# Julian Hodge Bank Limited

**Annual report and financial statements**
**31 October 2016**
**Registered number 743437**

# Officers and professional advisers

| | | | |
|---|---|---|---|
| **Directors** | Keith James | O.B.E., M.A. | Chairman |
| | Jonathan Hodge | | Deputy Chairman |
| | David Austin | LL.B., A.C.A. | Managing Director |
| | David Landen | B.Sc., F.C.C.A. | Finance Director |
| | Alun Bowen | M.A., F.C.A. | |
| | Adrian Piper | B.A., M.Sc., M.C.I.P.D., M.C.I.M. | |
| | Helen Molyneux | LLD (Hons) | |
| **Company Secretary** | Rhian Yates | B.Sc., F.C.C.A. | |
| **Registered Office** | One Central Square<br>Cardiff<br>CF10 1FS | | |
| **Auditor** | Ernst & Young LLP<br>Bristol | | |
| **Principal bankers** | Lloyds Bank Plc<br>London | | |
| | Barclays Bank Plc<br>Cardiff | | |
| **Economic adviser** | Professor Patrick Minford<br>Cardiff Business School | | |

# Contents

# Chairman's statement

I am pleased to present the Bank's results for the year ended 31 October 2016.

The Bank has enjoyed an exceptional year, making a pre-tax profit of £22.8 million (2015: £1.6 million). The results for this year reflect the transition to FRS101 and the prior year figures have been restated to be comparable.

FRS 101 creates much greater volatility within the Bank's income statement as it is now required to fair value certain assets previously held at amortised cost, as well as bringing hedging instruments on to the balance sheet.

Accordingly, to arrive at an assessment of operating performance which is better aligned to the Bank's key performance indicators, it is necessary to eliminate from the profit before tax, those items which distort year on year comparisons and arise primarily from changes in asset values, which have a tendency to fluctuate, particularly in the current environment.

Adjusted net operating income, which is explained in more detail in note 3 to the financial statements, is a more meaningful measure against which to assess the Bank's performance and it is this measure on which we now concentrate.

In this respect, performance for the year has been particularly gratifying, with a marked improvement in this measure.

**Highlights**

- Adjusted net operating income has increased by 86%.
- Tier 1 capital ratio of 19.1%.
- Increase in loans and advances to customers of 13%.
- Increase in deposits (customer accounts) of 17%.

**Economic Environment**

The economic environment during 2016 can be characterised by general concerns over global growth, interspersed by two major events, namely Brexit and the outcome of the US presidential election, neither of which was foreseen by financial markets. Furthermore, markets were wrong-footed in their expectations of the consequences.

With respect to Brexit, dire predictions were made as to the likely effect on stock markets, interest rates, exchange rates and GDP growth and whilst there have been some marked fluctuations, only the devaluation of sterling has yet come to pass.

In similar vein, Donald Trump was seen as both unpredictable and an advocate for protectionist policies which could have adverse consequences for global growth. Yet US stock markets have reached record levels and the dollar has strengthened markedly against the yen and euro.

What is evident however is that both events are seen by financial markets as creating more uncertainty at a time when confidence is fragile.

Whilst the Bank's activities are UK-based, it is not immune to market factors, influenced by global events. This is particularly so in the case of interest rates, which plumbed record lows in August, albeit, there has been a significant rally since.

## Chairman's statement (continued)

The market consensus is that Brexit will be inflationary, driven primarily by the drop in sterling's trade-weighted index, which will increase the cost of imports. Donald Trump's election has also increased inflation expectations in the US; with his plans for significant infrastructure spending.

After many false starts the Federal Reserve raised interest rates in December, which allied to the inflationary pressures referred to above, might be the catalyst for a "normalisation" of interest rates over the next few years.

If this is the case, the Bank is well-placed to benefit significantly from such a move, provided it is not so extreme as to impact adversely on commercial and real estate residential values, which underpin the bulk of the Bank's lending.

### Financial Performance

Setting aside the impact of the adoption of FRS101, the Bank's underlying performance has been positive with a strong performance within Commercial Lending and solid growth within Hodge Lifetime, which has expanded its product range

Net interest income has seen a marked improvement, increasing by 97% on our core lending products, reflecting a combination of growth in our loan book and margin improvement.

Administrative expenses have increased due to substantial investment in people, premises and systems to enable us to carry out our plans to grow the business over the coming years.

This investment has already started to bear fruit. This trend will be more evident as we increase the breadth of our services, expand our product range and develop our digital offering to provide our customers with more ways to engage with us.

### Five Year Summary

| | FRS101 | | UK GAAP | | |
|---|---|---|---|---|---|
| | **2016** | **2015** | **2014** | **2013** | **2012** |
| | **£m** | **£m** | **£m** | **£m** | **£m** |
| **Profit before tax** | **22.8** | **1.6** | **4.3** | **3.5** | **3.1** |
| **Adjusted net income or operating profit** | **14.3** | **7.7** | **0.2** | **(4.6)** | **(3.9)** |
| **Total assets** | **1,316.8** | **1,108.9** | **784.7** | **726.5** | **802.5** |
| **Loans and advances to customers** | **706.9** | **624.8** | **440.8** | **384.0** | **358.8** |
| **Customer deposits** | **991.7** | **848.6** | **633.2** | **583.6** | **658.9** |
| **Shareholder's funds** | **146.3** | **133.3** | **132.0** | **128.2** | **125.6** |

### Commercial Lending

Our Commercial Lending business has made excellent progress this year, writing over £100 million of new business, materially improving operating margins, generating recurring fee income of £3m and delivering a substantial increase in operating profit.

Impairment has been well-controlled, a testimony to our focus on risk management and the quality of lending.

# Chairman's statement (continued)

It is pleasing to note that these results were achieved with a relatively minor increase in overheads, justifying our investment in this business in recent years.

Our strategy is to be highly selective in our asset origination approach, focussing on the quality of clients and proposals, rather than a volume-led lending target. We provide bespoke and specialist real estate funding for a client base of proven and experienced property investors and developers. Our specialist, private bank proposition resonates well in this market and a significant amount of our business comes from existing client referrals.

As our business grows we continue to invest in risk systems and processes to maintain our emphasis on quality. Our client base is predominantly spread across the southern part of the UK across a mix of real estate categories, which provides diversification both geographically and in type of lending.

We have a proven strategy and see no reason to change this over the coming year.

**Hodge Lifetime**

Hodge Lifetime is the group's brand covering the retirement market. Our core products are pension annuities and "later life lending". Some of the business is conducted by the Bank with the rest being conducted by our subsidiary, Hodge Life Assurance Company Limited. This market offers significant growth potential, underpinned by strong demographic trends.

Over the past two years, we have added to our range of 'later life lending' services with two new products – a Retirement Mortgage (a hybrid lifetime mortgage) and 55+ Mortgage (a standard residential mortgage). These products are offered by the Bank and are expected to be an area of significant growth in future.

This strategic development means that Hodge Lifetime is the only business currently offering a full range of later life mortgage lending products, and puts us in a strong position to capitalise on this growing market.

We are also very pleased to have agreed an external funding arrangement, which allows us to increase the level of equity release lending we undertake, over and above our own requirements.

As at 31 October 2016 the Bank had £758 million of equity release mortgage assets under management including £447 million for other financial institutions.

**Treasury and Funding**

We implemented a new banking system during the year, which will enable us to develop our on-line capability to complement our existing telephone and postal operations.

We anticipate being able to provide our first on-line products in the second half of 2017. This will be a major new initiative for the Bank and our aim will be to provide the same first-class service to our customers, regardless of how they choose to do business with us.

Even without the option of an on-line service we were able to grow our deposit book by 17% to just under £1 billion at the end of the year. We now have over 33,000 customers, an increase of over 10% on the prior year.

## Chairman's statement (continued)

This is a tremendous performance given that interest rates have been at record lows for much of the year which creates a massive disincentive to save. However, interest rates have started to rise in recent weeks and it may be that 2017 will at last provide some relief for savers.

For our part, the Bank remains committed to developing its product range and the channels through which it serves its customers so that it can offer them a range of products to suit their particular needs.

**Our People**

To support our business growth we now have 142 staff, an increase of 25% over the financial year. As anticipated last year, the increase in staff complement has necessitated a move to new premises, in the heart of Cardiff's newest and most vibrant business location.

The Board believes that the Bank, as a key contributor to the burgeoning financial services sector in Cardiff, now has the right accommodation to attract the additional staff that it needs to build on its success in recent years.

I must again commend our staff for the commitment and enthusiasm they have displayed during what has been a year of substantial change for the Bank. We have implemented a new banking system and relocated our business whilst at the same time navigating a turbulent economic environment, culminating with Brexit and its aftermath.

**The Outlook**

The economic environment continues to be uncertain, with Brexit, the US presidential election and the Italian referendum all contributing to a climate of uncertainty, which shows little sign of abating.

Uncertainty is anathema to financial markets and whilst the Bank can control to some extent its own destiny, it is in thrall to the markets with respect to those factors which most affect its business, namely interest rates and residential and commercial real estate prices.

This has been heightened by the requirement for the Bank to adopt FRS101, which has the effect of generating much greater volatility within its reported results.

However, I have no doubt that the Bank has the resources to deal with these issues and the appropriate strategy to generate good returns for its shareholders.

**Keith James**
**Chairman**
**15 December 2016**

# Strategic Report

### Principal activities

The Bank is principally engaged in the business of banking and "later life lending." Details of the principal subsidiary and its activities are set out in note 18 to the accounts.

The Bank is an Authorised Institution under the Financial Services and Markets Act 2000.

### Corporate strategy

The Board has adopted a prudent strategic plan with the long term aim of achieving stable returns and modest capital growth in accordance with the requirements of its Shareholders. At the heart of the Bank's philosophy is a wish to protect its capital base for the benefit of its depositors and Shareholder by conducting business in those areas where it has the greatest expertise and experience and best understands the risks which it is taking.

A rolling five-year strategy is approved by the Board annually, complemented by a detailed business plan for the forthcoming financial year. The Board sets aside specific time during the year to review its strategy and to gauge progress towards its achievement. The current strategy is based on a continuing involvement in (a) commercial property, primarily through the Bank's commercial lending business and (b) residential property through its "later life lending" activities, both of which it believes will enable it to achieve its strategic objectives.

### Risk appetite

On an annual basis, in the context of the Board's review of its strategy, the Board establishes a risk appetite with appropriate key risk indicators and risk limits for executive management to operate within. The Board monitors adherence to the risk appetite on a regular basis.

### Business review and future developments

A review of business and future developments is included in the Chairman's statement on pages 1 to 4.

### Results and dividends

The profit for the year after taxation amounted to £17.6m *(2015: £1.0m).* No dividend was paid during the year *(2015: £nil)* leaving a surplus for the year of £17.6m (*2015: £1.0m)* to be taken to reserves.

### Employees

The Bank has an equal opportunities employment policy, and it is the Board's policy to employ disabled persons whenever suitable vacancies arise and to provide for such employees the appropriate level of training and career progression within the Bank.

The directors recognise the importance of communication with employees and they make it their policy to be accessible to them.

### Corporate governance

This statement explains the extent to which the Bank has applied the principles of good governance contained in The UK Corporate Governance Code for the year ended 31 October 2016.

# Strategic Report *(continued)*

### Corporate governance *(continued)*

The Board of the Bank comprises two executive and five non-executive directors. The roles of Chairman and Chief Executive are separate to ensure that neither can exercise unfettered powers of decision-making on matters of material importance to the Bank.

The Board has sought to ensure that directors are properly briefed on issues arising at Board meetings by:

- distributing papers sufficiently in advance of meetings;
- considering the adequacy of the information provided before making decisions; and
- deferring decisions when directors have concerns about the quality of information.

The Board is ultimately responsible for the Bank's system of internal control and for reviewing its effectiveness. The system of control is designed to manage rather than eliminate risks which are inherent in the Bank's business and can provide only reasonable and not absolute assurance against material misstatement or loss.

The Bank's system of internal financial control includes appropriate levels of authorisation, segregation of duties and limits for each aspect of the business. There are established procedures and information systems for regular budgeting and reporting of financial information. Financial reports are presented to the Board monthly detailing the results and other performance data.

There is a well-established internal audit function within the Bank that is provided by PwC on an outsourced basis. Its role is primarily to review the effectiveness of controls and procedures established to manage risk. An audit programme is agreed annually in advance with the audit committee and the head of internal audit attends each meeting of the committee to present a summary of audit reports completed during the period and to provide any explanations required by the committee.

The audit committee has reviewed the effectiveness of the Bank's system of internal financial control during the year and determined it was satisfactory.

### Governance framework

The following is a summary of the framework for corporate governance adopted by the Bank.

### The Board

The Board has ultimate responsibility for the proper stewardship of the Bank in all its undertakings. It meets regularly throughout the year to discharge its responsibilities for all important aspects of the Bank's affairs, including monitoring performance, considering major strategic issues, approving budgets and business plans and reporting to the shareholder.

A board control manual has been adopted which describes the high-level policy and decision-making arrangements within the Bank. The manual includes a schedule of matters reserved to the Board together with those items delegated to directors and Board and executive committees.

# Strategic Report *(continued)*

### Board Committees

The Board has established the following standing committees:

- **Audit committee:** Adrian Piper (Chairman), Keith James, Jonathan Hodge, Helen Molyneux and Alun Bowen.

  All members of the audit committee are non-executive. Executive members of the Board and other senior executives attend as required by the Chairman.

  The function of the audit committee is to review the work of the internal audit function, to consider the adequacy of internal control systems, to review the relationship with the external auditors, to review the statutory accounts including the key estimates and judgements used in the statutory accounts and to consider compliance issues.

  The committee meets at least four times a year.

- **Risk and conduct committee:** Alun Bowen (Chairman), Keith James, Jonathan Hodge, Helen Molyneux and Adrian Piper.

  All members of the risk and conduct committee are non-executive. Executive members of the Board and other senior executives attend as required by the Chairman.

  The function of the risk and conduct committee is to oversee the management of risk and the conduct of business on behalf of the Board to ensure that significant risks are identified, understood, assessed and managed and that good customer outcomes are achieved. It is responsible for the second line of defence of the business, ensuring that the level of assurance available to the Board is sufficient and appropriate.

  The committee meets at least four times a year.

- **Remuneration committee:** Helen Molyneux (Chairwoman), Keith James, Alun Bowen, Jonathan Hodge and Adrian Piper.

  All members of the remuneration committee are non-executive. Executive members of the Board and other senior executives attend as required by the Chairwoman.

  The function of the remuneration committee is to consider remuneration policy and specifically to determine the remuneration and other terms of service of executive directors and senior managers. The executive directors decide fees payable to non-executive directors.

  The committee meets as required.

- **Nomination committee:** Jonathan Hodge (Chairman), Keith James, Alun Bowen, Helen Molyneux and Adrian Piper.

  All members of the nomination committee are non-executive. Executive members of the Board and other senior executives attend as required by the Chairman.

  The function of the committee is to recommend the appointment of directors to the Board and Board committees and to ensure that the Bank has an appropriate succession plan for executive and senior management positions.

  The committee meets as required.

# Strategic Report *(continued)*

### Executive Committees

Executive management has primary responsibility for the operation of the Bank's internal financial control framework. It monitors credit risk, liquidity risk, house price risk, interest rate risk, conduct risk and operational risk by means of relevant committees as described below. The Bank's policy on risk management is set out on the following page.

- **Group management board**

  Chaired by the Managing Director the committee consists of executive management and is responsible for the formulation and execution of the Bank's strategy, and the day-to-day management of the Bank, subject to specific limitations and constraints imposed by the Board and is also responsible for formulating the IT strategy and policy and monitors and authorises IT activities throughout the Bank.

  The committee meets as required, but as a minimum will meet six times per year.

- **Executive risk committee**

  Chaired by the Managing Director, the committee meets quarterly and monitors the Bank's risk management framework. It also monitors and co-ordinates the activities of compliance, risk assurance and internal audit throughout the Bank.

- **Assets and liabilities committee**

  Chaired by the Managing Director, the committee implements the policies of the Board with respect to liquidity and interest rate risk management and provides recommendations to the Board on strategies for managing these risks. It also monitors and controls treasury counterparty risk arising from deposits with other banks and institutions which are usually unsecured together with debt securities acquired as investments. The committee meets weekly.

- **Retail credit committee**

  Chaired by the Managing Director, the committee's principal responsibility is to monitor and control retail credit risk throughout the Group and ensure risk underwriting is appropriate. The primary credit risk arises from loans to customers through the Hodge Lifetime division.

  The Committee meets as required, but as a minimum will meet four times a year.

- **Commercial credit committee**

  Chaired by the Managing Director, the committee's principal responsibility is the implementation and maintenance of the overall risk management framework relating to commercial credit risk. The Committee is also responsible for reviewing, challenging and if appropriate, approving credit proposals for new commercial lending deals that are within its remit as set by the Board.

  The Committee meets as required, but as a minimum will meet four times a year.

# Strategic Report *(continued)*

- ***Actuarial committee***

  The committee is responsible for monitoring the insurance risk exposure of the company including longevity risk, liquidity risk, house price risk and interest rate risks. It also monitors and provides input to the methods and assumptions used to undertake actuarial valuations of the Company's assets and liabilities.

  The Committee meets as required, but as a minimum will meet four times per annum.

**Risk Management**

The Bank regards the monitoring and controlling of risk as a fundamental part of the management of the business and accordingly involves its most senior people in developing risk policy and monitoring its application. The Board has agreed a risk management policy and a risk management framework.

The Bank operates a three lines of defence model for risk management and oversight. This structure defines the roles and responsibilities of risk management, risk oversight and risk assurance separately from those of commercial and operational activities undertaken by the Bank. This model comprises the following elements:

**First line of defence** has responsibility for implementation of the Bank's strategy and for the management of risk across the organisation and comprises executive committees, management and staff.

**Second line of defence** relates to risk oversight and independent challenge of the first line of defence. The board has delegated oversight of risk management to the risk and conduct committee. An internal assurance team is responsible for undertaking a monitoring programme to enable the risk and conduct committee to assess whether the first line of defence is operating effectively.

The **third line of defence** provides objective assurance on the effectiveness of the Bank's governance and risk management processes and controls. This assurance is obtained via the use of internal audit services provided by PwC. The Board retains ultimate responsibility for risk management in the Bank.

In the normal course of its business, the Bank is exposed to credit risk, liquidity risk, house price risk, interest rate risk, conduct risk and operational risk.

**Credit risk** is the risk that a counterparty will be unable or unwilling to meet a commitment that it has entered into with the Bank. The Bank manages its credit risk through the retail credit committee, commercial credit committee and the assets and liabilities committee. Regular credit exposure reports are produced which include information on credit and property underwriting, large exposures, asset concentrations, industry exposure and levels of bad debt provisioning.

**Liquidity risk** is the risk that the Bank will encounter difficulty in realising assets or otherwise raising funds to meet commitments as they fall due. The Bank manages its liquidity risk through its assets and liabilities committee, and monitors its liquidity position on a daily basis and has adopted a policy to ensure that it has adequate resources to enable it to conduct its normal business activities without interruption. The maturity analysis of assets and liabilities is disclosed in the notes to the financial statements.

The customer deposit base represents a stable source of funding due to the number and range of depositors. Liquidity is further managed through dealings in the money markets.

## Strategic Report *(continued)*

**House price risk** is the risk that arises when there is an adverse mismatch between actual house prices and those implicit in the costing of the Bank's lending into retirement products, such that the ultimate realisation of the property would not yield the expected return to the Bank and could, in certain circumstances, result in a capital loss.

**Interest rate risk** is the risk that arises when there is an imbalance between the maturity dates of rate sensitive assets, liabilities and off-balance sheet items. The Bank manages its interest rate risk through its assets and liabilities committee. The Bank's policy is to maintain interest rate risk at a controlled level within limits set by the Board.

The table in note 33 shows an estimate of the interest rate sensitivity gap as at 31 October 2016. Assets and liabilities are included in the table at the earliest date at which the applicable interest rate can change.

The Bank enters into derivative transactions, normally interest rate swaps. The purpose of such transactions is to manage the interest rate and other risks arising from the Bank's operations and other resultant positions. The Bank's interest rate risk management policy defines the type of derivative transactions that can be undertaken. Further information is given in note 33 to the accounts.

**Conduct risk** is the risk that the Bank's behaviour results in poor outcomes for customers. The Bank is exposed to this risk by virtue of the markets in which it chooses to operate.

**Operational risk** is the risk of economic loss from control failures or external events, which result in unexpected or indirect loss to the Bank.

The evaluation of the various risks and the setting of policy is carried out through the Bank's executive risk committee and reports to the risk and conduct committee, which ensures adherence to the Bank's risk management policy and framework.

The Company is also exposed to pension risk through its defined benefit scheme.

# Strategic Report *(continued)*

### Going concern

The Bank's business activities, together with the factors likely to affect its future development, its financial position, financial risk management objectives, and its exposures to credit and liquidity risk are described above.

The Bank's forecasts and projections include scenario testing undertaken in accordance with the Internal Capital Adequacy Process (ICAAP) and Individual Liquidity Adequacy Assessment Process (ILAAP), which are required by the Prudential Regulation Authority to demonstrate appropriate levels of capital and liquidity respectively under stressed conditions. The directors consider that the overall level of capital, including Tier 1 capital, of £130.3m (19.1% as a percentage of risk weighted assets) and liquidity, including liquid assets (Gilts, central bank reserves and wholesale cash deposits), of £286m (29% of total deposits) are adequate. Accordingly, the directors confirm that they are satisfied that the Bank has adequate resources to continue in business for the foreseeable future. For this reason, they continue to adopt the going concern basis in the preparation of the financial statements.

**David Landen**
*Director*

15 December 2016

One Central Square
Cardiff
CF10 1FS

# Directors' report

The directors present their report together with the audited financial statements for the year ended 31 October 2016.

Certain disclosures are given in the Strategic Report and are incorporated here by cross-reference. Specifically, these incorporate the following disclosures:

Future developments - page 5
Dividends - page 5
Going concern - page 11
Financial risk management policies - pages 9 to 10

**Directors and their interests**

The directors who held office during the year are listed below:

| | |
|---|---|
| D. K. M. James* | - Chairman |
| J. J. Hodge* | - Deputy Chairman |
| D. M. Austin | - Managing Director |
| D. J. Landen | - Finance Director |
| A. N. Piper* | |
| D. A. Bowen* | |
| H. Molyneux* | |

* Non-executive

No contract was entered into by the Bank in which a director had a material interest.

Jonathan Hodge's interests in the shares of Group undertakings are shown in the Directors' Report of the ultimate UK parent undertaking, The Carlyle Trust Limited.

None of the other directors held any interest in the shares of Group undertakings.

**Political contributions**

The Bank made no political contributions during the year.

**Post Balance Sheet events**

There are no post Balance Sheet events to disclose.

**Disclosure of information to the auditor**

The directors who held office at the date of approval of this directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Bank's auditor is unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Bank's auditor is aware of that information.

**Qualifying third-party indemnity provisions**

The Company has granted an indemnity to one or more of its directors against liability in respect of proceedings brought by third parties, subject to the conditions set out in the Companies' Act 2006. Such qualifying party indemnity provisions remain in force as at the date of approving the director's report

**Auditor**

In anticipation of the implementation of the EU audit reforms which became effective on 17 June 2016, which require public interest entities to change audit firms who have audited a relevant entity for over twenty years, the Audit Committee on behalf of the Board carried out a full audit tender, and following the conclusion of that process, Ernst & Young LLP was appointed to replace KPMG LLP.

A resolution for the re-appointment of Ernst & Young LLP as auditor of the company and authorising the Audit Committee to determine its remuneration is to be proposed at the forthcoming Annual General Meeting.

By order of the Board

**David Landen**
*Director*

15 December 2016

One Central Square
Cardiff
CF10 1FS

# Directors' Responsibilities Statement

The directors are responsible for preparing the Strategic Report, the Directors' report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice) including Financial Reporting Standard 101 Reduced Disclosure Framework (FRS 101).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions, and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the company 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 company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Independent auditor's report to the member of Julian Hodge Bank Limited

We have audited the financial statements of Julian Hodge Bank Limited for the year ended 31 October 2016, which comprise the Income Statement, the Statement of Other Comprehensive Income, the Balance Sheet, the Statement of Changes in Equity and the related notes 1 to 37. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice), including Financial Reporting Standard 101 'Reduced Disclosure Framework', applicable in the UK and Republic of Ireland.

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

**Respective responsibilities of directors and auditor**

As explained more fully in the Directors' Responsibilities Statement set out on page 14 the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

**Scope of the audit of the financial statements**

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

**Opinion on financial statements**

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 October 2016 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, including Financial Reporting Standard 101 'Reduced Disclosure Framework' applicable in the UK and Republic of Ireland and
- have been prepared in accordance with the requirements of the Companies Act 2006.

**Opinion on other matter prescribed by the Companies Act 2006**

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

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

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Andrew Blackmore (Senior statutory auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
Bristol
16 December 2016

Notes:
1. The maintenance and integrity of Julian Hodge Bank Limited's web site is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Income statement
For the year ended 31 October 2016

| | Notes | 2016 £m | 2015 £m |
|---|---|---|---|
| Interest receivable and similar income | 5 | 42.2 | 34.4 |
| Interest payable and similar charges | 6 | (29.0) | (27.7) |
| **Net interest income** | | **13.2** | **6.7** |
| Fees and commissions receivable | | 1.1 | 0.7 |
| Fees and commissions payable | | (0.7) | (0.8) |
| **Net fee and commission income** | | **0.4** | **(0.1)** |
| Other finance costs | | (0.1) | (0.4) |
| Other operating income | 7 | 0.8 | 1.5 |
| Other fair value gains | 8 | 19.2 | 1.2 |
| **Net operating income** | | **33.5** | **8.9** |
| Administrative expenses | 10 | (8.1) | (7.1) |
| Depreciation and amortisation | | (0.2) | - |
| Impairment provision for losses on loans and advances to customers | 17 | (2.4) | (0.2) |
| **Profit before taxation** | **9** | **22.8** | **1.6** |
| Tax on profit | 11 | (5.2) | (0.6) |
| **Profit for the financial year** | | **17.6** | **1.0** |

# Statement of other comprehensive income
For the year ended 31 October 2016

| | Notes | 2016 £m | 2015 £m |
|---|---|---|---|
| Profit for the financial year | | 17.6 | 1.0 |
| **Items that will not be reclassified subsequently to profit and loss:** | | | |
| Re-measurement of defined benefit pension plan | 30 | (9.1) | (0.6) |
| Deferred tax thereon | | 1.5 | 0.1 |
| Recognition of pension scheme reimbursement asset | | 2.3 | - |
| Deferred tax thereon | | (0.4) | - |
| **Items that may be transferred to the Income Statement<br>Available-for-sale investments:** | | | |
| Fair value movements taken to reserves | 8 | 1.1 | (0.4) |
| Amount transferred to Income Statement | | - | - |
| **Total comprehensive income for the year** | | **13.0** | **0.1** |

The results for the year ended 31 October 2016 relate entirely to continuing operations. The notes on pages 21 to 78 form part of these financial statements.

# Balance sheet
As at 31 October 2016

| | Notes | 2016 £m | 2015 £m |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances held at central banks | 12 | 168.0 | 101.6 |
| Treasury bills | 13 | 84.7 | 84.0 |
| Debt securities | 14 | 89.1 | 88.2 |
| Loans and advances to credit institutions | 15 | 128.3 | 89.5 |
| Loans and advances to customers | 16 | 706.9 | 624.8 |
| Shares in group undertakings and participating interests | 18 | 16.0 | 16.0 |
| Intangible assets | 19 | 1.2 | 1.2 |
| Property, plant & equipment | 20 | 2.1 | 0.1 |
| Investment properties | 21 | 107.8 | 97.0 |
| Deferred tax assets | 22 | 8.3 | 1.5 |
| Other assets | 23 | 4.4 | 1.6 |
| Assets classified as held for sale | 24 | - | 3.4 |
| **Total assets** | | **1,316.8** | **1,108.9** |

| | Notes | 2016 £m | 2015 £m |
|---|---|---|---|
| **Liabilities** | | | |
| Deposit from banks | | 2.8 | 2.8 |
| Deposits from customers | 25 | 991.7 | 848.6 |
| Derivative financial instruments | 26 | 150.6 | 112.8 |
| Other liabilities | 27 | 8.7 | 4.4 |
| Accruals and deferred income | 28 | 2.8 | 2.2 |
| Other provisions | 29 | 0.4 | 0.4 |
| Pension liabilities | 30 | 13.5 | 4.4 |
| **Total liabilities** | | **1,170.5** | **975.6** |
| **Share capital and reserves** | | | |
| Called-up share capital | 31 | 100.0 | 100.0 |
| Other Reserves | | 46.3 | 33.3 |
| **Total equity** | | **146.3** | **133.3** |
| **Total equity and liabilities** | | **1,316.8** | **1,108.9** |

These financial statements were approved by the Board of directors on 15 December 2016 and were signed on its behalf by:

**David Austin**
*Director*

**David Landen**
*Director*

## Statement of changes in equity
For the year ended 31 October 2016

| | Called up Share Capital | Profit and loss account | Available-for-sale reserve | Pension reserve | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **2016** | | | | | |
| At beginning of year | 100.0 | 31.8 | 4.0 | (2.5) | 133.3 |
| Profit for the financial year | - | 17.6 | - | - | 17.6 |
| Other comprehensive income | - | - | 1.1 | (5.7) | (4.6) |
| **At end of year** | **100.0** | **49.4** | **5.1** | **(8.2)** | **146.3** |

| | Called up Share Capital | Profit and loss account | Available-for-sale reserve | Pension reserve | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **2015** | | | | | |
| At beginning of year | 100.0 | 30.8 | 4.4 | (2.0) | 133.2 |
| Profit for the financial year | - | 1.0 | - | - | 1.0 |
| Other comprehensive income | - | - | (0.4) | (0.5) | (0.9) |
| **At end of year** | **100.0** | **31.8** | **4.0** | **(2.5)** | **133.3** |

# Notes to the accounts
For the year ended 31 October 2016

## 1 Accounting policies

### Basis of preparation

These financial statements were prepared in accordance with Financial Reporting Standard 101 Reduced Disclosure Framework ("FRS 101"). The amendments to FRS 101 (2014/15 Cycle) issued in July 2015 and effective immediately have been applied.

In preparing these financial statements, the Company applies the recognition, measurement and disclosure requirements of International Financial Reporting Standards as adopted by the EU ("adopted IFRSs"), but makes amendments where necessary in order to comply with Companies Act 2006 applicable to companies reporting under IFRS (Schedule 2 of the Regulation) and has set out below where advantage of the FRS 101 disclosure exemptions has been taken.

In the transition to FRS 101, the Company has applied IFRS 1 whilst ensuring that its assets and liabilities are measured in compliance with FRS 101. An explanation of how the transition to FRS 101 has affected the reported financial position and financial performance is provided in Note 37.

IFRS 1 grants certain exemptions from the full requirements of Adopted IFRS in the transition period. The following exemptions have been taken in these financial statements;

- Fair value or revaluation as deemed cost-at 1 November 2014, fair value has been used as deemed cost for investment properties previously measured at fair value.

The Company's immediate parent undertaking, The Carlyle Trust Limited, includes the Company in its consolidated financial statements. The consolidated financial statements of The Carlyle Trust Limited are prepared in accordance with International Financial Reporting Standards and are available to the public and may be obtained from The Registrar of Companies, Companies House, Crown way, Cardiff, CF14 3UZ.

In these financial statements, the Company has applied the exemptions available under FRS 101 in respect of the following disclosures:

- A Cash Flow Statement and related notes;
- Comparative period reconciliations for share capital, property plant and equipment, intangible assets and investment properties;
- Disclosures in respect of transactions with members of a group;
- The effects of new IFRSs; that have been issued but not yet effective;
- An additional balance sheet for the beginning of the earliest comparative period following reclassification of items in the financial statement; and
- Disclosures in respect of the compensation of Key Management Personnel and related parties.

The Company proposes to continue to adopt the reduced disclosure framework of FRS 101 in its next financial statements.

The accounting policies set out below have, unless otherwise stated, been applied consistently to all periods presented in these financial statements and in preparing an opening FRS 101 balance sheet as at 1 November 2014 for the purposes of the transition to FRS 101.

### Measurement convention
The Group prepares its accounts under the historical cost convention, except for certain financial assets and liabilities held at fair value and for all derivative contracts.

# Notes to the accounts

For the year ended 31 October 2016

## 1 Accounting policies (continued)

**Summary of Significant Accounting Policies**

*Consolidation*
The Company is a wholly owned subsidiary of The Carlyle Trust Limited and of its ultimate parent, The Carlyle Trust (Jersey) Limited. It is included in the consolidated financial statements of The Carlyle Trust Limited which are publicly available.

The Company is the parent of Hodge Life Assurance Company Limited. Therefore, the Company is exempt by virtue of section 400 of the Companies Act 2006 from the requirement to produce consolidated financial statements.

*Interest receivable and interest payable*
Interest receivable and payable for loans and advances to customers and customer accounts are recognised in the income statement using the effective interest rate method (EIR).

The effective interest rate method calculates the amortised cost of a financial asset or a financial liability, and allocates the interest income or interest expense over the expected product life. The EIR is the rate that exactly discounts the estimated associated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the net carrying amount of the financial asset.

In calculating the EIR, the Company estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees received and paid and costs borne that are an integral part of the EIR and other premiums above or below market rates.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

**Fees and commissions**
Fee and commission income arises through a range of services the Company provides to its customers.

Fee and commission income relates primarily to fees for arranging mortgages to customers. Fee and commission expenses primarily relate to broker fees.

Fees and commissions receivable and payable that are not spread across expected asset lives under the EIR method are taken to income on an accruals basis as services are provided, or on completion of an act to which the fee relates.

Loan commitment fees received are deferred and included in the EIR calculation upon completion of the loan.

**Segmental reporting**
The Company operates solely within the banking services sector and within the United Kingdom, as such no segmental analysis is required.

# Notes to the accounts

For the year ended 31 October 2016

## 1 Accounting policies (continued)

**Financial assets**
The Company classifies its financial assets at inception into the following categories:

**i) Loans and receivables**
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The company's commercial and residential loans and advances to customers and loans and advances to credit institutions are classified as loans and receivables and are measured at amortised cost using the effective interest rate method, net of impairment provisions, with all movements being recognised in the Income Statement. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees and costs that are an integral part of the EIR.

**ii) Fair value through profit or loss (FVTPL)**
This category consists of derivative financial assets, Treasury bills and fixed for life mortgages which are held at fair value. These financial assets are initially designated as FVTPL upon initial recognition and initially measured at fair value with transaction costs taken directly to the Income Statement. Subsequent measurement is at fair value with changes in value reflected in the Income Statement.

For those derivatives in fair value hedge accounting relationships, gains and losses arising from changes in the fair values are recognised in the Income Statement. The impact of hedging on the measurement of financial assets and liabilities is detailed in note 33, the derivatives and hedge accounting policy note.

**iii) Available-for-sale**
Available-for-sale financial assets are non-derivative financial assets, principally but not exclusively debt securities and Treasury bills intended to be held for an indefinite period of time and which may be sold in response to needs for liquidity. They are initially measured at fair value and subsequently at fair value with changes in fair value being recognised in Equity in the "Available for Sale" reserve, except for impairment losses which are recognised in the Income Statement. The fair value of available-for-sale assets is derived from market data. Where this market data is not available, an independent third party provides a valuation. If the asset is sold before maturity, cumulative gains and losses are recognised in Equity ("available for sale" reserve) and are recycled to the income statement and included in Other fair value gains/ (losses).

**iv) Held-to-maturity**

The Company does not hold any financial assets classified as held to maturity.

# Notes to the accounts
For the year ended 31 October 2016

## 1 Accounting policies (continued)

**Impairment of financial assets**
The Company assesses its loans and advances to customers for objective evidence of impairment at each Balance Sheet date. An impairment loss is recognised if, and only if, there is a loss event (or events) that have occurred after initial recognition and before the Balance Sheet date and which has a reliably measurable impact on the estimated future cash flows.

The Bank assesses at each reporting date whether there is any objective evidence that a financial asset or group of financial assets is impaired. A financial asset or group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (an incurred loss event or events) one which has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

If there is objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The resultant provisions have been deducted from the appropriate asset values in the Balance Sheet and the amount of the loss is recognised in the Income Statement.

Interest income continues to be accrued on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded as part of interest and similar income.

In the case of commercial loans that are considered individually significant, cash flows are estimated on a case-by-case basis considering the following factors:

i) Total aggregate exposure to the customer;
ii) The amount and timing of expected receipts and recoveries;
iii) The likely funds available on liquidation or bankruptcy including any guarantees;
iv) The realisable value of security at the expected date of sale and likelihood of successful repossession; and
v) The deduction of any likely costs involved in recovery of amounts outstanding.

In the case of commercial loans that are not considered individually significant, cash flows are estimated based on past experience taking into account the total exposure to the customer, the likelihood that the loan will progress through the various stages of delinquency, including being written off and the amount and timing of expected receipts and recoveries.

The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Company to reduce any difference between loss estimates and actual loss experience. If, in a subsequent period, the amount for the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the provision is adjusted and the amount of the reversal is recognised in the Income Statement.

Where a loan is not recoverable, it is written off against the related provision for loan impairment once all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses recorded in the Income Statement. Loans subject to individual impairment assessment are subject to ongoing review to determine whether they remain impaired or are considered to be past due. Management applies overlays to assumptions where there is a lack of past experience.

# Notes to the accounts

For the year ended 31 October 2016

## 1 Accounting policies (continued)

**Cash and balances Held at Central Banks**

Cash and balances held at Central Banks includes cash in hand, deposits held at call with central banks, other short term highly liquid investments with original maturities of three months or less and bank overdrafts.

**Financial Liabilities**

Financial liabilities incorporates bank and other deposits, amounts owed to other customers and derivative financial liabilities. The Company classifies its financial liabilities into the following categories:

**i) Amortised cost**

Financial liabilities (other than derivatives) are measured on an amortised cost basis. This represents the face value adjusted for any unamortised premiums, discounts and transaction costs directly attributable to the acquisition or issue. The amortisation is recognised in interest payable and similar charges using the EIR method.

**ii) Fair value through profit or loss**

All derivatives are initially measured at fair value and subsequently measured at fair value.

For those derivatives in fair value hedge accounting relationships and for any derivatives not in a hedge accounting relationship, gains and losses arising from changes in the fair values are recognised in the Income Statement. The impact of hedging on the measurement of financial assets and liabilities is detailed in note 33, the derivatives and hedge accounting policy note.

Financial liabilities held at fair value through the profit or loss are stated at fair value, with any gains or losses arising on re-measurement recognised in the Income Statement. The net gain or loss recognised in the Income Statement incorporates any interest paid on the financial liability and is included in the 'other gains and losses' line item in the Income Statement.

**De-recognition of financial assets and financial liabilities**

**(i) Financial assets**

A financial asset is de-recognised when:

– The rights to receive cash flows from the asset have expired.

– The Company has transferred its rights to receive cash flows from the asset or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a "pass-through arrangement; and either

– The Company has transferred substantially all the risks and rewards of the asset

Or

– The Company has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

**(ii) Financial liabilities**

Financial liabilities are de-recognised when the obligation is discharged, cancelled or has expired. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing facility are substantially modified, such an exchange or modification is treated as a de-recognition of the original liability and the recognition of a new liability. The difference between the carrying value of the original financial liability and the consideration paid is recognised in the Income Statement.

# Notes to the accounts
For the year ended 31 October 2016

## 1 Accounting policies (continued)

**Derivative financial instruments**
The Company holds derivative financial instruments to manage the risks associated with its various fixed rate assets and its fixed rate liabilities. The Company has no foreign currency transactions. In accordance with its treasury policy, the Company holds derivative financial instruments only for risk management and not for speculative or trading purposes.

Derivatives are initially measured at fair value on the date on which the derivative contract is entered into and are subsequently re-measured to fair value at each reporting date with movements recorded in the Income Statement. Fair values are calculated by discounted cash flow models using yield curves that are based on observable market data or are based on valuations from counterparties. Fair values are calculated using mid-prices. All derivatives are classified as assets where their fair value is positive and liabilities where their fair value is negative. Where there is the legal ability and intention to settle net, the derivative is classified as a net asset or liability, as appropriate.

Where cash collateral is given, to mitigate the risk inherent in amounts due from the Company, it is included as an asset in 'loans and advances to credit institutions'.

**Loans and advances to credit institutions**

The International Swaps and Derivatives Association (ISDA) Master Agreement is the Company's preferred agreement for documenting derivative activity. For certain counterparties a Credit Support Annex (CSA) has been executed in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between counter-parties to mitigate the market contingent counterparty risk inherent in the outstanding positions.

**Embedded derivatives**
Certain derivatives are embedded within other non-derivative host instruments to create a hybrid instrument. Where the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risk of the host instrument, the Company separates the embedded derivative from the host instrument and measures it at fair value with the changes in fair value recognised in the income statement.

The "no-negative equity guarantee" is an embedded derivative and further details are disclosed in Note 33(d).

**Hedge accounting**
All derivatives entered into by the Company are for the purposes of providing an economic hedge. Where the criteria set out in IAS 39 are met, the Company uses hedge accounting and designates the hedging derivative as hedging fair value risks.

At inception of the hedge relationship, the Bank formally documents the relationship between the hedged item and the hedging instrument, including the nature of the risk, the risk management objective and strategy for undertaking the hedge and the method that will be used to assess the effectiveness of the hedging relationship at inception and on an ongoing basis.

At each hedge effectiveness assessment date, a hedge relationship must be expected to be highly effective on a prospective basis and demonstrate that it was effective (retrospective effectiveness) for the designated period in order to qualify for hedge accounting. A formal assessment is undertaken by comparing the hedging instrument's effectiveness in offsetting the changes in fair value or cash flows attributable to the hedged risk in the hedged item, both at inception and at each quarter end on an ongoing basis. A hedge is expected to be highly effective if the changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated were offset by the hedging instrument in a range of 80% to 125% and were expected to achieve such offset in future periods.

## 1 Accounting policies (continued)

Hedge ineffectiveness is recognised in the Income Statement in other fair value gains/ (losses). For situations where the hedged item is a forecast transaction, the Company also assesses whether the transaction is highly probable and presents an exposure to variations in cash flows that could ultimately affect the income statement.

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the Income Statement under other fair value gains/ (losses) in the period in which the movement occurs together with the change in fair value of the hedged asset or liability that is attributable to the hedged risk (interest rate risk). This also applies if the hedged item is classified as an Available-for-sale financial asset.

**Shares in subsidiaries**
Investments in subsidiary undertakings and participating interests are stated at cost less accumulated impairment losses.

**Intangible assets**
IAS 38 'Intangible Assets' requires the capitalisation of certain expenditure relating to software development costs. Software development costs are capitalised if it is probable that the asset created will generate future economic benefits. Costs incurred to establish technological feasibility or to maintain existing levels of performance are recognised as an expense.

Where software costs are capitalised, they are amortised using the straight-line method over their estimated useful lives which is three to five years. The amortisation periods used are reviewed annually. Costs associated with maintaining software are expensed as they are incurred. Amortisation is charged to administration expenses in the Income Statement.

**Property, plant and equipment**
Property, plant and equipment is stated at cost less accumulated depreciation and any accumulated impairment losses. The carrying values of property, plant and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

An asset's carrying value is written down immediately to its recoverable amount if the asset's carrying value is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing the net disposal proceeds with the carrying value of the asset and are included within the Income Statement.

Depreciation is provided on a straight line basis over the anticipated useful lives as follows:

| | | |
|---|---|---|
| Fixtures, fittings and equipment | - | 5 years |
| Short leasehold improvements | - | Shorter of remaining term of the lease and useful life |

Depreciation methods, useful lives and residual values are reviewed, and adjusted if appropriate, at the end of each reporting period.

**Investment properties**

**i) Investment properties held by Company**
Investment property is property held to earn rentals, for capital appreciation or for both, rather than for sale or use in the business. The company recognises investment properties initially at cost and subsequently at fair value, with any change therein recognised in profit or loss within other operating income.

# Notes to the accounts

For the year ended 31 October 2016

## 1 Accounting policies (continued)

Fair value is based on valuations by external independent valuers and is performed at least annually to ensure that the fair value of investment properties does not differ materially from its carrying amount**.**

No depreciation is provided in respect of investment properties applying fair value.

Investment properties are de-recognised either when they have been disposed of, or when the investment property is permanently withdrawn from use and no future economic benefits is expected from its disposals. Any gains/ losses on the retirement or disposal of an investment property are recognised in the Income Statement in the year of disposal.

**ii) Reversionary interests in properties**
Reversionary interests in properties are included in the financial statements initially at cost (being the amount of the cash advanced to the customer together with related acquisition costs), and subsequently at fair value, with any change therein recognised in the Income Statement within other income.

The current market value is taken as the last formal valuation of the property on a vacant possession basis, modified by the change in the monthly national Nationwide House Price Index, adjusted down by an annual underperformance assumption.

A further deduction is made from the value to reflect the expected sale expenses and a delay factor between death and sale of the property.

Investment properties are de-recognised either when they have been disposed of, or when the investment property is permanently withdrawn from use and no future economic benefits is expected from its disposals. Any gains/ losses on the retirement or disposal of an investment property are recognised in the Income Statement in the year of disposal.

The calculation of the reimbursement asset is based on the split of scheme members by employer.

**Assets classified as held for sale**
Assets classified as held for sale are presented separately in the balance sheet and are carried at the lower of their carrying amount and fair value less costs to sell. These assets are classified as held for sale only if available for immediate sale in their present condition, a sale is highly probable and expected to be completed within one year from the date of classification. These assets are not amortised from date of classification.

**Taxation including deferred tax**
Corporation tax on profits for the year comprises current and deferred taxation.

Current tax assets and liabilities are measured at the amount expected to be recovered from or paid to the taxation authorities, based on tax rates and laws that are enacted or substantively enacted by the Balance Sheet date.

Deferred tax is recognised on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the deductible temporary differences, carried forward tax credits or tax losses can be utilised.

Deferred tax assets and liabilities are measured on a non-discounted basis at the tax rates that are expected to apply when the related asset is realised or liability settled based on the tax rates and laws enacted or substantively enacted at the Balance Sheet date.

# Notes to the accounts

For the year ended 31 October 2016

## 1 Accounting policies (continued)

Corporation tax is charged or credited directly to other comprehensive income if it relates to items that are credited or charged to other comprehensive income and to the statement of changes in equity if it relates to items that are credited or charged directly to equity. Otherwise corporation tax is recognised in the Income Statement.

**Employee benefits**

**i) Pensions**
The Company operates a defined benefit pension scheme for members of staff. The Company and its subsidiary undertaking are participating employers in The Carlyle (1972) Pension and Life Assurance Scheme, a defined benefits scheme operated by The Carlyle Trust Limited. The assets of the scheme are held separately from those of the Company.

The Company's net obligation under the defined benefit pension scheme is assessed annually by an independent qualified actuary. The net obligation is calculated as the difference between the fair value of the scheme's assets and the amount of future entitlements earned by scheme members from service in the current and prior periods, discounted back to present values using a rate based on an index of long-dated AA rated corporate bonds using the projected unit method. This calculation allows the net obligation of the scheme to be expressed as either a surplus or deficit, which is recognised as either an asset or liability respectively in the Company's accounts at the balance sheet date.

Pension costs for service in the period are assessed in accordance with advice from a qualified actuary and are recognised in the Income Statement. Gains or losses arising from the re-measurement of the defined benefit plan are recognised in full, in the year they occur, in the Statement of Other Comprehensive Income.

**ii) Reimbursement asset on pension deficit**
The Bank has recognised a reimbursement asset in respect of its pension scheme deficit (see note 30). The obligation falls to the Bank's immediate parent, The Carlyle Trust Limited. The movement in the reimbursement asset each year (following its initial recognition in the year ended 31 October 2014) is recognised in the Income Statement to the extent that the reimbursement relates to a charge in the Bank's Income Statement. Any movement in the reimbursement asset which does not relate to the Company's Income Statement is recognised in the Statement of Other Comprehensive Income.

**iii) Short-term employment benefits**
The cost of short-term employee benefits, including wages and salaries, social security costs, bonuses payable within twelve months and healthcare, is recognised in the year of service.

**Leases**
Where the Company enters into a lease that entails taking substantially all the risks and rewards of ownership of an asset the agreement is treated as a finance lease. The asset is recorded on the Balance Sheet within property, plant and equipment and is depreciated over its estimated useful life. If there is no reasonable certainty that the Company will obtain ownership at the end of the lease term, the asset is depreciated over the shorter of the lease term and its useful life. Future instalments under such leases, net of finance charges, are included within other liabilities. Rentals payable are apportioned between the finance element, which is charged to the Income Statement at a constant annual rate, and the capital element, which reduces the outstanding obligation for future instalments.

All other leases are accounted for as operating leases and payments are charged to administration expenses on a straight line basis over the period of the lease.

# Notes to the accounts
For the year ended 31 October 2016

## 1 Accounting policies (continued)

**Provisions and contingent liabilities**
A provision is recognised when there is a present obligation as a result of a past event, it is probable that the obligation will be settled and the amount can be estimated reliably. The expense relating to any increase in provision is charged to the Income Statement.

Contingent liabilities are potential obligations from past events which shall be confirmed by future events. Contingent liabilities are not recognised within the Balance Sheet unless arising from a business combination.

**Share capital**
Ordinary shares are classified as equity.

Incremental costs directly attributable to the issue of new ordinary shares are shown in equity as a deduction, net of tax, from the proceeds.

**Available for Sale Reserve**
The Available for Sale Reserve comprises changes in fair values of available for sale investments in the period.

**Funding for lending scheme (FLS)**
In order for the Company to access funding from the FLS, mortgages, covered bonds, supranationals and gilts have been pledged as collateral. Where the risk and reward of ownership of the collateral remains with the Company they are retained on Balance Sheet. The interest receivable on these assets continues to be accounted for as earned on an accruals basis. FLS transactions do not involve the transfer of risk on the collateral and hence fail the recognition criteria under IAS 39. Therefore, for accounting purposes, the underlying collateral is retained on the Balance Sheet and the Treasury bills received are not.

## 2 Judgement in applying accounting policies and critical accounting estimates

The Company has to make judgements in applying its accounting policies which affect the amounts recognised in the accounts. In addition, estimates and assumptions are made that could affect the reported amounts of assets and liabilities within the following financial year. The most significant areas where judgement and estimates are made are as follows:

**Commercial Loans EIR**
The Company recognises interest on loans and advances to customers on the basis of their Effective Interest Rate (EIR). This is a constant rate that averages out the effect of incentives and fees across the expected life of the loan account. A critical assumption in the calculation is the expected life, as this determines the assumed period over which customers may be paying various differentiated interest rates. The calculation of the EIR uses assumptions on expected life that are based on the experience of similar products. These assumptions are monitored to ensure their ongoing appropriateness. Changes in the amortised cost balance arising from actual product life experience, differing from the assumed life, are periodically calculated and an adjustment made to the loan balance, with a corresponding adjustment to interest receivable and similar income.

An increase in the average expected life of one month would result in an increase in loans and advances to customers of £10,000, with a corresponding reduction to income in the Income Statement.

Assumptions as to future market interest rates also affect the calculation.

**Impairment losses on loans and advances to customers**
In accordance with the accounting policy described in note 1, impairment is measured as the difference between an asset’s carrying amount and the present value of management’s estimate of discounted future cash flows. Key assumptions include the probability of any account going into default, the probability of defaulting accounts progressing to possession and the eventual loss incurred in the event of forced sale or write-off. These assumptions are based on observable historical (and other independent third party) data and updated as management considers appropriate to reflect current conditions.

In assessing the need for collective loss allowance, management considers factors such as credit quality, portfolio size, concentrations and economic factors. To estimate the required allowance assumptions are made based on historical experience and current economic conditions.

The sensitivity of provisions is affected in part due to the company’s policy of limiting advances to a maximum of 60% of property market value for residential properties. If average residential property prices were to fall by 10%, no further provision would be required.

The loan loss provision against the Commercial lending portfolio is sensitive to a number of factors including: Commercial real estate values at the expected date of sale, the likely funds available on liquidation or bankruptcy, including any guarantees, and the time taken to dispose of the collateral.

These assumptions are based on observed historical data and updated as management considers appropriate to reflect current and future conditions. The accuracy of the impairment provision would therefore be affected by unexpected changes in the above assumptions.

# Notes to the accounts
For the year ended 31 October 2016

## 2 Judgement in applying accounting policies and critical accounting estimates (continued)

**Fair values of Financial Instruments and Investment Properties**
The company uses widely recognised valuation models for determining the fair value of common and simple financial instruments, such as interest rate swaps that use only observable market data and require little management judgement and estimation.

Availability of observable market prices and model inputs reduces the need for management judgement and estimation and also reduces the uncertainty associated with determining fair values. Availability of observable market prices and inputs varies pending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

The major assumptions for Financial Instruments and Investment Properties are disclosed within the following notes:

| Area of significant judgement or risk | Note |
|---|---|
| Investment properties | 21 |
| Fixed for life mortgages | 33(d) |

**Pension scheme**
The Group has to make assumptions on the expected return on pension scheme assets, mortality, inflation and future salary rises when valuing its pension liability and the cost of benefits provided. Changes in assumptions could affect the reported liability, service cost and expected return on pension scheme assets.

Further details on the assumptions used in valuing pension obligations and other sensitivity analysis can be found in note 30.

# Notes to the accounts

For the year ended 31 October 2016

## 3 Reconciliation to non-GAAP measures and performance

In measuring the Company's adjusted performance, additional financial measures derived from the reported results have been used in order to eliminate factors which distort year on year comparisons. The Company's adjusted performance is used to explain year on year changes when the effect of certain items is significant, including net losses from revaluation of derivative financial instruments (interest rate swaps) and net gains or losses arising from fair value re-measurement. The Directors consider that this basis more appropriately reflects operating performance and a better understanding of the key performance indicators of the business.

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| **Reconciliation of net operating income to adjusted net operating income** | | |
| Net operating income | 33.5 | 8.9 |
| Adjusted for: | | |
| Net losses from derivative financial instruments; | 35.8 | 22.1 |
| Net gains arising from fair value re-measurements | (55.0) | (23.3) |
| **Adjusted net operating income** | **14.3** | **7.7** |

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| **Reconciliation of profit before tax to adjusted profit before tax** | | |
| Profit before tax | 22.8 | 1.6 |
| Adjusted for: | | |
| Net losses from derivative financial instruments; | 35.8 | 22.1 |
| Net gains arising from fair value re-measurements | (55.0) | (23.3) |
| **Adjusted profit before tax** | **3.6** | **0.4** |

The principal reconciling items are as follows:

**Net losses from derivative financial instruments**
Under FRS 101, the market value of the interest rate swaps is required to be reflected on the balance sheet. The movement of £35.8 million for the year to 31 October 2016 (2015; £22.1 million) represents the movement in market value of the derivative financial instruments for the year ending 31 October.

**Net gains arising from fair value re-measurements**
The fair value re-measurements relate to those assets and liabilities fair valued as disclosed in note 33. They reflect market value at 31 October discounted at an appropriate discount rate to reflect the time value of money.

# Notes to the accounts
For the year ended 31 October 2016

## 4 Segmental information

The Board of Directors is the Company's chief operating decision-maker. Management has determined the operating segments based on information reviewed by the Board of Directors for the purposes of allocating resources and assessing performance.

The Company operates solely within the banking services sector and within the United Kingdom, as such no segmental analysis is required.

## 5 Interest receivable and similar income

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Loans and advances to customers | 36.2 | 28.3 |
| Loans and advances to credit institutions | 0.7 | 0.5 |
| On other loans | 1.4 | 1.6 |
| Interest and other income on treasury bills & debt securities | 3.9 | 4.0 |
| | **42.2** | **34.4** |

## 6 Interest payable and similar charges

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| On customer accounts | 16.3 | 14.4 |
| On derivative financial instruments (see Note 26) | 12.7 | 13.3 |
| | **29.0** | **27.7** |

## 7 Other operating income

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Rental income from investment properties (Note 21) | - | 0.8 |
| Profit on sale of debt securities | 0.1 | 0.1 |
| Profit on assets available for sale | 0.7 | 0.6 |
| | **0.8** | **1.5** |

# Notes to the accounts
For the year ended 31 October 2016

## 8 Other fair value gains

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Losses on derivatives designated as fair value | (35.8) | (22.1) |
| Gains on assets designated as fair value* | 54.9 | 23.4 |
| Losses on derivatives designated as fair value hedges | - | (0.5) |
| Movement in fair value of hedged items attributable to hedged risk | 0.1 | 0.4 |
| | **19.2** | **1.2** |

*The unrealised gains/(losses) arising from changes in fair values of investment properties are disclosed in Note 21.

Fair value gains/(losses) on Available-for-sale investments of £1.1m (2015(0.4m)) has been taken to the Statement of Other Comprehensive Income.

## 9 Profit on ordinary activities before taxation

| | 2016 | 2015 |
|---|---|---|
| | £000 | £000 |
| **Profit on ordinary activities before taxation is stated after charging:** | | |
| Remuneration of the auditor and its associates | | |
| Audit of these financial statements | 57 | 25 |
| Other services relating to taxation | - | 25 |
| Other advisory services | - | 15 |
| Depreciation | 76 | 44 |
| Amortisation | 140 | - |
| Bad debt provision charge | 2,406 | 200 |

The fees paid to the Auditors in 2015 were paid to KPMG LLP, the previous auditors to the Company. Fees relating to 2016 were paid to Ernst & Young LLP.

# Notes to the accounts
For the year ended 31 October 2016

## 10 Administrative expenses

| | 2016 £m | 2015 £m |
|---|---|---|
| **Staff costs** | | |
| Wages and salaries | 4.1 | 3.8 |
| Social security | 0.4 | 0.3 |
| Pension costs (note 30) | 0.6 | 0.6 |
| | **5.1** | **4.7** |
| Other administrative expenses | 3.0 | 2.4 |
| | **8.1** | **7.1** |

**Directors and employees**
The average number of employees of the Company during the year was as follows:

| | 2016 No | 2015 No |
|---|---|---|
| Provision of finance and banking | 130 | 101 |
| | **130** | **101** |

Staff costs include remuneration in respect of directors as follows:

| | 2016 £m | 2015 £m |
|---|---|---|
| Fees | 0.2 | 0.1 |
| Aggregate emoluments as executives | 0.4 | 0.4 |
| | **0.6** | **0.5** |

The emoluments of the highest paid director, excluding pension contributions, were as follows:

| | 2016 £000 | 2015 £000 |
|---|---|---|
| Aggregate emoluments | 214 | 168 |
| | **214** | **168** |

The highest paid director is a deferred member of a defined benefit scheme under which his accrued pension at the year end was £46,200 *(2015: £61,000).*

Retirement benefits are accruing to 1 *(2015: 2)* director in a defined benefit scheme.

# Notes to the accounts
For the year ended 31 October 2016

## 11 Tax on profit

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| **Analysis of charge in year** | | | | |
| *UK corporation tax* | | | | |
| Current tax on income for the year | 10.9 | | 0.7 | |
| **Total current tax** | | **10.9** | | **0.7** |
| *Deferred tax (see note 22)* | | | | |
| Origination/reversal of timing differences | (5.7) | | (0.1) | |
| **Total deferred tax** | | **(5.7)** | | **(0.1)** |
| **Tax on profit on ordinary activities** | | **5.2** | | **0.6** |

The total tax charge for the year is higher (*2015: higher)* than the blended rate of corporation tax in the UK. The differences are explained below.

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| *Total tax reconciliation* | | |
| Profit on ordinary activities before tax | 22.8 | 1.6 |
| **Current tax at 20% (2015: 20.42%)** | **4.6** | **0.3** |
| Expenses not deductible for tax purposes | | - |
| Investment properties | - | 0.3 |
| Index Linked Gilt RPI movement | (0.1) | (0.1) |
| Rate differences | 0.8 | 0.1 |
| Other | (0.1) | - |
| | | |
| **Total tax charge (see above)** | **5.2** | **0.6** |

Reductions in the UK corporation tax rate to 19% (effective from 1 April 2017) and to 18% (effective 1 April 2020) were substantively enacted on 26 October 2015. A further reduction to 17% (effective 1 April 2020) was substantively enacted on 6 September 2016. This will reduce the company's future current tax charge accordingly.

The deferred tax asset at 31 October 2016 has been calculated based on these rates.

# Notes to the accounts
For the year ended 31 October 2016

## 12 Cash and balances held at central banks

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Repayable on demand: | | |
| Deposits with other central banks | 168.0 | 101.6 |
| | **168.0** | **101.6** |

## 13 Treasury bills

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Listed on a UK recognised investment exchange | 81.0 | 81.1 |
| Fair value adjustment – Hedge Accounting | 3.7 | 2.9 |
| | **84.7** | **84.0** |

The movement in debt securities is summarised as follows:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At 1 November | 84.0 | 75.5 |
| Additions | 23.0 | 7.0 |
| Redemptions | (25.0) | (1.6) |
| Gains from changes in fair value | 2.7 | 3.1 |
| **At 31 October** | **84.7** | **84.0** |

Of this amount £51m *(2015: £48m)* has been provided as collateral for derivative financial instruments (see note 26). Collateral that has been pledged is not restricted.

# Notes to the accounts
For the year ended 31 October 2016

## 14 Debt securities

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Debt securities – listed on a UK recognised investment exchange | 83.0 | 83.2 |
| Fair value adjustment – Hedge Accounting | 1.4 | 1.5 |
| Fair value adjustment – Available for Sale | 4.7 | 3.5 |
| | **89.1** | **88.2** |

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| ***Debt securities – maturity analysis*** | | |
| Within three months | 11.2 | 2.2 |
| Between three months and one year | 9.0 | 1.8 |
| More than one year but less than five years | 36.4 | 50.7 |
| Five years and over | 32.5 | 33.5 |
| | **89.1** | **88.2** |

Of this amount £21.2m *(2015: £18.7m)* has been pledged as collateral under the Funding for Lending Scheme. Collateral is provided by the Bank of England in the form of Treasury Bills against residential borrowing, as part of its participation in the FLS, which the Bank is permitted to re-use. Collateral that has been pledged is not restricted.

## 15 Loans and advances to credit institutions

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Repayable on demand | 27.6 | 20.5 |
| Collateral held by swap counterparties | 100.7 | 69.0 |
| | **128.3** | **89.5** |

The collateral is pledged against the market value of derivative instruments and comprises interest-bearing cash deposits (see Note 26). Collateral that has been pledged and held are not restricted and are returned at the end of the contract. There are no provisions held in respect of loans and advances to credit institutions (2015: Nil).

# Notes to the accounts

For the year ended 31 October 2016

## 16 Loans and advances to customers

| | 2016 £m | 2015 £m |
|---|---|---|
| Loans and advances – classified as loans and receivables | 374.2 | 325.8 |
| Amounts owed to immediate parent and fellow subsidiaries | 1.3 | 6.2 |
| Fair value adjustment for hedged risk | 0.4 | 0.9 |
| | **375.9** | **332.9** |
| Loans and advances (fixed for life mortgages) – classified as fair value through profit & loss – see note 33 | 331.0 | 291.9 |
| | **706.9** | **624.8** |

Of this amount £80.0m *(2015: £80.5m)* has been pledged as collateral under the Funding for Lending Scheme. Collateral is provided by The Bank of England in the form of Treasury Bills against residential borrowing, as part of its participation in the FLS, which the Bank is permitted to re-use. Collateral that has been pledged and held are not restricted and are returned at the end of the contract.

| | 2016 £m | 2015 £m |
|---|---|---|
| Loans and advances to customers | | |
| Gross balances | 386.5 | 335.3 |
| Less: Provision for impairment | (10.0) | (7.6) |
| Less: Loan fee deferral | (2.3) | (1.9) |
| **Net balance** | **374.2** | **325.8** |

# Notes to the accounts
For the year ended 31 October 2016

## 17 Impairment provisions on loans and advances to customers

| | Specific £m | Collective £m | Total £m |
|---|---|---|---|
| **2016** | | | |
| At 1 November 2015 | 6.9 | 0.7 | 7.6 |
| Amounts written back during the year | (0.5) | (0.5) | (1.0) |
| Charge for loan impairment | 3.4 | - | 3.4 |
| **At 31 October 2016** | **9.8** | **0.2** | **10.0** |

| | Specific £m | Collective £m | Total £m |
|---|---|---|---|
| **2015** | | | |
| At 1 November 2014 | 5.9 | 1.5 | 7.4 |
| Amounts written back during the year | (0.5) | (0.8) | (1.3) |
| Charge for loan impairment | 1.5 | - | 1.5 |
| **At 31 October 2015** | **6.9** | **0.7** | **7.6** |

For further details on loans and advances to customers refer to Note 34(a).

## 18 Shares in subsidiary undertakings

| | 2016 £m | 2015 £m |
|---|---|---|
| At cost | 16.0 | 16.0 |
| | **16.0** | **16.0** |

The Bank's only subsidiary undertaking is as follows:

| Subsidiary undertaking | Country of incorporation | Principal activity | Class and percentage of shareholding |
|---|---|---|---|
| Hodge Life Assurance Company Limited | United Kingdom | Life Assurance | 100% |

The registered address for Hodge Life Assurance Company Limited is One Central Square, Cardiff, CF10 1FS.

# Notes to the accounts

For the year ended 31 October 2016

## 19 Intangible assets

| | Computer software | |
|---|---|---|
| | 2016 | 2015 |
| | £m | £m |
| **Cost:** | | |
| At 1 November 2015 | 1.2 | 0.6 |
| Additions | 0.1 | 0.6 |
| **At 31 October 2016** | **1.3** | **1.2** |
| **Amortisation:** | | |
| At 1 November 2015 | - | - |
| Amortisation | (0.1) | - |
| **At 31 October 2016** | **(0.1)** | **-** |
| **Net book value:** | | |
| **At 31 October** | **1.2** | **1.2** |

## 20 Property, plant and equipment

| 2016: | Short leasehold improvements | Fixtures, fittings and equipment | Total |
|---|---|---|---|
| | £m | £m | £m |
| **Cost:** | | | |
| At 1 November 2015 | - | 0.8 | 0.8 |
| Additions | 1.5 | 0.6 | 2.1 |
| **At 31 October 2016** | **1.5** | **1.4** | **2.9** |
| **Depreciation:** | | | |
| At 1 November 2015 | - | (0.7) | (0.7) |
| Depreciation | - | (0.1) | (0.1) |
| **At 31 October 2016** | **-** | **(0.8)** | **(0.8)** |
| **Net book value:** | | | |
| **At 31 October 2016** | **1.5** | **0.6** | **2.1** |
| At 31 October 2015 | - | 0.1 | 0.1 |

# Notes to the accounts
For the year ended 31 October 2016

## 21 Investment properties

| | Freehold | Reversionary Interests | Total |
|---|---|---|---|
| | £m | £m | £m |
| **2016** | | | |
| At 1 November 2015 | 7.7 | 89.3 | 97.0 |
| Additions | 2.2 | 0.1 | 2.3 |
| Disposals | - | (5.3) | (5.3) |
| Valuation adjustment | (1.1) | - | (1.1) |
| Fair value adjustments | - | 14.9 | 14.9 |
| **At 31 October 2016** | **8.8** | **99.0** | **107.8** |

The fair value of freehold investment properties was determined by external, independent property valuers, having appropriate recognised professional qualifications and recent experience in the location and category of the property being valued.

The historical cost of the freehold investment properties was:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At cost | 12.6 | 10.3 |
| | **12.6** | **10.3** |

All of the investment properties have been categorised as a Level 3 fair value based on the inputs to the valuation technique used (see note 33).

The amounts recognised in the Income Statement in respect of Investment Properties were as follows:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Rental income from Investment properties | - | 0.8 |
| Direct operating expenses from Investment properties that generated rental income in year | - | (0.1) |
| Direct operating expenses from Investment properties that did not generate rental income in year | (0.4) | - |
| | **(0.4)** | **0.7** |

# Notes to the accounts
For the year ended 31 October 2016

## 21 Investment properties (continued)

Reversionary interests are categorised as Level 3 in the fair value hierarchy. There were no transfers into or out of Level 3 in the year.

**Reversionary interests - principal assumptions**

All gains and losses arising from reversionary interests are largely dependent on the longevity of the tenant.

Principal assumptions underlying the calculation of reversionary interests include the following:

**Mortality or entry into long term care**
This is based on the expected death or entry into long term care of the tenant or the last remaining tenant in relation to a joint contract. Mortality assumptions have been derived by reference to appropriate standard mortality tables and reflect mortality improvements.

**Expenses**
Assumptions for future policy expense levels are based on the Company's recent expense analyses. Expenses are modelled as an amount per policy per annum that incorporates an annual inflation rate allowance of 4.30% (2015: 3.88%).

**Discount rate**
The discount rate applied to the reversion cash flows comprises two parts: a risk free yield curve and an allowance for illiquidity. The risk free yield curve is based on the GBP curve published by EIOPA.

The average discount rate for the portfolio (assumed to be the 15 year point on the yield curve based on average duration at 31 October 2016) was 2.24% (31 October 2015: 3.12%).

**Property prices**
The value of a property is based on the value at the last survey increased to the current valuation date using an appropriate index of house prices, this is then adjusted down by an annual underperformance assumption. No future property price inflation is assumed beyond the valuation date.

**Sensitivity analysis**
Changes to unobservable inputs used in the valuation technique could give rise to significant changes in the fair value of the assets. The Group has estimated the impact on profit for the period arising from changes to these inputs as follows.

| | Freehold | Reversionary Interests | | |
|---|---|---|---|---|
| | Net Initial yield + 1% | Mortality or entry into long term care - 10% | Expenses +10% | Property prices -10% |
| | £m | £m | £m | £m |
| **Net decrease in profit before tax** | | | | |
| **At 31 October 2016** | **(1.3)** | **(1.4)** | **(0.1)** | **(10.0)** |
| At 31 October 2015 | (0.8) | (1.9) | (0.2) | (8.9) |

# Notes to the accounts

For the year ended 31 October 2016

## 22 Deferred tax

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At 1 November | 1.5 | 1.3 |
| Credited to the income statement | 5.7 | 0.1 |
| Credited to the statement of other comprehensive income | 1.1 | 0.1 |
| **At 31 October** | **8.3** | **1.5** |

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

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Accelerated capital allowances | 0.3 | 0.1 |
| Other timing differences | 6.2 | 0.8 |
| Pension adjustment | 1.8 | 0.6 |
| **At 31 October** | **8.3** | **1.5** |

The unprovided deferred tax asset is £Nil (2015: £Nil).

## 23 Other assets

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Prepayments and accrued income | 0.8 | 0.5 |
| Pension reimbursement asset | 3.4 | 1.1 |
| Other assets | 0.2 | - |
| **At 31 October** | **4.4** | **1.6** |

## 24 Assets classified as held for sale

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At 1 November | 3.4 | 3.2 |
| Disposal | (4.2) | (0.7) |
| Reversal of impairment of previous years | 0.8 | 0.9 |
| **At 31 October** | **-** | **3.4** |

Assets classified as held for sale in the prior year related to property which was being actively marketed for sale and was expected to be sold within the next twelve months.

# Notes to the accounts
For the year ended 31 October 2016

## 25 Deposits from customers

| | 2016<br>£m | 2015<br>£m |
|---|---|---|
| Repayable on demand | 26.5 | 10.3 |
| With agreed maturity dates or periods of notice and repayable: | | |
| - within three months | 353.5 | 321.0 |
| - between three months and one year | 318.1 | 276.7 |
| - between one and five years | 293.6 | 240.6 |
| - over five years | - | - |
| | **991.7** | **848.6** |

## 26 Derivative financial instruments

Interest rate swaps are used by the Company for hedging purposes. These are commitments to exchange one set of cash flows for another. No exchange of principal takes place.

| | Contract/notional amount | | Fair value | |
|---|---|---|---|---|
| | 2016<br>£m | 2015<br>£m | 2016<br>£m | 2015<br>£m |
| **Derivative liabilities held for hedging purposes and designated fair value hedges:** | | | | |
| Interest rate swaps | 326.9 | 415.8 | 143.9 | 108.0 |
| RPI index linked interest rate swaps | 55.0 | 55.0 | 0.9 | (0.9) |
| Fair value adjustment for hedged risk | 179.3 | 94.5 | 5.8 | 5.7 |
| **Total recognised derivative liabilities** | **561.2** | **565.3** | **150.6** | **112.8** |

# Notes to the accounts
For the year ended 31 October 2016

## 26 Derivative financial instruments (continued)

The following table describes the types of derivatives used, the related risks and the activities against which the derivative financial instruments are used to hedge.

| Type of Hedge | Risk | Activity |
|---|---|---|
| Interest rate swap | Sensitivity to changes in interest rates | Fixed rate savings products, fixed rate residential mortgages and fixed rate commercial loans. |
| RPI index linked interest rate swaps | Interest rates linked to retail price index | Investment securities linked to RPI |

At 31 October 2016, the fixed interest rates vary from 0.7% to 5.4% (2015: 0.6% to 5.4%) and the main floating rates are LIBOR. Gains and losses recognised on interest rate swap contracts are credited/ charged to the Income Statement.

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Gains | 0.8 | 0.9 |
| Losses | (13.5) | (14.2) |
| **Net losses to 31 October** | **(12.7)** | **(13.3)** |

The collateral pledged against the market value of derivative instruments comprises interest-bearing cash deposits, which are included in loans and advances to credit institutions (note 15), and Treasury bills (note 13).

## 27 Other liabilities

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Due within one year: | | |
| Corporation tax | 7.4 | 0.3 |
| Other taxation and social security | - | 0.1 |
| Amounts owed in relation to mortgages administered for third parties | 1.1 | 3.0 |
| Other creditors | 0.2 | 1.0 |
| | **8.7** | **4.4** |

## 28 Accruals and deferred income

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Due within one year: | | |
| Accruals | 2.8 | 2.2 |
| | **2.8** | **2.2** |

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# Notes to the accounts
For the year ended 31 October 2016

## 29 Other provisions

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At 1 November | 0.4 | 0.3 |
| Additions | 0.1 | 0.1 |
| Utilisation | (0.1) | - |
| **At 31 October** | **0.4** | **0.4** |

The Company is a member of the Financial Services Compensation Scheme (FSCS), and it has been advised that it will be asked to contribute additional levies for the foreseeable future following the failure of a number of banks. The amount held on the balance sheet in relation to the above at 31 October 2016 was £0.3m (2015: £0.3m).

In addition, a provision of £0.1m (2015: £0.1m) for conduct risk in relation to PPI is included at the balance sheet date.

## 30 Pension scheme

The Carlyle Trust Group operates a defined benefit pension scheme for certain directors and employees, The Carlyle (1972) Pension and Life Assurance Scheme.

The assets of the scheme are administered by Trustees and are held in a fund that is separate and independent of other Bank funds. The scheme was established with effect from 1972, is fully approved under Chapter I Part XIV of the Income and Corporation Taxes Act 1988.

The scheme is subject to the funding legislation outlined in the Pensions Act 2004. This, together with documents issued by the Pensions Regulator, and Guidance Notes adopted by the Financial Reporting Council, sets out the framework for funding defined benefit occupational pension schemes in the UK.

The scheme typically exposes the Company to actuarial risks such as investment risk, interest rate risk, mortality risk and longevity risk. A decrease in corporate bond yields, a rise in inflation or an increase in life expectancy would result in an increase to plan liabilities. This would detrimentally impact the balance sheet and may give rise to increased charges in future periods. The Company has not changed its processes used to manage its risks from previous periods.

The weighted average duration of the defined pension obligation at the period ended 31 October 2016 is 21 years (2015: 21 years).

Pension costs are assessed in accordance with the advice of a qualified, independent actuary using the projected unit method. The assumptions which have the most significant effect on the calculation are the long term average investment return expected in future and the rate of future increases to benefits, both before and after retirement.

The benefit basis changed to a career average revalued earnings ("CARE") basis, from a final salary basis, with effect from 1 April 2005.

The most recent actuarial report of the scheme, as at 1 April 2016, showed that the value of the assets was £24.4m. This represented 75% of the CARE benefits that had accrued to members after allowing for expected future increases to benefits.  Future investment returns of 4.20% per annum up to retirement and 3.2% in retirement and future benefit increases of 3.2% per annum were assumed.

# Notes to the accounts

For the year ended 31 October 2016

## 30 Pension scheme (continued)

The Bank's total expense for the year, including its share of prior service savings, amounted to £0.8m *(2015: £0.7m)*. The Company has agreed that it will aim to eliminate the pension scheme deficit over the next 12 years. Funding levels are monitored on an annual basis and the company has agreed to increase the contribution rate to 19.5% from 1 November 2016 *(2015: 15.3%)*.

*The IAS 19 valuation as at 31 October 2016 has been produced by a qualified independent actuary, and is based on the results of the valuation as at 1 April 2016.*

### Scheme assets and liabilities

The fair value of the scheme's assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of the scheme's liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, were:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Fair value of plan assets | 25.7 | 24.7 |
| Present value of defined benefit obligations | (39.2) | (29.1) |
| **Deficit** | **(13.5)** | **(4.4)** |

### Movements in present value of defined benefit obligation

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Present value of scheme liabilities at start of the period | 29.1 | 27.1 |
| Interest cost | 1.1 | 1.1 |
| Current service cost | 0.6 | 0.6 |
| Member contributions | 0.2 | 0.2 |
| Actuarial loss/(gain) on defined benefit obligation of which: | | |
| due to experience | 0.4 | - |
| due to demographic assumptions | (0.8) | (0.3) |
| due to financial assumptions | 9.9 | 1.0 |
| Benefits paid | (1.3) | (0.6) |
| **Present value of scheme liabilities at end of the period** | **39.2** | **29.1** |

# Notes to the accounts
For the year ended 31 October 2016

## 30 Pension scheme (continued)

### Movements in fair value of plan assets

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Market value of assets at the beginning of the year | 24.7 | 23.5 |
| Interest income | 1.0 | 0.9 |
| Actuarial gain | 0.4 | 0.1 |
| Member contributions | 0.2 | 0.2 |
| Employer contributions | 0.7 | 0.6 |
| Benefits paid | (1.3) | (0.6) |
| **Market value of assets at the end of the year** | **25.7** | **24.7** |

### Expense recognised in the profit and loss account

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Current service cost – staff costs | (0.6) | (0.6) |
| Net Interest expense – other finance costs | (0.2) | (0.1) |
| | **(0.8)** | **(0.7)** |

The total amount recognised in the statement of other comprehensive income in respect of actuarial gains and losses is a loss of £9.1m *(2015: loss of £0.6m)* before tax.

Cumulative actuarial losses reported in the statement of other comprehensive income since the date of transition to IFRS are losses of £9.7m *(2015: losses of £0.6m)* before tax.

Plan assets
The fair value of the plan assets and the return on those assets was as follows:

| | Fair Value | |
|---|---|---|
| | 2016 | 2015 |
| | £m | £m |
| Quoted Equity Investments | 12.9 | 12.6 |
| Bonds | 7.7 | 3.6 |
| Property | 0.7 | 0.2 |
| Other - cash | 4.4 | 8.3 |
| **Total market value of assets** | **25.7** | **24.7** |

The actual return on assets was £1.5m (2015: £1.1m)

# Notes to the accounts
For the year ended 31 October 2016

## 30 Pension scheme (continued)

**Future contributions**
The Bank expects to contribute approximately £1.1m to its defined benefit plan in the next financial year.

**Major assumptions**
The major assumptions underpinning the defined benefit obligation are:

| | 2016 | 2015 |
|---|---|---|
| | % | % |
| Rate of increase in salaries | 4.50 | 4.30 |
| Rate of increase in LPI pensions in payment and deferred pensions | 3.40 | 3.20 |
| Rate of CARE revaluation | 2.50 | 2.30 |
| Discount rate applied to scheme liabilities | 2.80 | 4.00 |
| RPI inflation assumption | 3.50 | 3.30 |

The assumptions relating to longevity underlying the pension liabilities at the balance sheet date are based on standard actuarial mortality tables and include an allowance for future improvements in longevity. The life expectancy of scheme members is as follows:

| | 2016 | 2015 |
|---|---|---|
| Current pensioners age 65 - male | 87.0 | 87.1 |
| Current pensioners age 65 - female | 88.9 | 89.1 |
| Future pensioners age 65 (current age 45) - males | 88.2 | 88.4 |
| Future pensioners age 65 (current age 45) - females | 90.4 | 90.6 |

**Sensitivities**

The Company has to make assumptions on the discount rate, inflation and life expectancy when valuing the pension scheme liability. The sensitivity of a defined pension obligation to changes in the weighted principal assumptions is:

Impact on present value of obligation:

| | Change in assumption | Increase in obligation | Decrease in obligation |
|---|---|---|---|
| Discount rate | 0.25% | (2.0) | 2.1 |
| Rate of Inflation ( RPI or CPI) | 0.25% | 1.2 | (1.2) |
| Life expectancy | 1 year | 1.2 | (1.2) |

The sensitivity analyses above have been determined based on a method that extrapolates the impact on the defined benefit obligation as a result of reasonable changes in key assumptions occurring at the end of the reporting period. The sensitivity analyses are based on a change in a significant assumption, keeping all other assumptions constant. The sensitivity analyses may not be representative of an actual change in the defined benefit obligation as it is unlikely that changes in assumptions would occur in isolation of one another.

# Notes to the accounts
For the year ended 31 October 2016

## 30 Pension schemes (continued)

### History of plan balance sheets

| (* the years from 2012 to 2014 were measured under UK Gaap) | 2016 | 2015 | 2014 | 2013 | 2012 |
|---|---|---|---|---|---|
| Fair value of plan assets | 25.7 | 24.7 | 23.5 | 23.0 | 21.0 |
| Present value of funded defined benefit obligations | (39.2) | (29.1) | (27.1) | (25.7) | (22.8) |
| **Deficit** | **(13.5)** | **(4.4)** | **(3.6)** | **(2.7)** | **(1.8)** |

### History of experience gains and losses

| (* the years from 2012 to 2014 were measured under UK Gaap) | 2016 | 2015 | 2014 | 2013 | 2012 |
|---|---|---|---|---|---|
| **Difference between the expected and actual return on scheme assets:** | | | | | |
| Present value of funded defined benefit obligations | £0.5m | £0.2m | £(0.6)m | £0.8m | £(0.4)m |
| Percentage of year end scheme assets | 1.5% | 0.7% | 2.5% | 3.5% | 1.9% |
| **Experience gains and losses on scheme liabilities:** | | | | | |
| Amount | £(0.4)m | £(0.0)m | £(0.0)m | £(0.0)m | £(0.0)m |
| Percentage of year end present value of scheme liabilities | 1.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Total amount recognised in statement of comprehensive income:** | | | | | |
| Losses before tax | £(9.1)m | £(0.6)m | £(1.7)m | £(1.2)m | £(1.4)m |
| Percentage of year end present value of scheme liabilities | 23.0% | 2.0% | 6.3% | 4.7% | 6.1% |

## 31 Called up share capital

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| **Allotted, called-up and fully paid:** | | |
| 100,000,000 *(2015: 100,000,000)* ordinary shares of £1 each | 100.0 | 100.0 |
| | **100.0** | **100.0** |

# Notes to the accounts
For the year ended 31 October 2016

## 32 Financial commitments and contingent liabilities

### Loan commitments

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| **Commitments** | | |
| expiring in less than one year | 111.9 | 69.4 |
| expiring in more than one year | 82.9 | 55.2 |
| | **194.8** | **124.6** |

### Capital commitments

The Bank had contracted capital commitments amounting to £nil at 31 October 2016 *(2015: £Nil).*

### Commitments under non-cancellable operating leases
In 2016, the Company leased an office building as its head office under a non-cancellable operating lease agreement. The lease term is 15 years, and is renewable at the end of the lease period.

Future minimum lease payments under non-cancellable operating leases relating to land and buildings were as follows:

| | 2016 |
|---|---|
| | £m |
| Within one year | - |
| Between one and five years | 1.8 |
| After five years | 4.2 |
| | **6.0** |

### Defined benefit pension scheme
The defined benefit scheme is subject to a triennial valuation by the scheme's independent actuary which was carried out on 1 April 2016.

The next triennial valuation will be carried out on 1 April 2019. No further provision has been recognised.

# Notes to the accounts
For the year ended 31 October 2016

## 33 Financial instruments

### a) Categories of financial assets and liabilities

Financial assets and liabilities are measured on an on-going basis either at fair value or at amortised cost.

The accounting policies note describes how the classes of financial instruments are measured and how income and expenses including fair value gains and losses, are recognised. The following tables analyse the financial assets and liabilities in the Balance Sheet by the class of financial instrument to which they are assigned and by the measurement basis and include both non-financial assets and liabilities in order to reconcile disclosures to Balance Sheet totals.

| As at 31 October 2016 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profit and loss | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Assets** | | | | | |
| Cash and balances held at central banks | 168.0 | - | - | - | 168.0 |
| Treasury Bills | 28.9 | - | - | 55.8 | 84.7 |
| Debt securities | 11.4 | - | 77.7 | - | 89.1 |
| Loans and advances to credit institutions | 128.3 | - | - | - | 128.3 |
| Loans and advances to customers | - | 375.9 | - | 331.0 | 706.9 |
| **Total financial assets** | **336.6** | **375.9** | **77.7** | **386.8** | **1,177.0** |
| Total non-financial assets | | | | | 139.8 |
| **Total assets** | | | | | **1,316.8** |
| **Liabilities** | | | | | |
| Deposit from banks | 2.8 | - | - | - | 2.8 |
| Deposit from customers | 991.7 | - | - | - | 991.7 |
| Derivative financial instruments | - | - | - | 150.6 | 150.6 |
| **Total financial liabilities** | **994.5** | **-** | **-** | **150.6** | **1,145.1** |
| Total non-financial liabilities | | | | | 25.4 |
| Share capital and other reserves | | | | | 146.3 |
| **Total reserves and liabilities** | | | | | **1,316.8** |

# Notes to the accounts
For the year ended 31 October 2016

## 33 Financial instruments (continued)

### a) Categories of financial assets and liabilities (continued)

| As at 31 October 2015 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profit and loss | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Assets** | | | | | |
| Cash and balances held at central banks | 101.6 | - | - | - | 101.6 |
| Treasury Bills | 30.1 | - | - | 53.9 | 84.0 |
| Debt securities | 18.0 | - | 70.2 | - | 88.2 |
| Loans and advances to credit institutions | 89.5 | - | - | - | 89.5 |
| Loans and advances to customers | - | 332.9 | - | 291.9 | 624.8 |
| **Total financial assets** | **239.2** | **332.9** | **70.2** | **345.8** | **988.1** |
| Total non-financial assets | | | | | 120.8 |
| **Total assets** | | | | | **1,108.9** |
| **Liabilities** | | | | | |
| Deposit from banks | 2.8 | - | - | - | 2.8 |
| Deposit from customers | 848.6 | - | - | - | 848.6 |
| Derivative financial instruments | - | - | - | 112.8 | 112.8 |
| **Total financial liabilities** | **851.4** | **-** | **-** | **112.8** | **964.2** |
| Total non-financial liabilities | | | | | 11.4 |
| Share capital and other reserves | | | | | 133.3 |
| **Total reserves and liabilities** | | | | | **1,108.9** |

## 33 Financial instruments (continued)

### b) Fair value estimation

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Company has access at that date.

The table below summarises the fair value of the Company's financial assets and liabilities. The different levels have been defined as follows:

- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2: Valuation techniques for which all significant inputs are based on observable market data.
- Level 3: Valuation techniques for which significant inputs are not based on observable market data.

Where applicable, the Company measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions take place with sufficient frequency and volume to provide pricing information on an on-going basis. For all other financial instruments the Company determines fair value using other valuation techniques.

The fair value of financial assets and liabilities carried at amortised cost approximate to their carrying value on the Balance Sheet.

The following table presents the Company's financial assets and liabilities that are measured at fair value on the face of the Company's Balance Sheet and the disaggregation by fair value hierarchy and product type:

| As at 31 October 2016 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| **Financial assets at fair value through profit or loss (FVTPL)** | | | | |
| Treasury bills | 55.8 | - | - | 55.8 |
| Loans and advances to customers | - | - | 331.0 | 331.0 |
| **Total financial assets at FVTPL** | **55.8** | **-** | **331.0** | **386.8** |
| **Financial liabilities at fair value through profit or loss (FVTPL)** | | | | |
| Derivative financial instruments | - | 150.6 | - | 150.6 |
| **Total financial liabilities at FVTPL** | **-** | **150.6** | **-** | **150.6** |

# Notes to the accounts
For the year ended 31 October 2016

## 33 Financial Instruments (continued)

| As at 31 October 2015 | Level 1 £m | Level 2 £m | Level 3 £m | Total £m |
|---|---|---|---|---|
| **Financial assets at fair value through profit or loss (FVTPL)** | | | | |
| Treasury bills | 53.9 | - | - | 53.9 |
| Loans and advances to customers | - | - | 291.9 | 291.9 |
| **Total financial assets at FVTPL** | **53.9** | **-** | **291.9** | **345.8** |
| **Financial liabilities at fair value through profit or loss (FVTPL)** | | | | |
| Derivative financial instruments | - | 112.8 | - | 112.8 |
| **Total financial liabilities at FVTPL** | **-** | **112.8** | **-** | **112.8** |

### c) Level 1 and 2 assets and liabilities measured at fair value

**Treasury bills and debt securities:**
The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Instruments included in Level 1 comprise primarily UK Government investment securities (Treasury bills) and equity investments classified as fair value through profit or loss.

**Derivative financial instruments:**
Derivative products using a valuation technique with observable market inputs are interest rate swaps. Their fair value is based on counterparty valuations. Those valuations are tested for reasonableness by discounting estimated future cash flows based on the terms and maturity of each contract and using market interest rates for a similar instrument at the measurement date.

The fair value of financial instruments that are not traded in an active market (for example, over the counter derivatives) is determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in level 2.

**Transfers**
There were no transfers between levels 1 and 2 during the year.

# Notes to the accounts

For the year ended 31 October 2016

## 33 Financial instruments (continued)

### d) Level 3 assets and liabilities measured at fair value

**Loans and advances to customers – Fixed for life mortgages:**

Loans and advances to customers include £331.0m (2015: £291.9m) of assets which have been classed as fair value through the profit and loss as they relate to fixed for life mortgages.

The fair value of loans secured by fixed for life mortgages is calculated by discounting the future cash flows at swap rates together with an allowance for illiquidity, and the difference between the fair value at transaction date and the transaction price is recognised and deferred over the expected life of each loan.

The movement in the aggregate difference yet to be recognised in profit or loss between the fair value of mortgages and the amount that would have been recognised using the valuation technique is shown below.

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At start of period | 16.3 | 14.1 |
| Amounts deferred in the period | 1.3 | 3.6 |
| Release of previously recognised gains | (1.7) | (1.3) |
| Amounts recognised in profit or loss in the period | 0.2 | (0.1) |
| **At end of period** | **16.1** | **16.3** |

Reconciliation of the opening and closing recorded amount of Level 3 loans secured by fixed for life mortgages:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| At start of period | 291.9 | 274.1 |
| Total gains in profit or loss | 54.7 | 18.6 |
| Loans advanced | 5.7 | 10.8 |
| Redemptions | (21.3) | (11.6) |
| **At end of period** | **331.0** | **291.9** |

***Fixed for life mortgages - principal assumptions***

Principal assumptions underlying the calculation of fixed for life mortgages include the following:

**Mortality or entry into long term care**
This is based on the expected death or entry into long term care of the customer or the last remaining customer for a joint contract. Mortality assumptions have been derived by reference to PCMA00/PCFA00 and CMI2011 model for longevity improvements.

## 33 Financial instruments (continued)

**Lapses**
Due to limited market information, these assumptions have been derived from the Company's own experience on this product.

**Expenses**
Assumptions for future policy expense levels are based on the Company's recent expense analyses. Expenses are modelled as an amount per policy per annum that incorporates an annual inflation rate allowance of 4.30% (2015: 3.88%).

**Discount rate**
The discount rate applied to the mortgage cash flows comprises two parts: a risk free yield curve and an allowance for illiquidity. The risk free yield curve is based on the GBP curve published by EIOPA.

The average discount rate for the portfolio (assumed to be the 15 year point on the yield curve based on average duration at 31 October 2016) was 2.24% (31 October 2015: 3.12%).

**No-negative equity guarantee**

The fair value of loans secured by mortgages takes into account an explicit provision in respect of the no-negative equity guarantee which is calculated using a variant of the Black Scholes option pricing model. The key assumptions used to derive the value of the no-negative equity guarantee include property growth, volatility and credit risk. Property price is based on the last survey valuation adjusted by Nationwide Monthly HPI with an annual underperformance assumption. The future property price is based on Future HPI with an annual underperformance assumption.

The property growth and volatility assumed at 31 October 2016 were 3.28% (31 October 2015: 2.17%) and 11% (31 October 2015: 11%) respectively. The value of the no-negative equity guarantee as at 31 October 2016 was £15.4m (31 October 2015: £27.8m).

The valuation technique that the Company uses to assess the value of the loans secured by mortgages will generally give a higher value than the price of the initial transaction. Any differences will be deferred over the expected life of the contract by setting up a deferred reserve within loan balances. Any Day 1 profit on valuation is not recognised immediately in the Income Statement and is deferred over the life of the related mortgages. At 31 October 2016 the amount deferred was £16.1m. (2015: £16.3m).

## 33 Financial instruments (continued)

**Sensitivity analysis**
Changes to unobservable inputs used in the valuation technique could give rise to significant changes in the fair value of the assets. The Company has estimated the impact on profit for the period in changes to these inputs as follows.

| | Interest rates +100 BP | Maintenance expenses +10% | Property inflation -100bps | Property prices -10% | Mass Voluntary redemptions +10% |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **Net decrease in profit before tax** | | | | | |
| **At 31 October 2016** | **(39.5)** | **(0.6)** | **(10.0)** | **(4.9)** | **(10.6)** |
| At 31 October 2015 | (34.0) | (0.5) | (13.2) | (6.8) | (6.8) |

The sensitivity factors are applied via actuarial models. The analysis has been prepared for a change in each variable with other assumptions remaining constant. In reality, such an occurrence is unlikely due to correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear and larger or smaller impacts cannot be interpolated or extrapolated from these results.

The sensitivity factors take into consideration that the Group's assets and liabilities are actively managed and may vary at the time that any actual market movement occurs. In addition, swaps taken out will mitigate some of these sensitivities to movements in rates disclosed above.

**Investment properties:**

See Note 21 for disclosures relating to Level 3 assets.

# Notes to the accounts

For the year ended 31 October 2016

## 33 Financial instruments (continued)

### e) Maturity profile of financial assets and liabilities

The table below analyses the carrying value of financial assets and liabilities into relevant maturity groupings based on the remaining period to the contractual maturity date. In practice, customer deposits will be repaid later than on the earliest date on which repayment can be required. Likewise, in practice, customer assets may be repaid ahead of their contractual maturity. As such, the Company uses past performance of each asset and liability class along with management judgement to forecast likely cash flow requirements.

| As at 31 October 2016 | Not more than three months | More than three months but not more than six months | More than six months but not more than one year | More than one year but not more than five years | More than five years | Total |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | |
| Cash and balances held at central banks | 168.0 | - | - | - | - | 168.0 |
| Treasury bills | - | - | 1.9 | 72.1 | 10.7 | 84.7 |
| Debt securities | 11.3 | 3.9 | 5.1 | 36.4 | 32.4 | 89.1 |
| Loans and advances to customers | 45.8 | 43.5 | 14.3 | 205.8 | 397.5 | 706.9 |
| Loans and advances to credit institutions | 128.3 | - | - | - | - | 128.3 |
| **Total financial assets** | **353.4** | **47.4** | **21.3** | **314.3** | **440.6** | **1,177.0** |
| **Liabilities** | | | | | | |
| Deposit from banks | 2.8 | - | - | - | - | 2.8 |
| Deposit from customers | 380.0 | 101.7 | 216.4 | 293.6 | - | 991.7 |
| Derivative financial instruments | 1.4 | 0.1 | 0.1 | 9.8 | 139.2 | 150.6 |
| **Total financial liabilities** | **384.2** | **101.8** | **216.5** | **303.4** | **139.2** | **1,145.1** |
| | | | | | | |
| **Loan Commitments liabilities** | **111.9** | **-** | **-** | **29.2** | **53.7** | **194.8** |

# Notes to the accounts

For the year ended 31 October 2016

## 33 Financial instruments (continued)

### e) Maturity profile of financial assets and liabilities (continued)

| As at 31 October 2015 | Not more than three months | More than three months but not more than six months | More than six months but not more than one year | More than one year but not more than five years | More than five years | Total |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | |
| Cash and balances held at central banks | 101.6 | | | | | 101.6 |
| Treasury bills | - | - | 4.1 | 69.8 | 10.1 | 84.0 |
| Debt securities | 2.2 | - | 1.8 | 50.7 | 33.5 | 88.2 |
| Loans and advances to credit institutions | 89.5 | | | | | 89.5 |
| Loans and advances to customers | 21.2 | 53.5 | 21.6 | 57.8 | 470.7 | 624.8 |
| **Total financial assets** | 214.5 | 53.5 | 27.5 | 178.3 | 514.3 | **988.1** |
| **Liabilities** | | | | | | |
| Deposit from banks | 2.8 | | | | | 2.8 |
| Deposit from customers | 331.4 | 80.9 | 195.7 | 240.6 | - | 848.6 |
| Derivative financial instruments | 0.2 | 0.1 | 0.1 | 7.2 | 105.2 | 112.8 |
| **Total financial liabilities** | **334.4** | **81.0** | **195.8** | **247.8** | **105.2** | **964.2** |
| | | | | | | |
| **Loan commitments Liabilities** | **69.4** | **-** | **-** | **4.2** | **51.0** | **124.6** |

# Notes to the accounts
For the year ended 31 October 2016

## 33 Financial instruments (continued)

### f) Maturity profile of financial liabilities-contractual undiscounted cash flows

The table below analyses the Company's non-derivative financial liabilities and net-settled derivative financial liabilities into relevant maturity groupings based on the period to maturity at the balance sheet. Derivative financial liabilities are included in the analysis if their contractual maturities are essential for an understanding of the timing of the cash flows. The amounts disclosed in the table are the contractual undiscounted cashflows.

| As at 31 October 2016 | Book value | Not more than three months | More than three months but not more than six months | More than six months but not more than one year | More than one year but not more than five years | More than five years | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Financial liabilities** | | | | | | | |
| Deposit from banks | 2.8 | 2.8 | - | - | - | - | 2.8 |
| Deposit from customers | 991.7 | 380.0 | 101.7 | 216.4 | 293.6 | - | 991.7 |
| Derivative financial instruments | 150.6 | 0.8 | 3.2 | 7.2 | 51.3 | 106.0 | 168.5 |
| **Total financial liabilities** | **1,145.1** | **384.8** | **104.9** | **223.6** | **344.9** | **106.0** | **1,163.0** |

| As at 31 October 2015 | Book value | Not more than three months | More than three months but not more than six months | More than six months but not more than one year | More than one year but not more than five years | More than five years | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Financial liabilities** | | | | | | | |
| Deposit from banks | 2.8 | 2.8 | | | | | 2.8 |
| Deposit from customers | 848.6 | 331.4 | 80.9 | 195.7 | 240.6 | - | 848.6 |
| Derivative financial instruments | 112.8 | 0.9 | 3.1 | 6.6 | 43.3 | 83.7 | 137.6 |
| **Total financial liabilities** | **964.2** | **335.1** | **84.0** | **202.3** | **283.9** | **83.7** | **989.0** |

The above disclosures do not directly align to those presented for the balance sheet as they include interest relating to future periods.

The contractual undiscounted cash flows related to derivative financial instruments used for risk management purposes are the net amounts for derivatives that are net settled.

## 33 Financial instruments (continued)

**g) Foreign currencies**
The Group holds no financial assets or liabilities denominated in foreign currencies.

## 34 Financial risk management objectives and policies

### Risk management

The risk management approach encompasses the requirements for identifying, assessing, managing, monitoring and reporting on risk.

The evaluation of the various risks and the setting of policy is carried out through the Bank's executive risk committee and reports to the risk and conduct committee, which ensures adherence to the Company's risk management policy and framework.

### Risk management objectives

Risk is inherent in all aspects of the Company's business. Within the Bank, a risk management framework is in place to ensure that all material risks faced by the Bank have been identified and measured, and that appropriate controls are in place to ensure that each risk is mitigated to an acceptable degree.

In the normal course of its business, the Company is exposed to credit risk, liquidity risk, house price risk, interest rate risk, conduct risk and operational risk. These are discussed in more detail in sections a) to f) below.

### (a) Credit risk

Credit risk is the risk that borrowers or a counterparty will be unable or unwilling to meet a commitment that they have entered into with the Bank.

The maximum credit risk as at 31 October is the carrying value recognised on the Balance Sheet as disclosed in the table in note 33(a), along with the loan commitments as disclosed in the table in note 33(e).

There were no past due, or impaired, or past due but not impaired balances in respect of all financial asset classes except for Commercial loans which is disclosed below.

Credit risk within the commercial lending portfolio is defined as a borrower's inability to repay or service their debt obligations. The primary drivers of credit risk in the Bank's case are property price risk and tenant risk.

The primary driver of credit risk within roll-up mortgages and reversionary interests in property is a fall in house prices, which would cause credit losses should house prices fall sufficiently in real terms at the date of redemption.

The primary driver of credit risk within the treasury assets portfolio, which comprises deposits with other banks, gilts and debt securities is counterparty default, meaning it can no longer repay its obligations. Only instruments used by counterparties with a minimum rating of BBB- at the point of purchase are issued.  The Company intends to hold its treasury assets to maturity and is therefore not directly affected by market risk.

For both commercial lending and residential mortgages, the Bank takes security in the form of a legal charge over the property against which loans are advanced. The Bank's low risk approach to new business lending is reflected in the loan to value profile of the commercial property and residential property books.

## 34 Financial risk management objectives and policies (continued)

The Bank manages its credit risk through its retail credit committee, commercial credit committee and assets and liabilities committee. Regular credit exposure reports are produced which include information on credit and property underwriting, large exposures, asset concentration and levels of bad debt provisioning.

Credit risk in relation to loans and advances to customers, analysed between residential lending credit risk, commercial lending credit risk and credit risk in relation to treasury financial instruments is described in the relevant sections below:

### Credit risk: loans and advances to residential customers

The Bank's exposure to credit risk relating to loans and advances to residential customers can be broken down by security as follows:

| | 2016 | |
|---|---|---|
| | £m | % |
| **In respect of loans and advances to customers:** | | |
| Fully secured by a first charge on residential property | 310.6 | 100.0 |
| | **312.0** | **100.0** |
| Fair value adjustments | 108.7 | |
| | **419.3** | |

| | 2015 | |
|---|---|---|
| | £m | % |
| **In respect of loans and advances to customers:** | | |
| Fully secured by a first charge on residential property | 292.2 | 100.0 |
| | **292.2** | **100.0** |
| Fair value adjustments | 68.5 | |
| | **360.7** | |

The cumulative change in fair values due to credit risk amounts to losses of £15.4m, and the change in the year is a profit of £12.4m.

There were no past due, but not impaired balances, nor were there any past due and impaired balances in respect of loans and advances to residential customers.

# Notes to the accounts
For the year ended 31 October 2016

## 34 Financial Risk Management objectives and policies (continued)

**Credit risk: loans and advances to residential customers (continued)**

**Residential: Risk concentrations**

Loan to value (LTV) is one of the main factors used to determine the credit quality of loans secured on residential property. All residential loans and receivables have a LTV of less than 60% when advanced.

The Bank provides loans secured on residential property across England, Northern Ireland, Scotland and Wales.

**Residential: Performance**

Performance risk is measured by those accounts in arrears. Total arrears balances as at 31 October 2016 amount to £Nil (2015: £Nil). The Bank has no accounts where forbearance options have been utilised.

**Credit risk: Commercial lending**

**Commercial: Analysis of Risk concentration**

Loans secured on commercial property are as follows:

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | £m | LTV %* | £m | LTV %* |
| Commercial mortgage | 23.6 | 64.3 | 18.4 | 57.6 |
| Development finance | 63.7 | 68.8 | 42.6 | 68.0 |
| Investment loans | 188.2 | 70.5 | 186.7 | 80.8 |
| | **275.5** | **69.6** | **247.7** | **76.9** |

*Loan to Value %

Collateral pertaining to Commercial lending.

On inception of Commercial property loans, these are fully secured against the value of the related properties.

**Commercial: Analysis of Risk concentration**

The Bank's commercial loan portfolio comprises the following:

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Loans secured on commercial property | 275.5 | 92.6 | 247.7 | 91.2 |
| Loans relating to Renewable energy sector | 22.1 | 7.4 | 24.0 | 8.8 |
| Provisions for impairment | (10.0) | - | (7.6) | - |
| | **287.6** | **100.0** | **264.1** | **100.0** |

## 34 Financial risk management objectives and policies (continued)

**Credit risk: Commercial lending (continued)**
**Commercial: Analysis of Risk concentration (continued)**

The Bank provides loans secured on property across England, Scotland and Wales. An analysis of commercial property and renewable energy sector loans by geographical location is provided below:

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Wales | 82.0 | 27.6 | 84.4 | 31.1 |
| London-England | 91.8 | 30.8 | 74.7 | 27.5 |
| South East & East of England | 35.6 | 12.0 | 13.5 | 5.0 |
| Midlands-England | 16.2 | 5.4 | 8.2 | 3.0 |
| South West of England | 57.3 | 19.3 | 72.3 | 26.6 |
| North West & North East of England | 3.8 | 1.3 | 12.2 | 4.5 |
| Scotland | 10.9 | 3.6 | 6.2 | 2.3 |
| Mixed/Other | - | - | 0.2 | - |
| | **297.6** | **100.0** | **271.7** | **100.0** |

The average loan to value (LTV) in respect of commercial loans is estimated to be 69.6%. LTV analysis has been undertaken by using a combination of external valuations and internal and external desktop reviews which consider the type and quality of security, lease term/tenant as well as geographical location.

£30.3m of exposures have an LTV of greater than 100%. Of these, £23.4m are already classified as impaired and a further £3.5m are on the Watchlist, leaving £3.4m of exposures considered to be satisfactory. In these instances, management is satisfied that the cash flows generated by the underlying assets will be sufficient to fully repay the debt over time.

The largest exposure to one counterparty is £17.7m (2015: £21m) or 6% (2015: 8%) of gross balances.

**Commercial: lending performance**
Procedures are in place which grade borrowers in line with the perceived severity of the risk and are designed to identify cases of potential cause for concern to facilitate early risk mitigation or forbearance activity where appropriate. Using this risk grading system the commercial loan portfolio is classified as follows (figures do not include provisions for loan impairment or unamortised loan fees):

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Satisfactory | 249.4 | 83.8 | 223.9 | 82.4 |
| Watchlist | 23.4 | 7.9 | 29.6 | 10.9 |
| Impaired | 24.8 | 8.3 | 18.2 | 6.7 |
| | **297.6** | **100.0** | **271.7** | **100.0** |

There are no commercial loans in arrears (2015: Nil).

# Notes to the accounts
For the year ended 31 October 2016

## 34 Financial risk management objectives and policies (continued)

**Credit risk: Commercial lending (continued)**
**Commercial: lending provisions**

Provisions are held against impaired loans as follows:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| Specific provisions | 9.8 | 6.9 |
| Collective provisions | 0.2 | 0.7 |
| | 10.0 | 7.6 |

**Past Due but not impaired**

As at 31 October 2016 there were commercial loans of £17.5 million (2015: £Nil) 60-120 days past due but not impaired.

As at 31 October 2016 there were no (2015: £Nil) commercial loans that were past due and impaired.

**Forbearance**
There have been no instances of forbearance arising during the year.

**Treasury credit risk**
Treasury risk comprises exposure to central banks, treasury bills, debt securities, credit institutions and financial derivatives. The following table shows the maximum exposure to credit risk excluding collateral:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| UK government and amounts held with central banks | 168.0 | 101.6 |
| Treasury bills | 84.7 | 84.0 |
| Loans and advances to credit institutions | 27.6 | 20.6 |
| Debt securities | 89.1 | 88.2 |
| | 369.4 | 294.4 |

None of these exposures are past due or impaired.

**Credit quality of financial assets that are neither past due nor impaired**
The following shows the exposures broken down by rating:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| AAA to AA- | 313.2 | 228.9 |
| A+ to A- | 35.6 | 35.1 |
| BBB+ to BBB- | 17.2 | 25.7 |
| BB+ to BB- | 3.4 | 4.7 |
| | 369.4 | 294.4 |

# Notes to the accounts
For the year ended 31 October 2016

## 34 Financial risk management objectives and policies (continued)

**Treasury Credit risk (continued)**

**Concentration of credit risk**

The geographical exposure is as follows:

| | 2016 | 2015 |
|---|---|---|
| | £m | £m |
| UK | 334.8 | 260.3 |
| Other | 34.6 | 34.1 |
| | **369.4** | **294.4** |

The treasury risk function monitors exposure concentrations against a variety of criteria including counterparty limits.

**b) Liquidity risk**

Liquidity risk is the risk that the Bank will encounter difficulty in realising assets or otherwise raising funds to meet commitments as they fall due. The Bank manages its liquidity risk through its assets and liabilities committee, and monitors its liquidity position on a daily basis and has adopted a policy to ensure that it has adequate resources to enable it to conduct its normal business activities without interruption. The maturity analysis of assets and liabilities is disclosed in note 33 (e) & (f) to the financial statements.

The customer deposit base represents a stable source of funding due to the number and range of depositors. Liquidity is further managed through dealings in the money markets.

The Board has approved a liquidity risk management policy that sets out the liquidity requirements with which the Bank must comply. The principal liquidity risk mitigants used by management are:

- A buffer of highly liquid assets (comprising high quality government, covered bonds and supranational bank securities) which can meet cash requirements;
- Cash reserves with the Bank of England;
- Cash resources held at other financial institutions.

.
**c) Interest rate risk**

Interest rate risk is the risk that arises when there is an imbalance between the maturity dates of rate sensitive assets, liabilities and commitments. The Company manages its interest rate risk through its assets and liabilities committee. The Company's policy is to maintain interest rate risk at a controlled level within limits set by the Board.

The table in note 33(d) shows an estimate of the interest rate sensitivity gap as at 31 October 2016. The principal risk management tool to mitigate interest rate risk is the use of derivatives to align the interest rate re-pricing profile of assets and liabilities. All of the derivatives used by the Company are interest rate swap contracts of varying maturities and start dates.

The Company's interest rate risk management policy defines the type of derivative transactions that can be undertaken, which are all actioned by the Bank's treasury function, and are subject to review and approval at the dealing stage. The Treasurer, who is responsible for

## 34 Financial risk management objectives and policies (continued)

treasury matters on a day to day basis, prepares a treasury report for the Board, which includes analysis of interest rate risk exposures.

**d) House price risk**

House price risk is the risk that arises when there is an adverse mismatch between actual house prices and those implicit in the costing of the Company's later life lending, such that the ultimate realisation of the property would not yield the expected return to the Company and could, in certain circumstances, result in a capital loss. The company mitigates house price risk by monitoring maximum Loan to Value at inception of the loan.

**e) Conduct risk**

Conduct risk is the risk that the Bank's behaviour results in poor outcomes for customers. The Bank is exposed to this risk by virtue of the markets in which it chooses to operate. The executive risk committee has overall responsibility for implementing and monitoring principles, frameworks, policies and limits. The committee is responsible for managing risk decisions and monitoring risk levels which it reports to the Board of Directors.

The Company holds a provision of £0.1m as at 31 October 2016 (2015; £0.1m) in respect of conduct risk which is disclosed in note 29.

**f) Operational risk**

Operational risk is the risk of economic loss from systemic failure, human error and fraud (control failures) or external events, which result in unexpected or indirect loss to the Company. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications or can lead to financial loss. The Company cannot expect to eliminate all operational risks but by initiating a rigorous control framework and by monitoring and responding to potential risks, the Company is able to manage the risks. Controls include effective segregation of duties, access controls, authorisation and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

## 35 Capital risk management

The Company conducts an internal capital adequacy assessment process ("ICAAP"), at least annually, which is approved by the Board. This is used to assess the Company's capital adequacy and to determine the level of capital required to support the future development of the business as set out in the strategic plan.

The ICAAP addresses all the Company's material risks and includes Board approved stress scenarios which are intended, as a minimum, to meet regulatory requirements. The ICAAP is used by the PRA to set the Company's Individual Capital Guidance (ICG)

The Company's capital resources requirements are calculated based on the CRD IV CRR regulatory framework as implemented by the PRA, namely:

- Pillar 1-based on a Standardised Approach for credit risk, operational risk and market risk;

- Pillar 2-set by the PRA via the ICG to address those risks not covered under Pillar 1.

# Notes to the accounts

For the year ended 31 October 2016

## 35 Capital risk management (continued)

The Board is ultimately responsible for capital management and monitors the capital position of the Company at each board meeting through the receipt of management information which sets out the Company's current and forecast capital position, based on the methodology adopted within its ICAAP.

This means that the Company will:

i) Maintain a level of capital at least equal to the minimum amount set by the PRA in the ICG, and;
ii) Hold all its capital in the form of Common Equity Tier 1 and Tier 2 capital.

The Company had a common equity tier 1 capital ratio of 19.1% (2015: 21.4%) and a total capital ratio of 19.2% (2015: 22.2%)

**CRD**

Article 89 of the Capital Requirements Directive IV (CRD IV) requires credit institutions and investment firms in the EU to disclose annually, specifying, by Member State and by third country in which it has an establishment, the following information:

- Name, nature of activities and geographical location: The Bank has one subsidiary and operates only in the United Kingdom. The principle activities of the Bank are noted in the Strategic Report on page 5 and the principal activities of the subsidiaries are disclosed in Note 18 to the accounts.
- Average number of employees: as disclosed in Note 10 to the accounts.
- Annual turnover (Net Interest Income) and profit before tax: as disclosed in the Income Statement on page 18.
- Corporation Tax paid: 2016 £3.7m *(2015: £0.4m)*.
- Public subsidies: There were none received in the year.

.
All minimum regulatory requirements were met during the year and the prior year.

The Company's objectives when managing capital are:

- To have sufficient capital to safeguard the Company's ability to continue as a going concern so that it can continue to provide returns for the shareholder and benefits for other stakeholders;
- To comply with the bank capital requirements set out by the PRA in the UK;
- When capital is needed, to require an adequate return to the shareholder by pricing insurance contracts according to the level of risk associated with the business written; and
- To meet the requirements of the Schemes of Transfer.

The Company's capital comprises all components of equity, movements of which are set out in the Statement of Changes in Equity.

# Notes to the accounts

For the year ended 31 October 2016

## 36 Ultimate parent undertaking

The immediate parent undertaking of the Bank is The Carlyle Trust Limited, registered in England and Wales, which controls and co-ordinates the management of a group of companies. The ultimate parent undertaking and controller is The Carlyle Trust (Jersey) Limited (incorporated in Jersey). Within the meaning of the Companies Act 2006, The Carlyle Trust Limited is the parent undertaking of the largest and only group of undertakings for which group accounts are drawn up and of which the Bank is a member. The accounts of The Carlyle Trust Limited can be obtained from The Registrar of Companies, Companies House, Crown Way, Cardiff, CF14 3UZ.

## 37 Explanation of transition to FRS 101

As stated in note 1, these are the Bank's first financial statements prepared in accordance with FRS 101. The accounting policies set out in Note 1 have been applied in preparing the financial statements for the year ended 31 October 2016, the comparative information presented in these financial statements for the year ended 31 October 2015 and in the preparation of an opening FRS 101 balance sheet as at 1 November 2014 (the Company's date of transition).

In preparing its FRS 101 balance sheet, the Company has adjusted amounts reported previously in financial statements prepared in accordance with its old basis of accounting (UK GAAP). An explanation of how the transition from UK GAAP to FRS 101 has affected the company's financial position, financial performance and cash flows is set out in the following tables and the notes that accompany the tables.

Adjustments have been made against opening reserves, unless otherwise stated.

# Notes to the accounts
For the year ended 31 October 2016

## 37 Explanation of transition to FRS 101 (continued)
**Reconciliation of equity**

| | Note | At 1 November 2014 | | | At 31 October 2015 | | |
|---|---|---|---|---|---|---|---|
| | | UK GAAP | Effect of transition to 101 | FRS 101 | UK GAAP | Effect of transition to 101 | FRS 101 |
| | | £m | £m | £m | £m | £m | £m |
| **Assets** | | | | | | | |
| | | | | | | | |
| Cash and balances held at central banks | | 18.5 | - | 18.5 | 101.6 | - | 101.6 |
| Treasury bills | a | 75.5 | 2.9 | 78.4 | 81.0 | 3.0 | 84.0 |
| Debt securities | b | 85.1 | 7.8 | 92.9 | 81.5 | 6.7 | 88.2 |
| Loans and advances to credit institutions | a | 70.6 | - | 70.6 | 89.8 | (0.3) | 89.5 |
| | | **249.7** | **10.7** | **260.4** | **353.9** | **9.4** | **363.3** |
| Loans and advances to customers | c | 440.8 | 53.6 | 494.4 | 557.5 | 67.3 | 624.8 |
| Shares in group undertakings and participating interests | | 16.0 | - | 16.0 | 16.0 | - | 16.0 |
| Intangible assets | d | - | 0.6 | 0.6 | - | 1.2 | 1.2 |
| Property, plant & equipment | d | 0.7 | (0.6) | 0.1 | 1.3 | (1.2) | 0.1 |
| Investment properties | e | 66.6 | 26.0 | 92.6 | 62.7 | 34.3 | 97.0 |
| Deferred tax assets | f | 0.7 | 0.6 | 1.3 | 0.7 | 0.8 | 1.5 |
| Stock | g | 3.2 | (3.2) | - | 3.4 | (3.4) | - |
| Other assets | | 7.0 | (1.4) | 5.6 | 3.5 | (1.9) | 1.6 |
| Assets classified as held for sale | g | - | 3.2 | 3.2 | - | 3.4 | 3.4 |
| **Total assets** | | **784.7** | **89.7** | **874.2** | **999.0** | **109.9** | **1,108.9** |

# Notes to the accounts
For the year ended 31 October 2016

## 37 Explanation of transition to FRS 101 (continued)

### Reconciliation of equity (continued)

| | Notes | At 1 November 2014 | | | At 31 October 2015 | | |
|---|---|---|---|---|---|---|---|
| | | UK GAAP | Effect of transition to 101 | FRS 101 | UK GAAP | Effect of transition to 101 | FRS 101 |
| | | £m | £m | £m | £m | £m | £m |
| **Liabilities** | | | | | | | |
| Deposit from banks | | 10.0 | - | 10.0 | 2.8 | - | 2.8 |
| Deposit from customers | | 633.2 | - | 633.2 | 848.6 | - | 848.6 |
| Derivative financial instruments | h | - | 90.9 | 90.9 | - | 112.8 | 112.8 |
| Other liabilities | | 1.4 | - | 1.4 | 4.4 | - | 4.4 |
| Accruals and deferred income | | 5.2 | (3.3) | 1.9 | 5.9 | (3.7) | 2.2 |
| Other provisions | | - | - | - | - | 0.4 | 0.4 |
| Pension liabilities | f | 2.9 | 0.7 | 3.6 | 3.6 | 0.8 | 4.4 |
| **Total liabilities** | | **652.7** | **88.3** | **741.0** | **865.3** | **110.3** | **975.6** |
| **Share capital and reserves** | | | | | | | |
| Called-up share capital | | 100.0 | - | 100.0 | 100.0 | - | 100.0 |
| Other reserves | i | 32.0 | 1.2 | 33.2 | 33.7 | (0.4) | 33.3 |
| Total equity | | **132.0** | **1.2** | **133.2** | **133.7** | **(0.4)** | **133.3** |
| **Total equity and liabilities** | | **784.7** | **89.5** | **874.2** | **999.0** | **109.9** | **1,108.9** |

## 37 Explanation of transition to FRS 101 (continued)

**Notes to the reconciliation of equity**

**a) Treasury bills/Loans and advances to credit institutions:**
Under UK GAAP Treasury bills were held at amortised cost. Under IFRS these are now held at fair value which equates to market value as these are actively traded on a recognised exchange. The net increase of £2.9m at 1 November 2014, and £3.0m at 31 October 2015 reflects the difference between amortised cost and market value.

Under UK GAAP the collateral pledged in the form of Treasury bills was held at amortised cost. Under IFRS this is now held at fair value which equates to market value as Treasury bills are actively traded on a recognised exchange. The net decrease of £nil at 1 November 2014, and £0.3m at 31 October 2015 reflects the difference between amortised cost and market value.

**b) Debt securities**
Under UK GAAP debt securities were held at amortised cost. Under IFRS these are now held at fair value which equates to market value as these are actively traded on a recognised exchange. The net increase of £7.8m at 1 November 2014, and £6.7m at 31 October 2015 reflects the difference between amortised cost and market value.

**c) Loans and advances to customers:**
Under UK GAAP, loans and advances to customers were held at cost less provisions. Under FRS 101 the fixed for life mortgages have been classified at Fair Value through Profit and Loss. As a consequence, there has been an increase of £53.6m in the value of loans and advances, being the cumulative difference between the two valuation bases as at 1 November 2014. The corresponding increase as at 31 October 2015 was £67.3m.

**d) Intangible assets and tangible fixed assets:**
Development costs relating to computer software developments of £0.6m as at 1 November 2014 and £1.2m as at 31 October 2015 that qualified for recognition as Intangible Assets under FRS 101 had previously been capitalised within tangible fixed assets and have thus been reclassified.

**e) Investment properties (reversionary interests in properties):**
Under UK GAAP, reversionary interests in properties were included at cost, being the amount of the cash advanced to the customer together with related acquisition costs. Under FRS 101, these are now carried at fair value, which in part reflects the current market value of the property (as opposed to the market value when the original amount was loaned to the customer). The market value is also impacted by discounting the time value of money using an appropriate discount rate. This has resulted in an increase of reversionary interests of £26.0m at 1 November 2014 and £34.3m at 31 October 2015.

**f) Deferred tax assets / Pension liabilities:**
Under UK GAAP the defined benefit pension scheme liability was reflected in the financial statements, net of deferred taxation. On transition to FRS 101 the tax element has been shown as a deferred tax asset. The deferred tax asset on accumulated actuarial gains and losses at 1 November 2014 was £0.4m and at 31 October 2015 was £0.6m.

## Notes to the accounts
For the year ended 31 October 2016

## 37 Explanation of transition to FRS 101 (continued)

**g) Inventories / Assets classified as held for sale:**
Under UK GAAP one property was classified as stock (inventory) at 1 November 2014 as it was being actively marketed for sale in the amount of £3.2m. Under FRS 101 this qualifies to be reclassified as an asset held for sale since it meets the recognition criteria under IFRS. As such the asset has been reclassified in the balance sheet. At 31 October 2015 the value of this property had increased to £3.4m.

**h) Derivative financial instruments:**
Under UK GAAP the fair value of interest rate swaps entered into by the Bank was disclosed as "off-balance sheet" items and the valuation was not incorporated into the balance sheet. Under FRS 101, the market value of the interest rate swaps is required to be reflected in the balance sheet. Accordingly, at 1 November 2014 a liability of £90.9m was recognised and included as a derivative financial liability. A liability of £112.8m was similarly recognised as at 31 October 2015.

**i) Revaluation reserves:**
The revaluation reserve arising under previous UK GAAP is eliminated, as on first time adoption the value at which the assets are held is deemed to be cost. The previously existing revaluation reserve has been transferred to opening P&L account reserves.

## Notes to the accounts

For the year ended 31 October 2016

### 37 Explanation of transition to FRS 101 (continued)

**Reconciliation of profit and comprehensive income for year ended 31 October 2015**

| Reconciliation of profit for year ended 31 October 2015 | Note | UK GAAP | Effect of transition to FRS 101 | FRS 101 |
|---|---|---|---|---|
| | | £m | £m | £m |
| Interest receivable and similar income | a | 33.3 | 1.1 | 34.4 |
| Interest payable and similar charges | | (27.7) | - | (27.7) |
| **Net interest income** | | **5.6** | **1.1** | **6.7** |
| Fees and commissions receivable | a | 2.8 | (2.1) | 0.7 |
| Fees and commissions payable | | (0.8) | - | (0.8) |
| **Net fee and commission income** | | **2.0** | **(2.1)** | **(0.1)** |
| Other finance income / (costs) | b | 0.4 | (0.8) | (0.4) |
| Other operating income | c | 5.0 | (3.5) | 1.5 |
| | | | | |
| Gains/ (losses) on investment properties | d | - | (1.5) | (1.5) |
| Net Losses from derivative financial instruments | e | - | (22.1) | (22.1) |
| Gain/ (loss) recognised on measurement to fair value | f | 0.9 | 23.9 | 24.8 |
| **Net fair value gains** | | **0.9** | **0.3** | **1.2** |
| **Net operating income** | | 13.9 | (5.0) | 8.9 |
| Administrative expenses | | (6.7) | (0.4) | (7.1) |
| Depreciation and amortisation | | - | - | - |
| Impairment provision for losses on loans and advances to customers | g | (2.1) | 1.9 | (0.2) |
| **Profit before taxation** | | **5.1** | **(3.5)** | **1.6** |
| Tax on profit | | (0.8) | 0.2 | (0.6) |
| **Profit after taxation** | | **4.3** | **(3.3)** | **1.0** |

# Notes to the accounts
For the year ended 31 October 2016

## 37 Explanation of transition to FRS 101 (continued)

**Notes to the reconciliation of profit**

**a) Interest receivable & similar income and Other operating income:**
Under UK GAAP, arrangement fees charged by the company on loan products were generally recognised on receipt (inception). Under FRS 101, arrangement fees cannot be recognised immediately as profit and consequently, amounts are classified as deferred income and recognised over the expected duration of the related loan contracts as part of the Effective Interest Rate (EIR) method. The EIR method is defined as a method of allocating the interest income or expense over the relevant period (expected product life or, if appropriate, a shorter period). This has resulted in an increase of £1.1m in interest receivable and similar income and a decrease of £2.1m in fees and commissions receivable.

**b) Defined benefit pension scheme/ Other finance costs:**
Under IFRS the expected return on pension scheme assets recognised differs to the treatment under UK GAAP. As a result, an additional charge of £0.6m has been made within the income statement and a corresponding reduction has been made within other comprehensive income.

**c) Other operating income**
As noted in note e) in Equity reconciliation, reversionary interests are now carried at fair value. Consequently, the profit on sale of these properties whilst under original historic cost is eliminated. As a result, profits have reduced by £3.5m in the year to 31 October 2015.

**d) Revaluation reserves:**
The Revaluation reserve is eliminated under FRS 101 and any gain or loss on the movement in the company’s investment properties now go through the income statement. The loss of £1.5m relates to the write-down of an investment property.

**e) Derivative financial instruments:**
Under UK GAAP the fair value of interest rate swaps entered into by the Bank was disclosed as an “off-balance sheet” item and the valuation was not incorporated into the balance sheet. Under FRS 101, the market value of the interest rate swaps is required to be reflected in the balance sheet. See note h) above relating to equity reconciliation. The movement of £22.1m represents the net loss on interest rate swaps for the year ended 31 October 2015.

**f) Gains/ (losses) on IFRS fair value re-measurements:**
The movement of £23.9m for the year to 31 October 2015 represents the movement in the fair value of both Loans and advances to customers and Investment properties (reversionary interests in properties) for the year to 31 October 2015. See notes c) & (e) to Equity transition table for more details.

**g) Impairment provision for losses on loans and advances to customers:**
The movement of £1.9m for the year to 31 October 2015 represents the movement in the impairment provision on conversion to FRS101.