the interest rates earned or charged on them resetting within a given time period. The aim is to prevent excessive volatility in the net interest margin that could arise if rates shifted adversely within a given time period, and since we cannot dictate interest rate movements themselves the best approach is to limit the amount of assets or liabilities that are exposed in this way. The analysis identifies the net asset/liability repricing position across a series of time intervals. Positions are calculated using nominal amounts and exclude interest flows. General reserves, fixed assets and other liabilities are classified as having 'non-specific' repricing characteristics with a zero rate of interest. The measure is calculated as a reverse cumulative gap.

All market risk is managed in the Society on behalf of the Group, hence the tables below apply to both the Group and the Society.

| 2007 | Year-end £000 | Average £000 | Maximum £000 | Minimum £000 |
|---|---|---|---|---|
| VaR | 6,529 | 4,727 | 6,529 | 2,210 |
| Basis risk | 196 | 296 | 407 | 196 |
| BP sensitivity | (6) | (40) | 52 | (138) |

| | Greater than one year £m | Greater than five years £m | Greater than 10 years £m |
|---|---|---|---|
| Repricing gap | 343 | (22) | (34) |

### 35. MARKET RISK (continued)

| 2006 | Year-end £000 | Average £000 | Maximum £000 | Minimum £000 |
|---|---|---|---|---|
| VaR | 4,100 | 9,800 | 12,300 | 4,100 |
| Basis risk | 414 | 319 | 414 | 221 |
| BP sensitivity | (20) | (227) | (20) | (328) |

| | Greater than one year £m | Greater than five years £m | Greater than 10 years £m |
|---|---|---|---|
| Repricing gap | 1,217 | (41) | (36) |

During the year the Group has transacted a number of basis risk swaps to reduce structural mismatches within the balance sheet between LIBOR and bank base rate. These swaps have reduced the basis risk sensitivity within the year.

The VaR and basis point sensitivity levels fell through most of 2007 compared to 2006 (hence the lower average figures for 2007), reflecting a reduction in fixed income positions in the period. The growth in the position towards the year end is largely driven by volatility in the markets and hence in the assumptions used rather than by a shift in underlying positions.

More detail of how the Group manages its interest rate risk is included in the Risk Management Report on pages 23 to 30.

### 36. CURRENCY RISK

Currency exchange risk is monitored daily and the Group seeks to minimise its net exposure to assets and liabilities denominated in currencies other than sterling. Actual positions, which represent the net amount on which the Group is exposed to movements in exchange rates, were around 0.01% of total assets throughout 2007. More detail of this policy can be found in the Risk Management Report on pages 23 to 30. Actual exposures were:

| | **2007 £m** | 2006 £m |
|---|---|---|
| Year-end | **0.3** | 1.0 |
| Maximum | **2.1** | 1.0 |

### 37 WHOLESALE CREDIT RISK

The Group's wholesale credit risk arises principally from assets held for liquidity purposes. The risk is that counterparties with whom the Group invests liquid assets fail to repay those investments when they fall due. The Group, through the Group Risk function, undertakes its own internal rating of all its counterparties and sets individual limits accordingly. These limits are reviewed at least annually, with revocation or suspension taking place where considered appropriate. The ratings are compared with those produced by external rating agencies at least annually. Whilst recognising that exposures will be maintained across a spectrum of counterparties, and that it is not commercially feasible to limit exposure to the highest (i.e. best) rated organisations, the board has established a risk averse policy. Individual exposure limits are set according to the credit rating applied to a given institution, i.e. lower limits for lower rated institutions. Limits are in place governing the types of instrument in which the Group will invest, as well as geographic and sector limits designed to prevent over-exposure to a given country or business type. The following table breaks down exposures using Basel exposure methodology and composite external ratings.

| | **2007** | 2006 |
|---|---|---|
| AAA | **28%** | 26% |
| AA+ to AA- | **37%** | 33% |
| A+ to A- | **34%** | 39% |
| Other | **1%** | 2% |
| | **100%** | 100% |

The maximum exposure to any one country (other than the UK) is £373 million (2006 – £465 million), or 8% of total liquid assets. 98% of all wholesale exposures are to major industrial countries with less than 1% being to the USA.

The largest exposure to a single institution (other than the UK Government) is £243 million (2006 – £204 million), and this is to an AA rated institution.

## 37 WHOLESALE CREDIT RISK (continued)

Wholesale credit risk is recorded in the following balance sheet captions:

| | 2007 £m | 2006 £m |
|---|---|---|
| Cash in hand and balances with the Bank of England | **434.9** | 36.2 |
| Loans and advances to credit institutions | **756.8** | 167.8 |
| Debt securities | **3,530.2** | 3,868.0 |
| Derivative financial instruments | **294.9** | 95.4 |
| Investments (note a) | **2.1** | 0.1 |
| Total wholesale credit risk | **5,018.9** | 4,167.5 |

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

| | 2007 £m | 2006 £m |
|---|---|---|
| UK Government securities | **267.2** | 268.6 |
| Medium term notes issued by financial institutions | **1,539.8** | 1,437.8 |
| Certificates of deposit | **1,035.0** | 1,524.5 |
| Mortgage backed securities (note b) | **553.0** | 484.4 |
| Structured investment vehicles (note c) | **22.7** | 47.9 |
| Combination note (note d) | **10.5** | 22.4 |
| Synthetic collateralised debt obligations (note e) | **58.0** | 40.9 |
| Cash collateralised debt obligations (note f) | **44.0** | 41.5 |
| | **3,530.2** | 3,868.0 |

(a) Principally the equity investment in VocaLink Holdings Limited which is associated with our operation of cash machines.

(b) Mortgage backed securities are all backed by UK prime residential mortgages.

(c) There are three investments in structured investment vehicles, all of which are held at fair value with movements in value being taken directly to the income statement. Two of these recognise the fair value as the net asset value determined by the manager of the investment. In the third instance the Group has received a firm proposal to restructure the investment and in this case the fair value has been estimated using details of the reconstruction. More details of this valuation can be found in Note 2.

(d) The combination note is an investment in a AAA rated capital protected vehicle that is structured to pay a bonus over and above its regular return.

(e) There are six investments in synthetic collateralised debt obligations. These contain embedded derivatives that have been separated with changes in fair value being taken directly to the income statement.

(f) There are ten investments in cash based collateralised debt obligations, each of which continues to perform and there is no evidence of any impairment. However, in most cases fair values have fallen in line with the general credit market. These investments have been classified as available for sale and falls in value have been recorded in reserves.

The fair value of the items in (c) to (f) above has continued to fluctuate since 31st December 2007. At 31st January 2008, the latest date for which relevant information is available, values had fallen further by £15 million of which £9 million will be recognised through fair value in the income statement and £6 million through reserves.

The maximum exposure to wholesale credit risk at 31st December is as reported in the Balance Sheet except in the case of derivatives where the maximum exposure is £303.9 million (2006 – £124.5 million).

## 38. RETAIL CREDIT RISK

The Group employs automated credit scoring tools in its mortgage lending activities to support sound credit decision-making. A proactive approach to the identification and control of changing risk profiles and loan impairment is maintained in the Lending Risk and Group Risk functions with challenge and oversight provided by the Group Credit Committee. This committee receives regular reports from the Retail Credit Risk Control Unit (part of the Group Risk function) on the risk profile of the Group portfolio by defined key risk indicators, to ensure the business profile remains within risk appetite.

Retail credit risk within the Group is predominantly related to mortgage lending of £9.3 billion (2006 – £8.8 billion) conducted through the branch network. Additionally its subsidiary Accord Mortgages Limited has mortgage lending of £6.0 billion (2006 – £4.4 billion) conducted through professional intermediaries.

The maximum exposure to retail credit risk is £15.4 billion (2006 – £13.3 billion).

| Geographic distribution of mortgage balances | **2007** | 2006 |
|---|---|---|
| | **%** | % |
| Scotland | **12** | 11 |
| North East | **6** | 5 |
| Yorkshire & Humberside | **17** | 18 |
| North West | **14** | 15 |
| Midlands | **11** | 11 |
| East Anglia | **3** | 3 |
| South West | **5** | 5 |
| Greater London | **11** | 11 |
| South East | **15** | 15 |
| Wales & Northern Ireland | **6** | 6 |
| | **100** | 100 |

### Loan to Value distribution

| | **Book** | | **New Lending** | |
|---|---|---|---|---|
| Loan to Value | **2007** | 2006 | **2007** | 2006 |
| | **%** | % | **%** | % |
| >90% | **9** | 10 | **23** | 29 |
| 75%-90% | **21** | 17 | **35** | 30 |
| 50%-75% | **30** | 29 | **28** | 28 |
| <50% | **40** | 44 | **14** | 13 |
| | **100** | 100 | **100** | 100 |

The Group's average indexed loan to value is 43.43% (2006 – 41.47%).

### Customer type

| | | | | |
|---|---|---|---|---|
| First time buyer | **21** | 21 | **22** | 23 |
| Other buyers i.e. movers | **50** | 54 | **41** | 49 |
| Remortgage | **29** | 25 | **37** | 28 |
| | **100** | 100 | **100** | 100 |

The Group does not participate in the buy-to-let market.

### Arrears statistics

| | **2007** | 2006 |
|---|---|---|
| Arrears outstanding as a percentage of debt | **%** | % |
| No arrears or <1.25% | **98.06** | 98.70 |
| 1.25% - 2.5% | **1.12** | 0.76 |
| >2.5% | **0.73** | 0.49 |
| Property in possession | **0.09** | 0.05 |
| | **100.00** | 100.00 |
| Number of properties in possession at the year end | **110** | 55 |

## 38 RETAIL CREDIT RISK (continued)

The Group's arrears have grown proportionally during 2007, in line with anticipated increases in the level of higher risk lending via intermediaries and in our credit repair portfolio and also driven by increases in the market as a whole. Nevertheless, our arrears ratios remain healthy compared to industry standards, and where they relate to higher risk lending our pricing approach ensures that the Group is adequately rewarded for the additional risks taken.

| | Loans and advances | | Fair value of collateral | |
|---|---|---|---|---|
| | **2007 £m** | 2006 £m | **2007 £m** | 2006 £m |
| Collectively assessed for impairment | **15,039.6** | 13,156.2 | **15,030.8** | 13,145.4 |
| Individually assessed for impairment | **303.8** | 171.2 | **293.8** | 166.7 |
| Total loans and advances | **15,343.4** | 13,327.4 | **15,324.6** | 13,312.1 |

The Group has assisted borrowers who have had financial difficulties by rearranging the terms of their loans. The total of such loans is £49.9 million (2006 – £21.7 million).

## 39 FAIR VALUES

The tables below are a comparison of book and fair values of the Group's financial instruments by category as at the balance sheet date. Where external market prices are available they have been used to determine fair value. Otherwise, internal pricing models using external market data have been used.

| | 2007 | | 2006 | |
|---|---|---|---|---|
| **Group** | **Book Value £m** | **Fair Value £m** | Book Value £m | Fair Value £m |
| Assets | | | | |
| Cash in hand and balances with the Bank of England | **434.9** | **434.9** | 36.2 | 36.2 |
| Loans and advances to credit institutions | **756.8** | **756.8** | 167.8 | 167.8 |
| Debt securities | **3,530.2** | **3,530.2** | 3,868.0 | 3,868.0 |
| Loans and advances to customers | **15,362.0** | **15,436.8** | 13,269.0 | 13,279.1 |
| Investments | **2.1** | **2.1** | 0.1 | 0.1 |
| Liabilities | | | | |
| Shares | **12,448.2** | **12,448.2** | 11,286.3 | 11,286.3 |
| Amounts due to credit institutions | **249.4** | **249.4** | 72.5 | 72.5 |
| Other deposits | **2,423.5** | **2,423.5** | 1,596.4 | 1,596.4 |
| Debt securities in issue | **3,967.4** | **3,950.8** | 3,262.0 | 3,250.3 |
| Subordinated liabilities | **105.0** | **112.9** | 105.3 | 119.9 |
| Subscribed capital | **146.0** | **148.8** | 145.2 | 145.2 |
| **Society** | | | | |
| Assets | | | | |
| Cash in hand and balances with the Bank of England | **434.9** | **434.9** | 36.2 | 36.2 |
| Loans and advances to credit institutions | **732.2** | **732.2** | 20.2 | 20.2 |
| Debt securities | **3,184.5** | **3,184.5** | 3,481.6 | 3,481.6 |
| Loans and advances to customers | **9,328.7** | **9,338.8** | 8,845.9 | 8,865.6 |
| Investments | **9,217.9** | **9,217.9** | 6,261.0 | 6,261.0 |
| Liabilities | | | | |
| Shares | **12,448.2** | **12,448.2** | 11,286.3 | 11,286.3 |
| Amounts due to credit institutions | **1,410.0** | **1,410.0** | 1,244.5 | 1,244.5 |
| Other deposits | **4,103.8** | **4,103.8** | 1,855.6 | 1,855.6 |
| Debt securities in issue | **3,967.4** | **3,950.8** | 3,262.0 | 3,250.3 |
| Subordinated liabilities | **105.0** | **112.9** | 130.3 | 145.0 |
| Subscribed capital | **146.0** | **148.8** | 145.2 | 145.2 |

Fair values of derivative financial instruments are shown in Note 33.

The fair value of all cash in hand, balances with the Bank of England and loans and advances to credit institutions have been recorded at par as they are all due in under one year and there is no impairment.

The fair value of loans and advances to customers has been calculated on an individual loan basis taking into account factors such as impairment and interest rates. It is not considered appropriate to value them collectively as a portfolio sale.

Debt securities are all classified as either fair value through the income statement or as available for sale and as such their book values are fair values.

## 40. RELATED PARTIES

**Identity of related parties**

The Group and Society have a related party relationship with their subsidiaries, joint venture, the pension scheme and key management personnel. The Group considers its key management personnel to be its directors.

**Contributions to the pension scheme**

The Society paid contributions of £9.5 million to the pension scheme (2006 – £9.6 million).

**Key management compensation**

The key management personnel compensations are as follows:

| | **No. of key management personnel** | **2007 £000** | No. of key management personnel | 2006 £000 |
|---|---|---|---|---|
| Short term employee benefits | | **1,894** | | 1,729 |
| Post employment benefits | | **52** | | 34 |
| Total key management personnel compensation | **14** | **1,946** | 13 | 1,763 |

**Transactions with key management personnel**

Key management personnel and their close family members have undertaken the following transactions with the Yorkshire Building Society under normal business terms.

| | **No. of key management personnel 2007** | **Amounts in respect of key management personnel and their close family members 2007 £000** | No. of key management personnel 2006 | Amounts in respect of key management personnel and their close family members 2006 £000 |
|---|---|---|---|---|
| Mortgage loans | | | | |
| At 1st January | | **352** | | 217 |
| Net movements in the year | | **347** | | 135 |
| At 31st December | **2** | **699** | 2 | 352 |
| Deposit accounts and investments | | | | |
| At 1st January | | **1,095** | | 1,106 |
| Net movements in the year | | **98** | | (11) |
| At 31st December | **11** | **1,193** | 10 | 1,095 |

Mortgage loans made to key management personnel and their close family members were granted in the ordinary course of business and are subject to repayment under normal lending terms. The maximum outstanding balances during the year were £955,000.

Amounts deposited by key management personnel and their close family members earn interest at the same rates offered to the public.

Key management personnel and their close family members paid interest totalling £28,682 (2006 – £5,897), received interest totalling £36,934 (2006 – £53,692), and paid no fees and commissions during the year. Interest paid reflects amounts relating to 'offset' mortgages where savings balances are used to reduce the interest bearing balance of mortgage loans.

40. RELATED PARTIES (continued)

**Transactions with subsidiaries**

The Society enters into a number of transactions with its subsidiaries in the normal course of business. These include loans and shares. The volume of related party transactions, outstanding balances at the year end and related income and expense for the financial year are as follows:

| | 2007 £m | 2006 £m |
|---|---|---|
| Shares in subsidiaries | | |
| At 1st January | **294.3** | 294.3 |
| Net movements | – | – |
| At 31st December | **294.3** | 294.3 |
| Loans to subsidiaries | | |
| At 1st January | **5,966.7** | 3,452.6 |
| Net movements | **2,954.9** | 2,514.1 |
| At 31st December | **8,921.6** | 5,966.7 |
| Deposits from subsidiaries | | |
| At 1st January | **2,614.7** | 1,111.5 |
| Net movements | **1,376.7** | 1,503.2 |
| At 31st December | **3,991.4** | 2,614.7 |
| Interest receivable on loans | **348.4** | 190.8 |
| Interest payable on deposits | **(145.4)** | (64.6) |
| Fees and expenses receivable | **16.4** | 14.4 |
| Fees and expenses payable | **(2.6)** | (2.4) |

**Transactions with joint ventures**

The Society holds 50% of the share capital in MutualPlus Ltd, a branch sharing company. The outstanding balances at the year end are as follows:

| | 2007 £m | 2006 £m |
|---|---|---|
| Loans | | |
| At 1st January | **0.1** | 0.1 |
| Net movements | **(0.1)** | – |
| At 31st December | **–** | 0.1 |

## 41. CASH FLOWS FROM OTHER OPERATING ACTIVITIES

| | Group | | Society | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| **Working capital adjustments:** | | | | |
| Depreciation and amortisation | **9.7** | 9.5 | **7.7** | 6.6 |
| Profit on sale of assets | **(9.1)** | 0.2 | **(9.0)** | – |
| Interest on subordinated liabilities and subscribed capital | **15.1** | 14.2 | **16.5** | 15.6 |
| (Increase)/decrease in other assets | **(0.8)** | (7.4) | **4.8** | (3.1) |
| Increase/(decrease) in other liabilities | **7.7** | (11.6) | **7.4** | (12.2) |
| **Working capital adjustments** | **22.6** | 4.9 | **27.4** | 6.9 |
| **Decrease/(increase) in operating assets:** | | | | |
| Loans and advances to customers | **(2,098.0)** | (1,178.6) | **(480.5)** | (150.0) |
| Investments | **(2.0)** | – | **(2,956.9)** | (2,514.1) |
| Derivative financial instruments | **8.5** | 35.0 | **169.7** | 36.4 |
| **Net increase in operating assets** | **(2,091.5)** | (1,143.6) | **(3,267.7)** | (2,627.7) |
| **Increase/(decrease) in operating liabilities:** | | | | |
| Shares | **1,161.9** | 1,083.9 | **1,161.9** | 1,083.9 |
| Amounts owed to credit institutions | **176.9** | (399.2) | **165.5** | (338.7) |
| Other deposits | **827.1** | (53.5) | **2,248.2** | 1,325.4 |
| **Net increase in operating liabilities** | **2,165.9** | 631.2 | **3,575.6** | 2,070.6 |

# Annual business statement

## for the year ended 31st December 2007

### 1. STATUTORY PERCENTAGES

| | 2007 % | Statutory Limit % |
|---|---|---|
| Lending Limit | **2.4** | 25.0 |
| Funding Limit | **32.3** | 50.0 |

The above percentages have been calculated in accordance with the provisions of the Building Societies Act 1986.

The Lending Limit measures the proportion of business assets not in the form of loans fully secured on residential property. The Funding Limit measures the proportion of shares and borrowings (excluding off-shore deposits held by individuals) not in the form of shares.

The statutory limits are as laid down under the Building Societies Act 1986 and ensure that the principal purpose of a building society is that of making loans which are secured on residential property and are funded substantially by its members.

### 2. OTHER PERCENTAGES

| | 2007 % | 2006 % |
|---|---|---|
| As a percentage of shares and borrowings: | | |
| Gross capital | **6.31** | 7.16 |
| Free capital | **5.86** | 6.63 |
| Liquid assets | **24.74** | 25.11 |
| Profit for the financial year as a percentage of mean total assets | **0.21** | 0.32 |
| Management expenses as a percentage of mean total assets | **0.63** | 0.69 |

The above percentages have been prepared from the Group accounts and in particular:

- 'Shares and borrowings' represent the total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue;
- 'Gross capital' represents the aggregate of general reserve, hedging reserve, available for sale reserve, subordinated liabilities and subscribed capital;
- 'Free capital' represents the aggregate of gross capital and collective impairment provision less property, plant and equipment, intangible assets and investment properties;
- 'Liquid assets' represent the total of cash in hand and balances with the Bank of England, loans and advances to credit institutions, debt securities and other liquid assets;
- 'Mean total assets' represent the amount produced by halving the aggregate of total assets at the beginning and end of the financial year; and
- 'Management expenses' represent the aggregate of administrative expenses, depreciation and amortisation.

# Annual business statement

continued

## 3. INFORMATION RELATING TO THE DIRECTORS AND OTHER OFFICERS AT 31ST DECEMBER 2007

| Director Name and Date of Birth | Business Occupation | Date of Appointment | Other Directorships |
|---|---|---|---|
| E. J. S. Anderson, B.Sc, CPFA<br>22nd December 1950 | Company Director | 19th May 2003 | Kelda Group Plc<br>Leeds Chamber of Commerce and Industry<br>Leeds International Pianoforte Competition<br>Leeds Trinity and All Saints College<br>Marketing Leeds Ltd<br>St.Gemma's Hospice<br>University of Leeds |
| Ms J. M. Baddeley, MA<br>21st March 1951 | Associate Fellow<br>Saïd Business School, Oxford | 2nd November 2001 | Art VPS Ltd<br>Browning Properties Ltd<br>Chrysalis VCT Plc<br>ComputerLand UK Plc<br>Department of Health<br>Greggs Plc |
| F. B. Beckett, CA<br>30th October 1941<br>(retired 31st December 2007) | Chartered Accountant (retired)<br>and Company Director | 27th July 2000 | Harrogate Golf Club Ltd<br>Paperworks (Harrogate) Ltd |
| I. J. Bullock, B.Sc, FIA<br>7th November 1960 | Building Society<br>Sales and Marketing Director | 12th April 2007 | Accord Mortgages Ltd<br>MutualPlus Ltd |
| A. M. Caton, BA<br>27th July 1963 | Building Society<br>Corporate Development<br>Director | 1st July 2004 | YBS Investments (No. 1) Ltd<br>YBS Investments (No. 2) Ltd<br>Yorksafe Insurance Company Ltd<br>Yorkshire Guernsey Ltd<br>Yorkshire Investment Services Ltd |
| Mrs L. F. Charlesworth, BA, MBA<br>24th August 1956 | Company Director | 31st December 2006 | St. James Investments Ltd<br>St. James Investment Company UK No. 2 Ltd<br>St. James Investment Company UK No. 3 Ltd |
| I. C. A. Cornish, B.Sc<br>11th November 1960 | Building Society<br>Chief Executive | 1st July 2003 | Accord Mortgages Ltd<br>Yorkshire Investment Services Ltd<br>Yorkshire Key Services Ltd<br>Yorkshire Key Services (No. 2) Ltd |
| R. H. Davey, BA<br>22nd July 1948 | Company Director | 27th September 2005 | Amlin Plc<br>Amlin Underwriting Ltd<br>London Capital Group Holdings Plc<br>Severn Trent Plc<br>Severn Trent Water Ltd |

## 3. INFORMATION RELATING TO THE DIRECTORS AND OTHER OFFICERS AT 31ST DECEMBER 2007 (continued)

| Director Name and Date of Birth | Business Occupation | Date of Appointment | Other Directorships |
|---|---|---|---|
| A. T. Gosling, MA, FCA<br>1st June 1955 | Building Society<br>Finance Director | 1st May 2001 | YBS Investments (No. 1) Ltd<br>YBS Investments (No. 2) Ltd<br>YBS Properties Ltd<br>YBS Properties (Edinburgh) Ltd<br>YBS Properties (York) Ltd<br>Yorksafe Insurance Company Ltd<br>Yorkshire Building Society Estate Agents Ltd<br>Yorkshire Computer Services Ltd<br>Yorkshire Guernsey Ltd<br>Yorkshire Investment Services Ltd |
| P. R. Johnson, FCA<br>12th October 1946 | Chartered Accountant | 1st June 2007 | Cheadle Hulme School |
| P. A. Lee, MA, LL.B<br>26th January 1946<br>(retired 31st December 2007) | Solicitor | 22nd May 1998 | A G Secretarial Ltd<br>Barlows Plc<br>Chepstow Trustee Ltd<br>Exchange Productions Ltd<br>Hopkins & Jones Ltd<br>Inhoco Formations Ltd<br>Leaf 2 Let Ltd<br>Leaf Properties Ltd<br>North West Business Leadership Team Ltd<br>Royal Exchange Theatre Catering Ltd<br>Royal Exchange Theatre Company Ltd<br>Royal Exchange Theatre Trustees Ltd |
| D. V. Paige, B.Sc, FCA<br>3rd July 1951 | Company Director | 31st December 2006 | Aegon UK Plc<br>Edgecumbe Consulting Group Ltd<br>Helphire Group Plc |
| S. Turner, B.Sc<br>29th November 1951 | Company Director | 13th October 2005 | DSG International Wholesale Ltd<br>DSG Retail Ltd<br>Fotovista SAS<br>Kotsovolos Société Anonyme Commercial and Industrial Company<br>SCM Microsystems Inc. |

Mr A.M. Caton, Mr I.C.A. Cornish and Mr A.T. Gosling entered into contracts with effect from 1st July 2004, 1st July 2003 and 1st April 2001 respectively which are terminable by the Society or the director on one year's notice. Mr I. J. Bullock entered into a contract with effect from 12th April 2007 which is terminable by the Society on one year's notice and by Mr Bullock on six months' notice. Unless notice to terminate is given, the contracts continue automatically to the age of 60.

Documents may be served on the above-named directors: Ref."Yorkshire Building Society" c/o KPMG Audit Plc at the following address:
1 The Embankment, Neville Street, Leeds LS1 4DW.

### 3. INFORMATION RELATING TO THE DIRECTORS AND OTHER OFFICERS AT 31ST DECEMBER 2007 (continued)

| Officer | Business Occupation | Directorships |
|---|---|---|
| R. J. Churchouse, MA, ACA | General Manager Risk and Planning | None |
| Mrs R. D. Court, BA | General Manager Human Resources and Customer Service | Yorkshire Guernsey Ltd<br>Prism (England) Ltd |
| Mrs A. L. FitzPatrick, LL.B | Group Secretary | Newhall Park Daycare Ltd |
| D. N. Henderson B.Sc | Chief Information Officer | Yorkshire Key Services Ltd<br>Yorkshire Key Services (No 2) Ltd |

**Principal Office:**
Yorkshire Building Society, Yorkshire House, Yorkshire Drive, Bradford BD5 8LJ. www.ybs.co.uk

**Auditors:**
KPMG Audit Plc, 1 The Embankment, Neville Street, Leeds LS1 4DW








Principal Office: Yorkshire Building Society, Yorkshire House, Yorkshire Drive, Bradford BD5 8LJ. www.ybs.co.uk



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