# Julian Hodge Bank Limited

**Annual report and financial statements**
**31 October 2017**
**Registered number 743437**

# Officers and professional advisers

| | | |
|---|---|---|
| **Directors** | Adrian Piper | Chairman<br>B.A.,M.Sc.,<br>M.C.I.P.D.,<br>M.C.I.M |
| | Jonathan Hodge | Deputy Chairman |
| | David Austin | Chief Executive<br>LL.B., A.C.A. |
| | David Landen | Chief Financial Officer<br>B.Sc., F.C.C.A. |
| | Alun Bowen | M.A., F.C.A. |
| | Helen Molyneux | LLD (Hons) |
| | John Barbour | BSc., MBA |
| **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<br><br>Barclays Bank Plc<br>Cardiff | |
| **Economic adviser** | Professor Patrick Minford<br>Cardiff Business School | |

# Contents

# Chairman's statement

I am pleased to present my first set of the Bank's results for the year ended 31 October 2017.

Keith James, my predecessor as Chairman of Hodge Bank retired from the board on 30 June 2017, having served as a director since 2002 and Chairman since 2012.

The Bank is immensely grateful for Keith's leadership and counsel during this time, which encompassed the financial crisis and I would like to wish him well, on behalf of the board and all our colleagues at Hodge.

The Bank has enjoyed another strong year, making a pre-tax profit of £10.5 million (2016: restated £23.1 million). The reduction in the profit before tax is due to a number of one-off fair value gains recognised in 2016 that have not recurred. The adjusted net operating income which excludes these fair value movements has increased to £19.0 million (2016: £18.3 million) due to growth in our loan book and an improvement in net interest margin.

The transition to FRS 101 in the prior period has created greater volatility within the Bank's income statement as it requires certain assets previously held at amortised cost, to be at fair value 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.

Management consider 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.

**Highlights**

- Adjusted profit before tax has increased by 35.6%.
- Adjusted net operating income has increased by 3.9%.
- Tier 1 capital ratio of 21.1%.
- Increase in loans and advances to customers of 7.2%.
- Reduction in deposits (customer accounts) of 4.4%, as the Bank utilises excess liquidity.

**Economic Environment**

From a Hodge perspective, the key economic factors that affect performance are interest rates and residential and commercial real estate prices. Whilst UK-centric, these elements are heavily influenced by the perception of the U.K. globally, in particular, its attractiveness to the overseas investor.

The outlook for Brexit is clearly a major factor in this respect.

House price inflation has been relatively benign over the year marked by some regional variations, with London and the South-east for once, bringing up the rear. The commercial real estate market, in the areas in which we are engaged, has been relatively benign.

Longer term interest rates, whilst volatile over the year, have settled at a level slightly higher that that at which they opened; higher long-term interest rates are generally positive for the Bank.

## **Chairman's statement** (continued)

From an economic perspective, 2017 could be characterised as a year of relative stability, but there are potential headwinds for next year in the form of Brexit uncertainty, lack of wage growth relative to inflation and lower growth projections generally for the U.K; all of which could adversely impact on consumer confidence which remains an important driver of the economy.

**Financial Performance**

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 increased by 5.3% on our core lending products, reflecting a combination of growth in our loan book and margin improvement.

Administrative expenses have continued to increase 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.

**Five Year Summary**

| | **FRS101** | | | **UK GAAP** | |
|---|---|---|---|---|---|
| | **2017** | **Restated 2016** | **Restated 2015** | **2014** | **2013** |
| | **£m** | **£m** | **£m** | **£m** | **£m** |
| **Profit before tax** | **10.5** | **23.1** | **1.9** | **4.3** | **3.5** |
| **Adjusted operating profit** | **19.0** | **18.3** | **7.7** | **0.2** | **(4.6)** |
| **Total assets** | **1,267.4** | **1,324.0** | **1,115.7** | **784.7** | **726.5** |
| **Loans and advances to customers** | **757.9** | **706.9** | **624.8** | **440.8** | **384.0** |
| **Customer deposits** | **947.7** | **991.7** | **848.6** | **633.2** | **583.6** |
| **Shareholder's funds** | **167.3** | **153.5** | **140.1** | **132.0** | **128.2** |

**Commercial Lending**
Commercial Lending has had an exceptional year, driven primarily by increased fee income and bad debt recoveries whilst improving interest margin.

The recoveries made were especially pleasing as these were long-standing legacy cases where our determination and persistence to achieve the best possible result ultimately paid off. Because of these successes, we have seen a marked improvement in the risk profile of our loan book.

We have funded a wide variety of development and investment projects across the U.K; some highlights have included:

- financing renewable energy projects in Scotland and Northern Ireland;
- supporting the redevelopment of an historic London building involving creation of a museum featuring the U.K's earliest surgical theatre and a home for a renowned Michelin-starred restaurant;
- financing the development of a new leisure destination in Mumbles, Swansea, transforming the vibrancy of the seafront.

# **Chairman's statement** (continued)

Our strategy continues to be highly selective with respect to asset origination, 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.

## Hodge Lifetime

Hodge Lifetime is the Group's brand in the retirement market, focusing on later life lending, equity release and annuity products. Having been established in 1965, we were the first entrant into the equity release market, and have been a constant presence ever since.

*Equity release*

Residential property remains the principal asset for retirees and it is inevitable that a growing proportion will utilise their major asset to improve their retirement prospects through equity release. We have seen significant growth in this market over the past year, and it is expected to top £3 billion for the first time in 2017. Hodge Lifetime is well positioned to be able to offer the best products to this growing market, with over 50 years of experience.

*Later life lending*

In addition to growth in the equity release market, there is a developing need for broader 'later life lending' products to reflect the growing trend of mortgage debt being carried into older age and beyond retirement. A key driver of this trend is the number of interest-only mortgages falling due for repayment where the existing repayment vehicle is insufficient to clear the loan in full.

Over the past two years, we have responded to this trend by developing our later life lending proposition through the addition of our Retirement Mortgage (a hybrid lifetime mortgage) and 55+ Mortgage (a standard residential mortgage) to our product range.

Hodge Lifetime offers a full range of later life mortgage lending products which puts us in a strong position to capitalise on this growing market.

During the year we invested in a new customer relationship management system for our intermediary servicing team to improve our ability to support our intermediary relationships. We have also committed significant investment towards the development of a web portal to materially enhance the intermediary experience and allow them to transact business with us online.

## Treasury and Funding

The most significant event during the year was the launch of our on-line deposit service in September. This was achieved in the space of seven months and represented our most ambitious project to date, a first step towards delivering a digital strategy that will enable us to flourish in an ever more competitive marketplace.

We are currently undertaking the second phase of this project which is designed to offer on-line account servicing and increase the range of products that can be accessed in this manner.

Our aim is to expand the scope of our services so that customers can choose how they wish to do business with us.

# **Chairman's statement** (continued)

Initial uptake has been very encouraging with a significant proportion of new deposits being sourced through our on-line channel. Whilst it remains early days, with the developments we have planned, we will have a materially enhanced service offering and be able to attract new customers who previously would not have availed themselves of our services.

At the same time we recognise that there are some who prefer the traditional communication methods of telephone and post. Whatever the preference, we wish to ensure that we provide all customers with the same quality of service, and importantly, personalise that service as much as possible.

This is vitally important to support the growth in lending that we need to deliver our strategic objectives.

The Bank is a participant in the Bank of England's Term Funding Scheme, which provides a cost-effective source of funding in the form of central bank reserves to support additional lending to the real economy.

**Culture**

As the Bank continues to put the customer at the heart of its business, during the year, the board instigated a review of the organisation's purpose, mission and values and the culture which underpins them.

The board determined that to deliver its strategic objectives, there needed to be absolute clarity of purpose and an alignment with values and culture and in this respect a forum has been established involving people throughout the business to drive this initiative forward.

The board believes that a strong culture will serve to unify the organisation to work together in co-operation and collaboration towards common goal and objectives, which is imperative to generate greater value for all stakeholders.

**Our people**

We have been in our new premises in the heart of Cardiff for just over a year, and to accommodate our continued growth, we have recently taken additional space in the same building.

We now employ over 160 people and this will increase further over the next year as we implement our strategy to expand our distribution channels, deliver digital transformation and generate alternative funding sources to leverage our expertise in our core markets.

We have ambitious plans which will provide our people with challenge, but also the opportunity for development and advancement in an exciting and engaging environment.

In this regard, I would like to extend my thanks to our people who have invested a huge amount of time and energy to deliver an immense amount of change over the past year, whilst still maintaining a great service to customers.

# **Chairman's statement** (continued)

## Outlook

It is safe to assume that the economic environment will remain uncertain for the foreseeable future. Brexit and the likelihood of some form of transitional arrangement, should see to that.

In addition, regulatory change continues to increase and will clearly continue to be an area of focus for the industry and the Bank, as we respond to the increasingly demanding agenda.

The pace of business change is unremitting and the Board has committed to significant investment over the next few years to ensure that our people have the right systems and resources to enhance our products and services and to ensure that we remain relevant to our customers in the digital age.

In doing so, we are determined not to lose sight of those qualities which have contributed to our success, namely, fairness, personal service and a commitment to excellence in everything we do.

**Adrian Piper**
Chairman
14 December 2017

# 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 strategic plan with the long-term aim of achieving strong and stable returns for our Shareholder. At the heart of the Bank's philosophy is a wish to protect its capital base for the benefit of its depositors, and shareholders 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 and lifetime mortgages 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 5.

## Results and dividends

The profit for the year after taxation amounted to £10.2m *(2016 restated: £17.9m).* No dividend was paid during the year *(2016: £nil)* leaving a surplus for the year of £10.2m (*2016 restated: £17.9m)* 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.

# **Strategic Report** (continued)

## Corporate Governance

A comprehensive corporate governance framework is vital in supporting executive management in its execution of strategy and in driving long-term sustainable performance. It helps ensure that the shareholder's investment in the Bank is protected, while at the same time recognising the interests of our wider stakeholders.

The Board's agenda during 2017 was focused on overseeing and supporting executive management in delivering on the Bank's strategic objectives.

The Board comprises two executive and five non-executive directors and 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.

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 at every Board meeting 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.

# **Strategic Report** (continued)

## 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 reviewing operational performance of the Bank. The Board holds regular discussions with the Bank's major shareholders to ensure a clear understanding of their views and requirements and during the year a shareholder covenant was agreed detailing the shareholders' expectations of the Bank.

The Chairman is responsible for the leadership and operation of the Board, setting the agenda and the tone of Board discussions as well as assessing the effectiveness of the Board and its directors.

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.

Details of the members of the Board are set out below.

### Adrian Piper – Chairman

Adrian has been a non-executive director since 2010, and was appointed its Chairman in July 2017.

Before joining the Board, Adrian enjoyed a career of almost 40 years with the Bank of England, latterly as its Agent for Wales. Adrian is also a member of the Audit Committee of Cardiff Metropolitan University.

### Alun Bowen - Non-executive director

Alun joined the Board in 2013, and is the Chair of the Risk and Conduct Committee.

Alun enjoyed a long career at KPMG. He became the Managing Partner of KPMG in Kazakhstan in 2008 and before that was the firm's Senior Partner in Wales, specialising in the banking, insurance and retail financial services sectors. Between 2001 and 2005, he also headed KPMG's practice advising global companies on sustainability.

Alun is Chair of the Audit Committees of PAO Severstal and is a Fellow of the Institute of Chartered Accountants in England & Wales.

Alun has also been chairman of Business in the Community in Wales, a member of the Council of the Prince's Trust Cymru and the BT Wales Advisory Board.

### Jonathan Hodge - Non-executive director

Jonathan is the son of the Company's founder, Sir Julian Hodge, and represents the family's interest on the Board as well as chairing the Nomination Committee.

# **Strategic Report** (continued)

### Helen Molyneux - Non-executive director

Helen joined the Board in June 2015 and is also Chair of the Remuneration Committee.

Until November 2016, Helen was chief executive of NewLaw Legal, a business she established from scratch, which now employs over 400 people. She is a non-executive director of NewLaw Legal and a non-executive director of EUI Ltd, a subsidiary of the Admiral Insurance Group.

In 2011 Helen was named Welsh Woman of the Year and in 2013, the Law Society's Business Woman of the Year. She was a member of the Silk Commission on Devolution in Wales and currently chairs the Institute of Welsh Affairs. In 2016, she was awarded an honorary doctorate by the University of South Wales in recognition of her services to the legal profession.

### John Barbour - Non-executive director

John joined the Board in March 2017, and is also Chair of the Audit Committee.

John was previously Managing Director of Treasury at ICBC Standard Bank, the London-based financial markets and commodities bank, owned by China-based ICBC and South African-based Standard Bank. He has spent his entire career in treasury and financial markets-related roles, having previously worked at Investec and Bank of New York.

### David Landen – Chief Financial Officer

David joined the Bank in 2002 and has held a variety of finance and treasury roles during his time with the organisation. He was appointed to the Board as Chief Financial Officer in 2011. An accountancy graduate from Cardiff University, he is a fellow of the Association of Chartered Certified Accountants.

### David Austin – Chief Executive

David joined the Board in 1991 as Finance Director and was appointed Chief Executive in 1997. David is a chartered accountant having spent twelve years at KPMG in its Cardiff office.

### Rhian Yates - Company Secretary

Rhian joined the Company in 2004 as a graduate within Internal Audit, progressing to become Internal Audit Manager. She was appointed to the role of Company Secretary in 2010. In the same year Rhian became the Head of Compliance & Risk.

A mathematics graduate from Swansea University, Rhian is also a fellow of the Association of Chartered Certified Accountants.

# **Strategic Report** (continued)

## Board Committees

The Board has established the following standing committees:

- **Audit committee:** John Barbour (Chair), Jonathan Hodge, Helen Molyneux, Adrian Piper 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 (Chair), Jonathan Hodge, Helen Molyneux, John Barbour 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 (Chair), Alun Bowen, Jonathan Hodge, John Barbour 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 Chairman.

  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.

# **Strategic Report** (continued)

- **Nomination committee:** Jonathan Hodge (Chair), Alun Bowen, Helen Molyneux, John Barbour 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 Company has an appropriate succession plan for executive and senior management positions.

  The committee meets as required.

### Board and Committee Membership and Attendance

| Name | Board | | Audit committee | | Risk and conduct committee | | Remuneration committee | | Nomination committee | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **(a)** | **(b)** | **(a)** | **(b)** | **(a)** | **(b)** | **(a)** | **(b)** | **(a)** | **(b)** |
| Keith James* | 8 | 6 | 4 | 3 | 4 | 3 | 3 | 3 | 1 | 1 |
| John Barbour** | 8 | 5 | 4 | 3 | 4 | 2 | 3 | 1 | - | - |
| Jonathan Hodge | 8 | 8 | 4 | 4 | 4 | 4 | 3 | 3 | 1 | 1 |
| Helen Molyneux | 8 | 8 | 4 | 4 | 4 | 4 | 3 | 3 | 1 | 1 |
| Adrian Piper | 8 | 8 | 4 | 4 | 4 | 4 | 3 | 3 | 1 | 1 |
| Alun Bowen | 8 | 8 | 4 | 4 | 4 | 4 | 3 | 3 | 1 | 1 |
| David Austin | 8 | 8 | 4 | 4 | 4 | 4 | - | - | - | - |
| David Landen | 8 | 8 | 4 | 4 | 4 | 4 | - | - | - | - |

**(a)** Number of meetings held
**(b)** Number of meetings attended

* Keith James retired from the Bank in June 2017.
** John Barbour was appointed as a non-executive director in March 2017.

# **Strategic Report** (continued)

### Risk management

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.

**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. The company mitigates house price risk by monitoring maximum Loan to Value at inception of the loan.

**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 32 shows an estimate of the interest rate sensitivity gap as at 31 October 2017. 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. 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.

**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 reports to the risk and conduct committee, which ensures adherence to the Bank's risk management policy and framework. The assets and liabilities committee covers liquidity risk, market risk and credit risk for treasury counterparties. Strategic risk is monitored through the Board.

The Bank 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 £149.3m (21.1% as a percentage of risk weighted assets) and liquidity, including liquid assets (Gilts, central bank reserves and wholesale cash deposits), of £216.6m (22.8% 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*
14 December 2017

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 2017.

During the year the Company issued 5,000,000 of ordinary shares at par of £1 each to The Carlyle Trust Limited.

During the year there was a transfer of ownership of the Company from The Carlyle Trust Limited to Hodge Limited by way of a share for share exchange.

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

Business review and future developments - page 6
Results and dividends - page 6
Going concern - page 13
Risk management policies - page 12
Financial instruments – note 32

**Directors and their interests**

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

| | |
|---|---|
| Adrian Piper * | Chairman |
| Keith James* (resigned 30 June 2017) | |
| David Austin | Chief Executive |
| Alun Bowen * | |
| Jonathan Hodge * | Deputy Chairman |
| Helen Molyneux* | |
| John Barbour* (appointed 16 March 2017) | |
| David Landen | Chief Financial Officer |

* Non-executive

All non-executive directors excluding Jonathan Hodge are deemed to be independent by the board. Jonathan Hodge is the holder of 45,724 ordinary shares in the Bank's U.K. parent entity, The Carlyle Trust Limited. None of the other directors held any interests in the shares of any Group companies.

During the year, there were no contracts entered into by the Bank in which the directors had a material interest.

**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.

# **Directors' report** (continued)

### 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 directors' report.

### Prior period misstatement

The Income Statement, Statement of Comprehensive Income, Balance Sheet and Statement of Changes in Equity have been restated for a prior period misstatement. Further information is provided within note 36 to the financial statements.

### Auditor

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

By order of the Board

**David Landen**
*Director*

14 December 2017

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

## Opinion

We have audited the financial statements of Julian Hodge Bank Limited for the year ended 31 October 2017 which comprise the Income Statement, Statement of Comprehensive Income, Balance Sheet, Statement of Changes in Equity and the related notes 1 to 36 including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards including FRS 101 "Reduced Disclosure Framework" (United Kingdom Generally Accepted Accounting Practice).

In our opinion, the financial statements:

- give a true and fair view of the company's affairs as at 31 October 2017 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

## Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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

## Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

## Overview of our audit approach

| | |
|---|---|
| Key audit matters | • Actuarial assumptions for the equity release mortgage assets<br>• Collateral valuations for the commercial loan loss provision<br>• Valuation of derivative financial instruments<br>• Correction of prior year reversion error |
| Materiality | • Overall materiality of £2.3m which represents 1.4% of equity. |

**Key audit matters**

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

| **Risk** | **Our response to the risk** | **Key observations communicated to the Audit Committee** |
|---|---|---|
| Actuarial assumptions for the equity release mortgage assets (Fixed for life mortgages: £294.7m, 2016: £331.0m, Reversion properties: £105.8m, 2016 restated: £106.1m)<br><br>The valuation of the equity release mortgage assets (fixed for life mortgages and reversion products) is highly judgemental as it relies upon a number of assumptions with high estimation uncertainty, including those in respect of the No Negative Equity Guarantee (NNEG), voluntary early redemption, discount rate, policyholder mortality/longevity and expenses.<br><br>Inappropriate assumptions may lead to a material misstatement in the financial statements.<br><br>The fixed for life mortgages are disclosed as loans and advances in note 16 of the financial statements, which also includes sensitivity analysis of changes to key assumptions.<br><br>The reversion properties are disclosed as investment properties in note 21 of the financial statements, with the principal assumptions and sensitivities analysis of changes to key assumptions disclosed in note 21. | We assessed the Equity Release Mortgage (ERM) asset valuation to ensure that it is in accordance with industry 'best practice' and the requirements of financial reporting and regulatory standards. As part of our audit, we assessed the valuation methods and assumptions used. The key assumptions we focussed our audit work on were as follows:<br><br><u>No Negative Equity Guarantee</u><br>We considered a combination of current and projected future economic experience and the historic experience of the portfolio.<br><br><u>ERM voluntary early redemption</u><br>We considered both partial and full early redemption levels compared to the assumed levels along with other deviations in experience throughout the year. Particular attention was paid to the level of current and future early redemption charges within the ERM contracts and the interaction of this with the revised ERM operating environment that has emerged over the last 18 months.<br><br><u>Discount rate</u><br>We assessed the discount rate assumption within the valuation. This includes comparison of the discount rates against the range used by other companies in the sector as well as relative liquidity levels and customer rates available in the market. | Overall, we consider the assumptions that are used within the ERM valuation to be reasonable.<br><br><u>No Negative Equity Guarantee</u><br>We consider the approach taken by management to calculate the value of the NNEG to be reasonable. In line with the position at YE 2016, the methodology applied is conservative in comparison to the wider industry, yet within an acceptable range.<br><br><u>ERM voluntary early redemption</u><br>We consider the voluntary early redemption assumptions to be reasonable in light of recent company experience.<br><br><u>Discount rate</u><br>We consider the discount rates applied for lifetime mortgages and reversions to be appropriate given current market rates.<br><br>However, we note that the discount rates applied by management in the valuation of lifetime mortgages are less conservative than those applied within the wider industry, and we have therefore determined that the assumption is at the lower end of the acceptable range. |

| | | |
|---|---|---|
| | Policyholder mortality/longevity<br>We assessed the mortality assumptions by considering recent actual experience. We also compared the assumption adopted by management for future improvements with those used by other companies in the sector, allowing for particular factors around the profile of the Company's business compared to the industry experience.<br><br>Expenses<br>Our assessment considered both recent and future expected expense experience and how this has been appropriately reflected within the unit costs and inflation assumptions used within the valuation. | Policyholder mortality/longevity<br>Overall, we consider the mortality assumptions to be reasonable, noting in particular for YE 2017 that management has moved from the Continuous Mortality Improvement (CMI) 2011 to the recently published CMI 2016 table, for mortality improvements. The use of the CMI 2016 table is in line with current market practice and represents the most up to date view of mortality improvement in the UK.<br><br>Expenses<br>We consider the expense assumptions used in the valuation to be reasonable.<br><br>However, the best estimate allowances for expenses contain limited buffer in respect of the high level of uncertainty within the cost base. As a result, these are at the lower end of the reasonable range. |
| Collateral valuations for the commercial loan loss provision (2017: £33.2m, 2016: £43.5m)<br><br>The assessment of the loan loss provision is inherently judgemental, with the valuation of the collateral a key input to the calculation of the provision.<br><br>The loan collateral is disclosed in note 33 of the financial statements. | We performed a walkthrough to understand the provisioning process, and tested the controls over the valuation of collateral. We also assessed the provisioning methodology to ensure compliance with financial reporting standards.<br><br>For a sample of individually impaired loans we utilised our property valuation team specialists to evaluate whether a sample of the property valuations were materially correct at the reporting date. This involved understanding the latest developments on the property and performing an independent valuation of the collateral.<br><br>The sample covered £32.6m of the collateral value for impaired loans. | The controls within the process were tested and were operating effectively.<br><br>For the sample selected for testing, each item was evaluated and determined to be within an acceptable range. |

| | | |
|---|---|---|
| Valuation of derivative financial instruments (£131.1m, 2016: £150.6m)<br><br>The Company has significant derivative financial instruments, which it uses to manage interest rate risk. The valuation of these derivatives is determined through the application of valuation techniques which often involve the exercise of judgement and the use of assumptions and estimates.<br><br>Due to the significance of the financial instruments and the related estimation uncertainty this is considered a key audit risk.<br><br>The financial statement value is the counterparty valuation, which is independently assessed for reasonableness by management.<br><br>The fair value of these derivative financial instruments is disclosed in note 25 of the financial statements. | We worked with our derivative valuation specialists to value a sample of derivative financial instruments.<br><br>The valuation involved making an independent valuation and comparing whether management's value was within an acceptable threshold.<br><br>The sample selected covered £125.3m (96%) of the total population. | The valuation of the items in the sample selected was within an acceptable range, albeit towards the optimistic end. |
| Correction of prior year reversion error (2017: £0m, 2016: £7.1m, 2015: £6.8m)<br><br>During the financial year the Company identified that a data error in the recorded valuation date, resulting from a historic migration in 2004, had resulted in the incorrect indexing of a number of reversion properties.<br><br>An exercise was undertaken to correct the valuation of these assets, and to determine if any other assets were impacted.<br><br>The correction of the error is disclosed in note 36 of the financial statements. | We obtained management's assessment of reversion policies and tested the calculations to assess the quantification of the financial statement impact. This included validating the filtering criteria applied to the reversion population to identify the policies with the data error, and validating the revised model results.<br><br>For 22 policies with a data error we obtained the underlying file to independently verify the correction of the data. We also tested a sample of 25 policies which had not been identified as having a data error by management and obtained the underlying file to independently verify the date recorded.<br>We considered whether the errors identified were isolated to the subset of data or indicative of other underlying data issues. This included discussions with management to identify any other historic migrations which could indicate other data errors.<br>We validated that the error quantified by management was appropriately disclosed in the financial statements. | Based on the testing performed we are satisfied that the correcting adjustment is materially correct and appropriately disclosed in the financial statements.<br>Our testing did not identify any further data errors. |

**An overview of the scope of our audit**

**Tailoring the scope**
Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for the company. This enables us to form an opinion on the financial statements. We take into account size, risk profile, the organisation of the company and effectiveness of controls, including controls and changes in the business environment when assessing the level of work to be performed.

**Our application of materiality**

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

**Materiality:** *The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.*

We determined materiality for the company to be £2.3m (2016: £1.5m), which is 1.4% (2016: 1%) of equity. We believe equity to be the most appropriate basis as the PRA's primary concern is solvency and the principal shareholder is focused on the long term future of the business. We set materiality at 1% in the prior year due to the focus on the IFRS conversion and its impact on the income statement and balance sheet.

During the course of our audit, we reassessed and confirmed that the final materiality was in line with initial materiality.

**Performance materiality:** *The application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.*

On the basis of our risk assessments, together with our assessment of the company's overall control environment, our judgement was that performance materiality was 50% (2016: 50%) of our planning materiality, namely £1.1m (2016: £0.8m). We have set performance materiality at this percentage due to the audit differences identified in 2016 and the prior year restatement.

**Reporting threshold:** *An amount below which identified misstatements are considered as being clearly trivial.*

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.1m (2016: £0.1m), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

**Other information**

The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

**Opinions on other matters prescribed by the Companies Act 2006**

In our opinion, based on the work undertaken in the course of the audit:

- 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; and
- the strategic report and directors' report have been prepared in accordance with applicable legal requirements.

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

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or directors' report.

We have nothing to report in respect of the following matters in relation to which 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 to be audited 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.

**Responsibilities of directors**

As explained more fully in the Directors' Responsibilities Statement set out on page 16, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

**Auditor's responsibilities for the audit of the financial statements**

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

**Explanation as to what extent the audit was considered capable of detecting irregularities, including fraud**

The objectives of our audit, in respect to fraud, are; to identify and assess the risks of material misstatement of the financial statements due to fraud; to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and to respond appropriately to fraud or suspected fraud identified during the audit. However, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

Our approach was as follows:

- We obtained an understanding of the legal and regulatory frameworks that are applicable to the company and determined that the most significant were the regulations, permissions and supervisory requirements of the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA'), under the terms of the Financial Services and Markets Act 2000 (the Act).

- We understood how the Company complies with these legal and regulatory frameworks by making enquiries of management, internal audit, and those responsible for legal and compliance matters. We also reviewed correspondence between the Company and UK regulatory bodies; reviewed minutes of the Board and Executive Risk Committees; and gained an understanding of the Company's approach to governance, demonstrated by the Board's approval of the Company's governance framework and the Board's review of the Company's risk management framework ('RMF') and internal control processes.

- Based on this understanding we designed our audit procedures to identify non-compliance with such laws and regulations identified in the paragraphs above. Our procedures involved: making enquiry of those charged with governance and senior management for their awareness of any non-compliance of laws or regulations, inquiring about the policies that have been established to prevent non-compliance with laws and regulations by officers and employees, inquiring about the company's methods of enforcing and monitoring compliance with such policies, inspecting significant correspondence with the FCA and PRA.

- The Company operates in the banking industry which is a highly regulated environment. As such the Senior Statutory Auditor considered the experience and expertise of the engagement team to ensure that the team had the appropriate competence and capabilities, which included the use of specialists where appropriate.

- We assessed the susceptibility of the Company's financial statements to material misstatement, including how fraud might occur, by considering the controls that the Company has established to address risks identified by the entity, or that otherwise seek to prevent, deter or detect fraud. We also considered areas of significant judgement, and the impact these have on the control environment. Where this risk was considered to be higher, we performed audit procedures to address each identified fraud risk. These procedures included testing manual journals and were designed to provide reasonable assurance that the financial statements were free from fraud or error.

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.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at https://www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

**Other matters we are required to address**

- We were appointed by the company on 22 April 2016 to audit the financial statements for the year ending 31 October 2016 and subsequent financial periods. The period of total uninterrupted engagement including previous renewals and reappointments is 2 years, covering the years ending 31 October 2016 to 31 October 2017.

- Non-audit services prohibited by the FRC's Ethical Standard were not provided to the company and we remain independent of the company in conducting the audit.

- The audit opinion is consistent with the additional report to the audit committee.

***Andy Blackmore*** *(Senior statutory auditor)*
*for and on behalf of Ernst & Young LLP, Statutory Auditor*
*Bristol*
*18 December 2017*

Notes:
1. The maintenance and integrity of the Julian Hodge Bank Limited 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 2017

| | Notes | 2017 £m | Restated 2016 £m |
|---|---|---|---|
| Interest receivable and similar income | 5 | 41.3 | 42.2 |
| Interest payable and similar charges | 6 | (27.4) | (29.0) |
| **Net interest income** | | **13.9** | **13.2** |
| Fees and commissions receivable | | 0.5 | 1.1 |
| Fees and commissions payable | | (1.2) | (0.7) |
| **Net fee and commission income** | | **(0.7)** | **0.4** |
| Other finance costs | | - | (0.1) |
| Other operating income | 7 | 1.0 | 0.8 |
| Investment income | | 4.8 | 4.0 |
| Other fair value gains | 8 | 0.3 | 15.5 |
| **Net operating income** | | **19.3** | **33.8** |
| Administrative expenses | 10 | (9.9) | (8.1) |
| Depreciation and amortisation | | (0.5) | (0.2) |
| Impairment provision credit/(expense) for losses on loans and advances to customers | 17 | 1.6 | (2.4) |
| **Profit before taxation** | **9** | **10.5** | **23.1** |
| Tax on profit | 11 | (0.3) | (5.2) |
| **Profit for the financial year** | | **10.2** | **17.9** |

# Statement of other comprehensive income
For the year ended 31 October 2017

| | Notes | 2017 £m | Restated 2016 £m |
|---|---|---|---|
| Profit for the financial year | | 10.2 | 17.9 |
| **Items that will not be reclassified subsequently to profit and loss:** | | | |
| Re-measurement of defined benefit pension plan | 29 | 0.4 | (9.1) |
| Deferred tax thereon | 22 | (0.1) | 1.5 |
| Movement of pension scheme reimbursement asset | 23 | (0.9) | 2.3 |
| Deferred tax thereon | 22 | 0.1 | (0.4) |
| **Items that may be transferred to the Income Statement Available-for-sale investments:** | | | |
| Fair value movements taken to reserves | | (0.1) | 1.1 |
| Deferred tax thereon | 22 | (0.8) | - |
| **Total comprehensive income for the year** | | **8.8** | **13.3** |

The results for the year ended 31 October 2017 relate entirely to continuing operations. The notes on pages 28 to 80 form part of these financial statements.

# Balance sheet
As at 31 October 2017

| | Notes | 2017 £m | Restated 2016 £m |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances held at central banks | 12 | 87.0 | 168.0 |
| Treasury bills | 13 | 87.3 | 84.7 |
| Debt securities | 14 | 77.0 | 89.1 |
| Loans and advances to credit institutions | 15 | 107.6 | 128.3 |
| Loans and advances to customers | 16 | 757.9 | 706.9 |
| Shares in group undertakings and participating interests | 18 | 16.0 | 16.0 |
| Intangible assets | 19 | 1.7 | 1.2 |
| Property, plant & equipment | 20 | 2.0 | 2.1 |
| Investment properties | 21 | 118.6 | 114.9 |
| Deferred tax assets | 22 | 7.3 | 8.3 |
| Other assets | 23 | 5.0 | 4.5 |
| **Total assets** | | **1,267.4** | **1,324.0** |

| | Notes | 2017 £m | Restated 2016 £m |
|---|---|---|---|
| **Liabilities** | | | |
| Deposit from banks | | 2.8 | 2.8 |
| Deposits from customers | 24 | 947.7 | 991.7 |
| Derivative financial instruments | 25 | 131.1 | 150.6 |
| Other liabilities | 26 | 2.1 | 8.7 |
| Accruals and deferred income | 27 | 3.1 | 2.8 |
| Other provisions | 28 | 0.3 | 0.4 |
| Pension liabilities | 29 | 13.0 | 13.5 |
| **Total liabilities** | | **1,100.1** | **1,170.5** |
| **Share capital and reserves** | | | |
| Called-up share capital | 30 | 105.0 | 100.0 |
| Other Reserves | | 62.3 | 53.5 |
| **Total equity** | | **167.3** | **153.5** |
| **Total equity and liabilities** | | **1,267.4** | **1,324.0** |

These financial statements were approved by the Board of directors on 14 December 2017 and were signed on its behalf by:

**David Austin**
*Director*

**David Landen**
*Director*

## Statement of changes in equity
For the year ended 31 October 2017

| | Called up Share Capital | Profit and loss account | Available-for-sale reserve | Pension reserve | Total |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| **2017** | | | | | |
| Restated at beginning of year | 100.0 | 56.6 | 5.1 | (8.2) | 153.5 |
| Profit for the financial year | - | 10.2 | - | - | 10.2 |
| Other comprehensive income | - | - | (0.9) | (0.5) | (1.4) |
| Issue of share capital | 5.0 | - | - | - | 5.0 |
| **At end of year** | **105.0** | **66.8** | **4.2** | **(8.7)** | **167.3** |

| | 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 | 31.9 | 4.0 | (2.5) | 133.4 |
| Restated for prior period error (see note 36) | - | 6.8 | - | - | 6.8 |
| **Restated at beginning of year** | **100.0** | **38.7** | **4.0** | **(2.5)** | **140.2** |
| Restated profit for the financial year (see note 36) | - | 17.9 | - | - | 17.9 |
| Other comprehensive income | - | - | 1.1 | (5.7) | (4.6) |
| **At end of year** | **100.0** | **56.6** | **5.1** | **(8.2)** | **153.5** |

# Notes to the accounts

For the year ended 31 October 2017

## 1 Accounting policies

**Basis of preparation**

These financial statements were prepared in accordance with Financial Reporting Standard 101 Reduced Disclosure Framework ("FRS 101").

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.

The immediate parent undertaking of the Company is Hodge Limited. The parent undertaking of the smallest group of undertakings for which group accounts are drawn up and of which the company is a member is Hodge Limited. 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 group of undertakings for which group accounts are drawn up and of which the company is a member. The accounts of Hodge Limited and The Carlyle Trust Limited can 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 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;
- 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.

**Measurement convention**

The Company prepares its accounts under the historical cost convention, except for certain financial assets and liabilities held at fair value.

**Summary of Significant Accounting Policies**

**Consolidation**

The Company is the parent of Hodge Life Assurance Company Limited.

The Company is a wholly owned subsidiary of its immediate parent Hodge Limited, the intermediate parent The Carlyle Trust Limited and ultimate parent, The Carlyle Trust (Jersey) Limited. Julian Hodge Bank Limited is included in the consolidated financial statements of both Hodge Limited and The Carlyle Trust Limited which are publicly available.

Therefore, the Company is exempt by virtue of section 400 of the Companies Act 2006 from the requirement to produce consolidated financial statements.

## 1 Accounting policies (continued)

**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.

**Investment income**

Investment income consists of realised gains and losses on financial assets and liabilities at fair value through profit and 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.

## 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 32.

**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 2017

## 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) 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 2017

## 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 32.

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 fair value gains' 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 2017

## 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 counterparties 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 32.

**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.

# Notes to the accounts
For the year ended 31 October 2017

## 1 Accounting policies (continued)

### Hedge accounting (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 the 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.

## 1 Accounting policies (continued)

**Investment properties (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 benefit is expected from its disposal. 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 fair value gains'.

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 benefit is expected from its disposal. Any gains/ losses on the retirement or disposal of an investment property are recognised in the Income Statement in the year of disposal.

**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.

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.

# Notes to the accounts
For the year ended 31 October 2017

## 1 Accounting policies (continued)

**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 29). The obligation falls to the Bank's ultimate UK 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.

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

**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 2017

## 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 from which it is probable that the obligation will be settled and a reliable estimate can be made of the amount of the obligation.

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 value 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 financial statements. 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:

**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 condition.

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 2017

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

**Fair values of Financial Instruments**
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, further analysis can be found in note 25.

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 depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

**Measurement of the no-negative guarantee with respect to lifetime mortgages.**
Estimation uncertainty surrounds the measurement of liabilities arising from the no-negative guarantee in respect of lifetime mortgages. The key assumptions used as part of the valuation calculation include future property prices and their volatility, mortality and the rate of voluntary redemptions. Further information on these assumptions is given in note 32(d).

**Value of investment properties.**
All gains and losses arising from reversionary interests in property are largely dependent on property prices and longevity of the tenant. The key assumptions used are disclosed in note 21.

# Notes to the accounts

For the year ended 31 October 2017

## 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**.**

| | 2017 | Restated 2016 |
|---|---|---|
| | £m | £m |
| **Reconciliation of net operating income to adjusted net operating income** | | |
| Net operating income | 19.3 | 33.8 |
| Adjusted for: | | |
| Net (gains)/losses from derivative financial instruments; | (18.4) | 35.8 |
| Net losses/(gains) arising from fair value re-measurements | 16.8 | (51.2) |
| Movement in fair value of hedged items attributable to hedged risk | 1.3 | (0.1) |
| **Adjusted net operating income** | **19.0** | **18.3** |

| | 2017 | Restated 2016 |
|---|---|---|
| | £m | £m |
| **Reconciliation of profit before tax to adjusted profit before tax** | | |
| Profit before tax | 10.5 | 23.1 |
| Adjusted for: | | |
| Net (gains)/losses from derivative financial instruments; | (18.4) | 35.8 |
| Net losses/(gains) arising from fair value re-measurements | 16.8 | (51.2) |
| Movement in fair value of hedged items attributable to hedged risk | 1.3 | (0.1) |
| **Adjusted profit before tax** | **10.2** | **7.6** |

The principal reconciling items are as follows:

**Net gains 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 gain of £18.4 million for the year to 31 October 2017 (2016: losses of £35.8 million) represents the movement in market value of the derivative financial instruments for the year ending 31 October.

**Net losses arising from fair value re-measurements**
The fair value re-measurements relate to those assets and liabilities fair valued as disclosed in note 32. 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 2017

## 3 Reconciliation to non-GAAP measures and performance (continued)

**Movement in fair value of hedged items attributable to hedged risk**
The fair value movements relate to the fair value movements of items attributable to hedged risk as disclosed in note 8.

## 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

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Loans and advances to customers | 36.6 | 36.2 |
| Loans and advances to credit institutions | 0.8 | 0.7 |
| On other loans | 0.2 | 1.4 |
| Interest and other income on treasury bills & debt securities | 3.7 | 3.9 |
| | **41.3** | **42.2** |

## 6 Interest payable and similar charges

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| On customer accounts | 14.2 | 16.3 |
| On derivative financial instruments | 13.2 | 12.7 |
| | **27.4** | **29.0** |

## 7 Other operating income

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Rental income from investment properties (Note 21) | 0.4 | - |
| Profit on sale of debt securities | - | 0.1 |
| Profit on assets available for sale | - | 0.7 |
| Other | 0.6 | - |
| | **1.0** | **0.8** |

# Notes to the accounts
For the year ended 31 October 2017

## 8 Other fair value gains

| | 2017 | Restated 2016 |
|---|---|---|
| | £m | £m |
| Gains/(losses) on derivatives designated as fair value | 18.4 | (35.8) |
| (Losses)/gains on assets designated as fair value* | (16.8) | 51.2 |
| Movement in fair value of hedged items attributable to hedged risk | (1.3) | 0.1 |
| | **0.3** | **15.5** |

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

Fair value (losses)/gains on Available-for-sale investments of £(0.1)m (2016: £1.1m) have been taken to the Statement of Other Comprehensive Income.

## 9 Profit on ordinary activities before taxation

| | 2017 | 2016 |
|---|---|---|
| | £000 | £000 |
| **Profit on ordinary activities before taxation is stated after charging:** | | |
| Remuneration of the auditor and its associates | | |
| Audit of these financial statements | 48 | 57 |
| Audit of pension scheme | 10 | 9 |
| Depreciation | 274 | 76 |
| Amortisation | 243 | 140 |
| Bad debt provision (credit)/expense | (1,554) | 2,406 |

## 10 Administrative expenses

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| **Staff costs** | | |
| Wages and salaries | 4.9 | 4.1 |
| Social security | 0.5 | 0.4 |
| Pension costs (note 29) | 1.2 | 0.6 |
| | **6.6** | **5.1** |
| Other administrative expenses | 3.3 | 3.0 |
| | **9.9** | **8.1** |

## 10 Administrative expenses (continued)

### Directors and employees

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

| | 2017 | 2016 |
|---|---|---|
| | No | No |
| Provision of finance and banking | 105 | 90 |
| | **105** | **90** |

Staff costs include remuneration in respect of directors as follows:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Fees | 0.2 | 0.2 |
| Aggregate emoluments as executives | 0.3 | 0.4 |
| | **0.5** | **0.6** |

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

| | 2017 | 2016 |
|---|---|---|
| | £000 | £000 |
| Aggregate emoluments | 206 | 214 |
| | **206** | **214** |

The highest paid director is a deferred member of a defined benefit scheme under which his accrued pension at the year end was £Nil *(2016: £46,000).*

Retirement benefits are accruing to 1 *(2016: 1)* director in a defined benefit scheme.

# Notes to the accounts
For the year ended 31 October 2017

## 11 Tax on profit

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| **Analysis of charge in year** | | | | |
| *UK corporation tax* | | | | |
| Current tax on income for the year | - | | 10.9 | |
| Prior period adjustment | 0.1 | | - | |
| **Total current tax** | | **0.1** | | **10.9** |
| *Deferred tax (see note 22)* | | | | |
| Origination/reversal of timing differences: | | | | |
| Current period | 1.0 | | (5.7) | |
| Prior period adjustment | (0.8) | | - | |
| **Total deferred tax** | | **0.2** | | **(5.7)** |
| **Tax on profit on ordinary activities** | | **0.3** | | **5.2** |

The total tax charge for the year is lower than (*2016: higher than)* the blended rate of corporation tax in the UK. The differences are explained below.

| | 2017 | Restated 2016 |
|---|---|---|
| | £m | £m |
| *Total tax reconciliation* | | |
| Profit on ordinary activities before tax | 10.5 | 23.1 |
| **Current tax at 19.40% (2016: 20.00%)** | **2.0** | **4.6** |
| Expenses not deductible for tax purposes | | |
| Investment properties | (0.8) | - |
| Index Linked Gilt RPI movement | (0.3) | (0.1) |
| Rate differences | (0.1) | 0.8 |
| Other | 0.2 | (0.1) |
| Adjustments in respect of previous years | (0.7) | - |
| **Total tax charge (see above)** | **0.3** | **5.2** |

Reductions in the UK corporation tax rate to 17% (effective 1 April 2020) were substantively enacted on 6 September 2016. This will reduce the company's future current tax charge accordingly.

The deferred tax asset at 31 October 2017 has been calculated based on these rates.

# Notes to the accounts
For the year ended 31 October 2017

## 12 Cash and balances held at central banks

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Repayable on demand: | | |
| Deposits with other central banks | 87.0 | 168.0 |
| | **87.0** | **168.0** |

## 13 Treasury bills

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Listed on a UK recognised investment exchange | 84.5 | 81.0 |
| Fair value adjustment – Hedge Accounting | 2.8 | 3.7 |
| | **87.3** | **84.7** |

The movement in treasury bills is summarised as follows:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| At 1 November | 84.7 | 84.0 |
| Additions | 6.0 | 23.0 |
| Redemptions | (2.0) | (25.0) |
| (Losses)/gains from changes in fair value | (1.4) | 2.7 |
| **At 31 October** | **87.3** | **84.7** |

Of this amount £30m *(2016: £51m)* has been provided as collateral for derivative financial instruments (see note 25). Collateral that has been pledged is not restricted.

# Notes to the accounts
For the year ended 31 October 2017

## 14 Debt securities

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Debt securities – listed on a UK recognised investment exchange | 71.5 | 83.0 |
| Fair value adjustment – Hedge Accounting | 0.9 | 1.4 |
| Fair value adjustment – Available for Sale | 4.6 | 4.7 |
| | **77.0** | **89.1** |

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| ***Debt securities – maturity analysis*** | | |
| Within three months | 27.3 | 11.2 |
| Between three months and one year | 3.9 | 9.0 |
| More than one year but less than five years | 14.8 | 36.4 |
| Five years and over | 31.0 | 32.5 |
| | **77.0** | **89.1** |

Of this amount £18.2m *(2016: £21.2m)* 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

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Repayable on demand | 4.3 | 27.6 |
| Collateral held by swap counterparties | 103.3 | 100.7 |
| | **107.6** | **128.3** |

The collateral is pledged against the market value of derivative instruments and comprises interest-bearing cash deposits (see note 25). Collateral that has been pledged and held is not restricted and is returned at the end of the contract. There are no provisions held in respect of loans and advances to credit institutions (2016: Nil).

# Notes to the accounts
For the year ended 31 October 2017

## 16 Loans and advances to customers

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Loans and advances – classified as loans and receivables | 461.0 | 374.2 |
| Amounts owed from immediate parent and fellow subsidiaries | 1.8 | 1.3 |
| Fair value adjustment for hedged risk | 0.4 | 0.4 |
| | **463.2** | **375.9** |
| Loans and advances (fixed for life mortgages) – classified as fair value through profit & loss – see note 32 | 294.7 | 331.0 |
| | **757.9** | **706.9** |

Of this amount £76.3m *(2016: £80.0m)* 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 is not restricted and is returned at the end of the contract.

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Loans and advances to customers | | |
| Gross balances | 469.9 | 386.5 |
| Less: Provision for impairment | (6.4) | (10.0) |
| Less: Loan fee deferral | (2.5) | (2.3) |
| **Net balance** | **461.0** | **374.2** |

# Notes to the accounts
For the year ended 31 October 2017

## 17 Impairment provisions on loans and advances to customers

| | Specific | Collective | Total |
|---|---|---|---|
| | £m | £m | £m |
| **2017** | | | |
| At 1 November 2016 | 9.8 | 0.2 | 10.0 |
| Utilised on redemption | (2.0) | - | (2.0) |
| Amounts written back during the year – Income Statement | (2.4) | - | (2.4) |
| Charge for loan impairment – Income Statement | 0.8 | - | 0.8 |
| **At 31 October 2017** | **6.2** | **0.2** | **6.4** |

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

For further details on loans and advances to customers refer to Note 33(a).

## 18 Shares in subsidiary undertakings

| | 2017 | 2016 |
|---|---|---|
| | £m | £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 2017

## 19 Intangible assets

| | Computer software | |
|---|---|---|
| | 2017 | 2016 |
| | £m | £m |
| **Cost:** | | |
| At 1 November 2016 | 1.3 | 1.2 |
| Additions | 0.7 | 0.1 |
| **At 31 October 2017** | **2.0** | **1.3** |
| **Amortisation:** | | |
| At 1 November 2016 | (0.1) | - |
| Amortisation | (0.2) | (0.1) |
| **At 31 October 2017** | **(0.3)** | **(0.1)** |
| **Net book value:** | | |
| **At 31 October 2017** | **1.7** | **1.2** |

## 20 Property, plant and equipment

| 2017: | Short leasehold improvements | Fixtures, fittings and equipment | Total |
|---|---|---|---|
| | £m | £m | £m |
| **Cost:** | | | |
| At 1 November 2016 | 1.5 | 1.4 | 2.9 |
| Additions | 0.1 | 0.1 | 0.2 |
| Disposals | - | (0.8) | (0.8) |
| **At 31 October 2017** | **1.6** | **0.7** | **2.3** |
| **Depreciation:** | | | |
| At 1 November 2016 | - | (0.8) | (0.8) |
| Disposal | - | 0.8 | 0.8 |
| Depreciation | (0.1) | (0.2) | (0.3) |
| **At 31 October 2017** | **(0.1)** | **(0.2)** | **(0.3)** |
| **Net book value:** | | | |
| **At 31 October 2017** | **1.5** | **0.5** | **2.0** |
| At 31 October 2016 | 1.5 | 0.6 | 2.1 |

## Notes to the accounts
For the year ended 31 October 2017

### 21 Investment properties

| | Freehold | Restated Reversionary Interests | Total |
|---|---|---|---|
| | £m | £m | £m |
| **2017** | | | |
| Restated at 1 November 2016 | 8.8 | 106.1 | 114.9 |
| Additions | 0.1 | - | 0.1 |
| Disposals | - | (7.7) | (7.7) |
| Fair value adjustments | 3.9 | 7.4 | 11.3 |
| **At 31 October 2017** | **12.8** | **105.8** | **118.6** |

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. In arriving at the valuation, the key considerations made included the age of the property, its location, its existing tenant as well as the proposed redevelopment of the surrounding area.

The historical cost of the freehold investment properties was:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| At cost | 12.7 | 12.6 |
| | **12.7** | **12.6** |

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 32).

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

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Rental income from Investment properties | 0.4 | - |
| Direct operating expenses from Investment properties that did not generate rental income in year | - | (0.4) |
| | **0.4** | **(0.4)** |

## 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 4.16% (2016: 4.30%).

**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 2017) was 2.46% (31 October 2016: 2.24%).

**Property prices**
The value of a property is based on the value at the last survey increased to the current valuation date using the Nationwide House Price Index, 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 Company has estimated the net decrease in profit before tax 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 |
| **At 31 October 2017** | **(1.8)** | **(1.4)** | **(0.1)** | **(10.0)** |
| At 31 October 2016 | (1.3) | (1.4) | (0.1) | (10.0) |

# Notes to the accounts
For the year ended 31 October 2017

## 22 Deferred tax

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| At 1 November | 8.3 | 1.5 |
| (Charge) / Credit to the income statement | (0.2) | 5.7 |
| (Charge) / Credit to the statement of other comprehensive income | (0.8) | 1.1 |
| **At 31 October** | **7.3** | **8.3** |

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

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Accelerated capital allowances | 0.3 | 0.3 |
| Other timing differences | 6.0 | 6.2 |
| Timing differences on AFS reserve | (0.8) | - |
| Timing differences on reimbursement asset | (0.4) | (0.5) |
| Defined benefit pension scheme | 2.2 | 2.3 |
| **At 31 October** | **7.3** | **8.3** |

The unrecognised deferred tax assets are £Nil (2016: £Nil).

## 23 Other assets

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Prepayments and accrued income | 1.2 | 0.8 |
| Pension reimbursement asset | 2.5 | 3.4 |
| Corporation tax debtor | 0.8 | - |
| Other assets | 0.5 | 0.3 |
| **At 31 October** | **5.0** | **4.5** |

## 24 Deposits from customers

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Repayable on demand | 20.0 | 10.9 |
| With agreed maturity dates or periods of notice and repayable: | | |
| - within three months | 337.7 | 353.5 |
| - between three months and one year | 366.3 | 318.1 |
| - between one and five years | 214.8 | 293.6 |
| - over five years | - | - |
| | **938.8** | **976.1** |
| Amounts owed to parent and fellow subsidiary undertakings | 9.2 | 15.6 |
| Fair value adjustment for hedged risk | (0.3) | - |
| | **947.7** | **991.7** |

# Notes to the accounts
For the year ended 31 October 2017

## 25 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 | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| | £m | £m | £m | £m |
| **Derivative liabilities held for hedging purposes and designated fair value hedges:** | | | | |
| Interest rate swaps | 338.3 | 326.9 | 126.5 | 143.9 |
| RPI index linked interest rate swaps | 55.0 | 55.0 | (0.1) | 0.9 |
| Fair value adjustment for hedged risk | 176.5 | 179.3 | 4.7 | 5.8 |
| **Total recognised derivative liabilities** | **569.8** | **561.2** | **131.1** | **150.6** |

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 2017, the fixed interest rates vary from 0.3% to 5.4% (2016: 0.7% 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.

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Net gains/(losses) recognised within the income statement | 18.4 | (35.8) |
| | **18.4** | **(35.8)** |

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).

# Notes to the accounts

For the year ended 31 October 2017

## 26 Other liabilities

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Due within one year: | | |
| Corporation tax liability | - | 7.4 |
| Amounts owed in relation to mortgages administered for third parties | 1.8 | 1.1 |
| Other creditors | 0.3 | 0.2 |
| | **2.1** | **8.7** |

## 27 Accruals and deferred income

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Due within one year: | | |
| Accruals | 3.1 | 2.8 |
| | **3.1** | **2.8** |

## 28 Other provisions

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| At 1 November | 0.4 | 0.4 |
| Additions | - | 0.1 |
| Utilisation | (0.1) | (0.1) |
| **At 31 October** | **0.3** | **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 2017 was £0.2m (2016: £0.3m).

In addition, a provision of £0.1m (2016: £0.1m) for conduct risk in relation to PPI is included at the balance sheet date.

## 29 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 2017 is 21 years (2016: 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 calculations are based upon an assessment of the Scheme’s liabilities as at 31 October 2017. These have been based upon the results of the 1 April 2016 formal triennial valuation projected forward with allowance for benefit accrual and expected investment return. The next triennial valuation will be carried out on 1 April 2019. No further provision has been recognised.

The Bank’s total expense for the year, including its share of prior service savings, amounted to £1.6m *(2016: £0.8m)*. Its subsidiary Hodge Life Assurance Company Limited reimbursed the Company £0.3m for its share of the total expense. The Company has agreed that it will aim to eliminate the pension scheme deficit over the next 11 years and additional contributions of £0.8m were paid into the scheme in the year ended 31 October 2017. Funding levels are monitored on an annual basis and the company has agreed to maintain the contribution rate at 19.5% from 1 November 2017.

The IAS 19 valuation as at 31 October 2017 has been produced by a qualified independent actuary, and is based on the results of the valuation as at 1 April 2016.

## 29 Pension scheme (continued)

### 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:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Fair value of plan assets | 24.2 | 25.7 |
| Present value of defined benefit obligations | (37.2) | (39.2) |
| **Deficit** | **(13.0)** | **(13.5)** |

### Movements in present value of defined benefit obligation

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Present value of scheme liabilities at start of the period | 39.2 | 29.1 |
| Interest cost | 1.1 | 1.1 |
| Current service cost | 1.2 | 0.6 |
| Member contributions | 0.2 | 0.2 |
| **Actuarial (gain)/loss on defined benefit obligation of which:** | | |
| due to experience | - | 0.4 |
| due to demographic assumptions | (0.4) | (0.8) |
| due to financial assumptions | 0.1 | 9.9 |
| Benefits paid | (4.2) | (1.3) |
| **Present value of scheme liabilities at end of the period** | **37.2** | **39.2** |

# Notes to the accounts
For the year ended 31 October 2017

## 29 Pension scheme (continued)

Cashflows have been adjusted to allow for the IAS19 assumptions detailed below:

### Movements in fair value of plan assets

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Market value of assets at the beginning of the year | 25.7 | 24.7 |
| Interest income | 0.7 | 1.0 |
| Actuarial gain | 0.1 | 0.4 |
| Member contributions | 0.2 | 0.2 |
| Employer contributions | 1.7 | 0.7 |
| Benefits paid | (4.2) | (1.3) |
| **Market value of assets at the end of the year** | **24.2** | **25.7** |

### Expense recognised in the profit and loss account

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Current service cost – staff costs | (1.2) | (0.6) |
| Net Interest expense – other finance costs | (0.4) | (0.2) |
| | **(1.6)** | **(0.8)** |

The total amount recognised in the statement of other comprehensive income in respect of actuarial gains and losses is a gain of £0.4m (2016: loss of £9.1m) before tax.

Cumulative actuarial losses reported in the statement of other comprehensive income since the date of transition to FRS 101 are losses of £9.3m (2016: losses of £9.7m) before tax.

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

| | Fair Value | |
|---|---|---|
| | 2017 | 2016 |
| | £m | £m |
| Quoted equity investments | 5.8 | 6.2 |
| Diversified growth funds | 16.1 | 16.5 |
| Property | 0.2 | 0.1 |
| Bonds | 1.3 | 2.0 |
| Cash | 0.8 | 0.9 |
| **Total market value of assets** | **24.2** | **25.7** |

The actual return on assets was £0.7m (2016: £1.5m)

## 29 Pension scheme (continued)

**Future contributions**
The Bank expects to contribute approximately £2.0m to its defined benefit plan in the next financial year.

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

| | 2017 | 2016 |
|---|---|---|
| | % | % |
| Rate of increase in salaries | 4.4 | 4.5 |
| Rate of increase in LPI pensions in payment and deferred pensions | 3.3 | 3.4 |
| Rate of CARE revaluation | 2.4 | 2.5 |
| Discount rate applied to scheme liabilities | 2.7 | 2.8 |
| RPI inflation assumption | 3.4 | 3.5 |

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:

| | 2017 | 2016 |
|---|---|---|
| Current pensioners age 65 - male | 87.0 | 87.0 |
| Current pensioners age 65 - female | 88.8 | 88.9 |
| Future pensioners age 65 (current age 45) - males | 88.0 | 88.2 |
| Future pensioners age 65 (current age 45) - females | 90.0 | 90.4 |

**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 | Change in deficit £m |
|---|---|---|
| Discount rate | 0.1% | 0.8 |
| Rate of Inflation ( RPI or CPI) | 0.1% | 0.6 |
| Life expectancy | 1 year | 1.1 |

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 2017

## 29 Pension schemes (continued)

### History of plan balance sheets

| (* the years from 2013 to 2014 were measured under UK Gaap) | 2017 £m | 2016 £m | 2015 £m | 2014 £m | 2013 £m |
|---|---|---|---|---|---|
| Fair value of plan assets | 24.2 | 25.7 | 24.7 | 23.5 | 23.0 |
| Present value of funded defined benefit obligations | (37.2) | (39.2) | (29.1) | (27.1) | (25.7) |
| **Deficit** | **(13.0)** | **(13.5)** | **(4.4)** | **(3.6)** | **(2.7)** |

### History of experience gains and losses

| (* the years from 2013 to 2014 were measured under UK GAAP) | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| **Difference between the expected and actual return on scheme assets:** | | | | | |
| Amount | £0.0m | £0.5m | £0.2m | £(0.6)m | £0.8m |
| Percentage of year end scheme assets | 0.0% | 1.5% | 0.7% | 2.5% | 3.5% |
| **Experience gains and losses on scheme liabilities:** | | | | | |
| Amount | £(0.0)m | £(0.4)m | £(0.0)m | £(0.0)m | £(0.0)m |
| Percentage of year end present value of scheme liabilities | 0.0% | 1.0% | 0.0% | 0.0% | 0.0% |
| **Total amount recognised in statement of comprehensive income:** | | | | | |
| Gain/(losses) before tax | £0.4m | £(9.1)m | £(0.6)m | £(1.7)m | £(1.2)m |
| Percentage of year end present value of scheme liabilities | 1.1% | 23.0% | 2.0% | 6.3% | 4.7% |

## 30 Called up share capital

| | 2017 £m | 2016 £m |
|---|---|---|
| **Allotted, called-up and fully paid:** | | |
| 105,000,000 *(2016: 100,000,000)* ordinary shares of £1 each | 105.0 | 100.0 |
| | **105.0** | **100.0** |

On the 31 October 2017, 5,000,000 ordinary shares of £1 each were issued at par to The Carlyle Trust Limited.

## 31 Financial commitments and contingent liabilities

### Loan commitments

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| **Commitments** | | |
| expiring in less than one year | 83.8 | 111.9 |
| expiring in more than one year | 57.3 | 82.9 |
| | **141.1** | **194.8** |

### Capital commitments

The Bank had contracted capital commitments amounting to £nil at 31 October 2017 *(2016: £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:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Within one year | 0.5 | - |
| Between one and five years | 2.2 | 1.8 |
| After five years | 4.7 | 4.2 |
| | **7.4** | **6.0** |

# Notes to the accounts
For the year ended 31 October 2017

## 32 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 2017 | 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 | 87.0 | - | - | - | 87.0 |
| Treasury bills | 11.6 | - | 20.6 | 55.1 | 87.3 |
| Debt securities | 9.0 | - | 68.0 | - | 77.0 |
| Loans and advances to credit institutions | 107.6 | - | - | - | 107.6 |
| Loans and advances to customers | 2.2 | 461.0 | - | 294.7 | 757.9 |
| **Total financial assets** | **217.4** | **461.0** | **88.6** | **349.8** | **1,116.8** |
| Total non-financial assets | | | | | 150.6 |
| **Total assets** | | | | | **1,267.4** |
| **Liabilities** | | | | | |
| Deposit from banks | 2.8 | - | - | - | 2.8 |
| Deposit from customers | 947.7 | - | - | - | 947.7 |
| Derivative financial instruments | - | - | - | 131.1 | 131.1 |
| Other liabilities | 2.1 | - | - | - | 2.1 |
| Accruals and deferred income | 3.1 | - | - | - | 3.1 |
| **Total financial liabilities** | **955.7** | **-** | **-** | **131.1** | **1,086.8** |
| Total non-financial liabilities | | | | | 13.3 |
| Share capital and other reserves | | | | | 167.3 |
| **Total reserves and liabilities** | | | | | **1,267.4** |

# Notes to the accounts
For the year ended 31 October 2017

## 32 Financial instruments (continued)

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

| As at 31 October 2016 | At amortised cost | Loans and receivables | Available-for-sale | Fair value through profit and loss | Restated 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 | | | | | 147.0 |
| **Total assets** | | | | | **1,324.0** |
| **Liabilities** | | | | | |
| Deposit from banks | 2.8 | - | - | - | 2.8 |
| Deposit from customers | 991.7 | - | - | - | 991.7 |
| Derivative financial instruments | - | - | - | 150.6 | 150.6 |
| Other liabilities | 8.7 | - | - | - | 8.7 |
| Accruals and deferred income | 2.8 | - | - | - | 2.8 |
| **Total financial liabilities** | **1,006.0** | **-** | **-** | **150.6** | **1,156.6** |
| Total non-financial liabilities | | | | | 13.9 |
| Share capital and other reserves | | | | | 153.5 |
| **Total reserves and liabilities** | | | | | **1,324.0** |

## 32 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 2017 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| **Financial assets at fair value through profit or loss (FVTPL)** | | | | |
| Treasury bills | 55.1 | - | - | 55.1 |
| Loans and advances to customers | - | - | 294.7 | 294.7 |
| **Total financial assets at FVTPL** | **55.1** | **-** | **294.7** | **349.8** |
| **Financial liabilities at fair value through profit or loss (FVTPL)** | | | | |
| Derivative financial instruments | - | 131.1 | - | 131.1 |
| **Total financial liabilities at FVTPL** | **-** | **131.1** | **-** | **131.1** |

# Notes to the accounts
For the year ended 31 October 2017

## 32 Financial instruments (continued)

| As at 31 October 2016 | Level 1 £m | Level 2 £m | Level 3 £m | Total £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** |

### 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 debt securities 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.

## 32 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 £294.7m (2016: £331.0m) of assets which have been classed as fair value through the profit and loss as they relate to fixed for life mortgages.

On initial recognition, the fair value of loans secured by mortgages is calculated by discounting the future cash flows at swap rates together with an allowance for illiquidity. If the difference between the fair value at transaction date and the transaction price is a gain, it is not recognised but deferred and recognised uniformly over the expected life of the loan. If the difference is a loss, this is expensed to the income statement immediately.

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.

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| At start of period | 16.1 | 16.3 |
| Amounts deferred in the period | 1.0 | 1.3 |
| Release of previously recognised gains | - | (1.7) |
| Amounts recognised in the income statement in the period | (2.3) | 0.2 |
| **At end of period** | **14.8** | **16.1** |

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

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| At start of period | 331.0 | 291.9 |
| Total gains in income statement | (9.8) | 54.7 |
| Loans advanced | 2.6 | 5.7 |
| Redemptions | (29.1) | (21.3) |
| **At end of period** | **294.7** | **331.0** |

***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 CMI2016 model for longevity improvements.

## 32 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 4.16% (2016: 4.30%).

**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 2017) was 2.46% (31 October 2016: 2.24%).

**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 2017 were 3.04% (31 October 2016: 3.28%) and 11% (31 October 2016: 11%) respectively. The value of the no-negative equity guarantee as at 31 October 2017 was £13.3m (31 October 2016: £15.4m).

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 2017 the amount deferred was £14.8m. (2016: £16.1m).

# Notes to the accounts
For the year ended 31 October 2017

## 32 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 net decrease in profit before tax for the period arising from changes to these inputs as follows:

| | Interest rates +100 BP | Maintenance expenses +10% | Property inflation -100bps | Property prices -10% | Lapses +10% | Mortality +10% |
|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m |
| **At 31 October 2017** | **(32.6)** | **(0.5)** | **(7.9)** | **(4.4)** | **(8.5)** | **(3.1)** |
| At 31 October 2016 | (39.5) | (0.6) | (10.0) | (4.9) | (10.6) | (3.3) |

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.

# Notes to the accounts
For the year ended 31 October 2017

## 32 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 2017 | 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 | 87.0 | - | - | - | - | 87.0 |
| Treasury bills | - | 4.5 | 6.2 | 66.1 | 10.5 | 87.3 |
| Debt securities | 27.4 | 1.9 | 2.0 | 14.8 | 30.9 | 77.0 |
| Loans and advances to customers | 30.9 | 25.7 | 11.9 | 224.4 | 465.0 | 757.9 |
| Loans and advances to credit institutions | 107.6 | - | - | - | - | 107.6 |
| **Total financial assets** | **252.9** | **32.1** | **20.1** | **305.3** | **506.4** | **1,116.8** |
| **Liabilities** | | | | | | |
| Deposit from banks | 2.8 | - | - | - | - | 2.8 |
| Deposit from customers | 366.6 | 114.0 | 252.3 | 214.8 | - | 947.7 |
| Derivative financial instruments | 0.2 | 0.1 | 0.5 | 10.2 | 120.1 | 131.1 |
| Other liabilities | 2.1 | - | - | - | - | 2.1 |
| Accruals and deferred income | 3.1 | - | - | - | - | 3.1 |
| **Total financial liabilities** | **374.8** | **114.1** | **252.8** | **225.0** | **120.1** | **1,086.8** |
| | | | | | | |
| **Loan Commitments liabilities** | **82.2** | **0.8** | **0.8** | **50.0** | **7.3** | **141.1** |

## 32 Financial instruments (continued)

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

| 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 |
| Other liabilities | 8.7 | - | - | - | - | 8.7 |
| Accruals and deferred income | 2.8 | - | - | - | - | 2.8 |
| **Total financial liabilities** | **395.7** | **101.8** | **216.5** | **303.4** | **139.2** | **1,156.6** |
| | | | | | | |
| **Loan commitments Liabilities** | **111.9** | **-** | **-** | **29.2** | **53.7** | **194.8** |

# Notes to the accounts
For the year ended 31 October 2017

## 32 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 2017 | 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 | 947.7 | 366.5 | 114.5 | 254.9 | 224.6 | - | 960.5 |
| Derivative financial instruments | 131.1 | 7.7 | 4.4 | 7.1 | 44.9 | 91.2 | 155.3 |
| Other liabilities | 2.1 | 2.1 | - | - | - | - | 2.1 |
| Accruals and deferred income | 3.1 | 3.1 | - | - | - | - | 3.1 |
| **Total financial liabilities** | **1,086.8** | **382.2** | **118.9** | **262.0** | **269.5** | **91.2** | **1,123.8** |

| 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 | 380.9 | 102.4 | 219.7 | 307.7 | - | 1,010.7 |
| Derivative financial instruments | 150.6 | 0.8 | 3.2 | 7.2 | 51.3 | 106.0 | 168.5 |
| Other liabilities | 8.7 | 8.7 | - | - | - | - | 8.7 |
| Accruals and deferred income | 2.8 | 2.8 | - | - | - | - | 2.8 |
| **Total financial liabilities** | **1,156.6** | **396.0** | **105.6** | **226.9** | **359.0** | **106.0** | **1,193.5** |

## 32 Financial instruments (continued)

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.

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

## 33 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 which reports to the risk and conduct committee, which ensures adherence to the Bank's risk management policy and framework.

**Risk management objectives**
Risk is inherent in all aspects of the Bank's business. 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 Bank 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 32(a), along with the loan commitments as disclosed in the table in note 32(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 lending 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 a counterparty can no longer repay its obligations. Only instruments issued by counterparties with a minimum rating of BBB- at the point of purchase are held. 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.

## 33 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:

| | 2017 | |
|---|---|---|
| | £m | % |
| **In respect of loans and advances to customers:** | | |
| Fully secured by a first charge on residential property | 369.4 | 100.0 |
| | **369.4** | **100.0** |
| Fair value adjustments | 84.9 | |
| | **454.3** | |

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

The cumulative change in fair values due to credit risk amounts to losses of £13.3m (2016: £15.4m), and the change in the year is a profit of £2.1m (2016: £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. There are no residential loans and receivables that are impaired.

## 33 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 an 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 2017 amount to £Nil (2016: £Nil). The Bank has no accounts where forbearance options have been utilised. There are no residential loans and receivables that are impaired.

**Credit risk: Commercial lending**

**Commercial: Analysis of Risk concentration**

Loans secured on commercial property are as follows:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Loan Balance £m | Collateral Held £m | Loan Balance £m | Collateral Held £m |
| Commercial mortgage | 26.0 | 48.2 | 23.6 | 36.7 |
| Development finance | 45.6 | 70.8 | 63.7 | 92.6 |
| Investment loans | 217.8 | 373.4 | 188.2 | 267.0 |
| | **289.4** | **492.4** | **275.5** | **396.3** |

On inception commercial property loans are fully secured against the value of the related properties.

**Commercial: Analysis of Risk concentration**

The Bank's commercial loan portfolio comprises the following:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Loans secured on commercial property | 289.4 | 93.2 | 275.5 | 92.6 |
| Loans relating to Renewable energy sector | 20.9 | 6.8 | 22.1 | 7.4 |
| | **310.3** | **100.0** | **297.6** | **100.0** |
| Less: Loan fee deferral | (2.5) | | (2.3) | |
| Provisions for impairment | (6.4) | | (10.0) | |
| | **301.4** | | **285.3** | |

## 33 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:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Wales | 85.8 | 27.7 | 82.0 | 27.6 |
| London-England | 106.1 | 34.2 | 91.8 | 30.8 |
| South East & East of England | 22.4 | 7.2 | 35.6 | 12.0 |
| Midlands-England | 4.9 | 1.6 | 16.2 | 5.4 |
| South West of England | 73.4 | 23.6 | 57.3 | 19.3 |
| North West & North East of England | 4.1 | 1.3 | 3.8 | 1.3 |
| Scotland | 13.0 | 4.2 | 10.9 | 3.6 |
| Mixed/Other | 0.6 | 0.2 | - | - |
| | **310.3** | **100.0** | **297.6** | **100.0** |

The average loan to value (LTV) in respect of commercial loans is estimated to be 58.8% (2016: 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.

£16.2m (2016: £30.3m) of exposures have an LTV of greater than 100%. Of these, £14.8m (2016: £23.4m) are already classified as impaired, £Nil (2016: £3.5m) are on the Watchlist, leaving £1.4m (2016: £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 £23.0m (2016: £17.7m) or 7% (2016: 6%) 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):

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Satisfactory | 277.3 | 89.4 | 249.4 | 83.8 |
| Watchlist | 18.1 | 5.8 | 23.4 | 7.9 |
| Impaired | 14.9 | 4.8 | 24.8 | 8.3 |
| | **310.3** | **100.0** | **297.6** | **100.0** |

There are no commercial loans in arrears (2016: Nil).

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

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

Provisions are held against impaired loans as follows:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| Specific provisions | 6.2 | 9.8 |
| Collective provisions | 0.2 | 0.2 |
| | **6.4** | **10.0** |

**Past Due but not impaired**
As at 31 October 2017 there were no (2016: Nil) commercial loans that were past due and not impaired.

As at 31 October 2017 there were no commercial loans (2016: £Nil) 0-60 days past due but not impaired.

As at 31 October 2017 there were no commercial loans (2016: £17.5 million) 60-120 days past due but not 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:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| UK government and amounts held with central banks | 87.0 | 168.0 |
| Treasury bills | 87.3 | 84.7 |
| Loans and advances to credit institutions | 4.3 | 27.6 |
| Debt securities | 77.0 | 89.1 |
| | **255.6** | **369.4** |

None of these exposures is past due or impaired.

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

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| AAA to AA- | 225.3 | 313.2 |
| A+ to A- | 14.3 | 35.6 |
| BBB+ to BBB- | 12.1 | 17.2 |
| BB+ to BB- | 3.9 | 3.4 |
| | **255.6** | **369.4** |

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

### Treasury Credit risk (continued)

### Concentration of credit risk

The geographical exposure is as follows:

| | 2017 | 2016 |
|---|---|---|
| | £m | £m |
| UK | 229.6 | 334.8 |
| Other | 26.0 | 34.6 |
| | **255.6** | **369.4** |

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 32 (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 32(d) shows an estimate of the interest rate sensitivity gap as at 31 October 2017. 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 treasury matters on a day to day basis, prepares a treasury report for the Board, which includes analysis of interest rate risk exposures.

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

**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.

*Geographical analysis of loans secured on mortgages*

The company provides loans secured on property across England, Scotland, Northern Ireland and Wales. An analysis of residential property by geographical location is provided below:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | £m | % | £m | % |
| Wales | 7.9 | 3.9% | 7.8 | 3.5% |
| South East | 47.5 | 23.1% | 49.4 | 22.9% |
| South West | 26.2 | 12.7% | 27.4 | 12.7% |
| London | 22.5 | 11.0% | 27.1 | 12.6% |
| East Anglia | 25.0 | 12.2% | 26.7 | 12.4% |
| North West | 20.1 | 9.8% | 21.0 | 9.8% |
| West Midlands | 12.2 | 6.0% | 12.1 | 5.6% |
| North East | 9.6 | 4.7% | 9.6 | 4.5% |
| Yorkshire & Humberside | 8.7 | 4.2% | 8.9 | 4.1% |
| East Midlands | 9.3 | 4.5% | 9.6 | 4.5% |
| Scotland | 7.5 | 3.7% | 7.6 | 3.8% |
| Northern Ireland & Other | 8.5 | 4.2% | 8.3 | 3.6% |
| | **205.0** | **100.0%** | **215.5** | **100.0%** |

**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 Risk and Conduct Committee.

The Company holds a provision of £0.1m as at 31 October 2017 (2016: £0.1m) in respect of conduct risk which is disclosed in note 28.

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

**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.

## 34 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.

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 21.1% (2016: 19.1%) and a total capital ratio of 21.2% (2016: 19.2%) at 31 October 2017.

## 34 Capital risk management (continued)

**Capital Requirements Directive**
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 principal activities of the Bank are noted in the Strategic Report and the principal activities of its subsidiary 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.
- Corporation Tax paid: 2017 £8.4m *(2016: £3.7m)*.
- Public subsidies: There were none received in the year.

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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;

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

## 35 Ultimate parent undertaking

The immediate parent undertaking of the Company is Hodge Limited. The parent undertaking of the smallest group of undertakings for which group accounts are drawn up and of which the company is a member is Hodge Limited. The ultimate parent undertaking and controller is The Carlyle Trust (Jersey) Limited (incorporated in Jersey), a company controlled by a Hodge family trust, whose sole natural trustee is Jonathan Hodge.

Within the meaning of the Companies Act 2006, The Carlyle Trust Limited is the parent undertaking of the largest group of undertakings for which group accounts are drawn up and of which the company is a member. The accounts of Hodge Limited and The Carlyle Trust Limited can be obtained from The Registrar of Companies, Companies House, Crown Way, Cardiff, CF14 3UZ.

# Notes to the accounts
For the year ended 31 October 2017

## 36 Prior period misstatements

Following a review of the underlying data used, as part of the transition to IFRS, the directors have identified an understatement in the carrying value of reversionary interests disclosed within the investment properties balance. This has resulted in an adjustment being recognised to increase the carrying value of reversionary interests by £7.1 million at 31 October 2016 (£6.8 million at 31 October 2015). The corresponding adjustment has increased the other fair value gains within the Income Statement for the year ended 31 October 2016 by £0.3 million and other reserves balance within the Balance Sheet by £7.1 million at 31 October 2016.

In addition, the directors have decided to present realised gains/losses on the disposal of reversionary properties within investment income. These gains/losses were previously disclosed within other fair value gains. This change in presentation brings the classification of gains and losses in line with the group accounting policy. The directors consider the revised classification to be more reliable and relevant to the users of the financial statements as the nature of these realised gains and losses are more akin to investment income as opposed to being driven by fair value movements.

| | 2016 | Prior period misstatement | Reclassification | Restated 2016 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| **Income Statement:** | | | | |
| Investment income | - | - | 4.0 | 4.0 |
| Other fair value gains | 19.2 | 0.3 | (4.0) | 15.5 |
| **Net operating income** | **33.5** | **0.3** | **-** | **33.8** |
| **Profit before taxation** | **22.8** | **0.3** | **-** | **23.1** |
| **Profit for the financial year** | **17.6** | **0.3** | **-** | **17.9** |
| | | | | |
| **Balance Sheet:** | | | | |
| Reversionary interests | 107.8 | 7.1 | - | 114.9 |
| **Total assets** | **1,316.9** | **7.1** | **-** | **1,324.0** |
| Other reserves | 46.4 | 7.1 | - | 53.5 |
| **Total equity** | **146.4** | **7.1** | **-** | **153.5** |