HODGE

31 OCTOBER 2019

ANNUAL REPORT AND FINANCIAL STATEMENTS

Officers and professional advisers

DIRECTOR
Adrian Piper
Chairman
B.A., M.Sc.,
M.C.I.P.D., M.C.I.M.

DIRECTOR
Stephen Pateman
Chief Executive Officer
F.C.I.B.S.

DIRECTOR
Helen Molyneux
LLD (Hons),
LLB (Hons).

DIRECTOR
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AUDITOR
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DIRECTOR
David Landen
Chief Financial Officer
F.C.C.A., B.Sc.

DIRECTOR
Alun Bowen
F.C.A., M.A.

DIRECTOR
Graeme Hughes
A.C.I.B., M.B.A.

COMPANY SECRETARY
Kirsty Williams
LLB (Hons)

PRINCIPLE BANKERS
Lloyds Bank Plc
London

ECONOMIC ADVISORS
Professor Patrick Minford
Cardiff Business School

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STRATEGIC REPORT 2019

Chairman's Statement

Adrian Piper, Chairman
19 December 2019

I am pleased to present the financial statements of the Hodge Limited group (the 'Group') and Hodge Limited (the 'Company') for the year ended 31 October 2019.

The Group has two subsidiaries: Julian Hodge Bank Limited (the 'Bank') and Hodge Life Assurance Company Limited ('Hodge Life').

It is nearly 80 years since Sir Julian Hodge founded the Hodge group and our 79th year has been one of change as we look towards the future with a strategy that will seek to significantly improve our profitability and scale, with the aim of creating a financial services business with a £4.0bn Balance Sheet by 2023.

Whilst our focus will remain on the later life market, through the provision of annuities, equity release and retirement mortgages. We will continue to develop our commercial lending activities in development and investment finance and build out new niche markets. This year we entered the professional buy-to-let market and launched holiday let mortgages.

We continue to see ourselves as an innovator and recently launched a lifetime fixed rate retirement mortgage; we are also considering a range of inter-generational mortgage products that will help address the challenges that society faces in terms of unlocking housing equity to support a longer retirement or to help the next generation buy their first home.

We continue to place great value on having access to liquidity, primarily in the form of retail savings; our annuity and savings balances now total over £1.5bn; we seek to remain competitive, whilst offering good value to customers.

Our strategy is discussed in greater detail by our new Chief Executive on page 12. Steve Pateman joined us in January 2019 from Shawbrook and has made a very encouraging start; I and the Board would like to extend our appreciation to David Austin who retired as our Chief Executive Officer (CEO) this year after 28 years with Hodge. David made a significant contribution to our business over many years working through many challenges and we wish him well in his retirement.

Our results are discussed in detail by our Chief Financial Officer (CFO) on page 16. It was undoubtedly a challenging environment for both our Life and Banking businesses with significant volatility in equity and debt markets and historically low interest rates, all of which impacted capital levels as well as the IFRS results despite a robust performance at an operating profit level; notwithstanding a significant £4.3m loss on a commercial lending development transaction.

We took the opportunity to reduce our holding of legacy equity release mortgages in the banking business and this crystallised a gain of £19.5m compared with the balance outstanding on the mortgages but a loss of £4.6m on the IFRS fair value. The liquidity and capital created from this disposal will be deployed into our core businesses to produce less volatile returns in the future. We will look for further opportunities to reduce our legacy assets over the coming months and we have adjusted the fair value of the remaining assets to reflect the current market conditions.

The IFRS loss was mitigated in part by the gain of £3.1m which arose from selling our holding of corporate bonds as a result of the decision to restructure the treasury portfolio.

Notwithstanding the clarity provided by the general election result and the potential for a recovery in confidence and investment, there remains much uncertainty at this time both in the United Kingdom and on a global level and our central assumption is that interest rates and growth will remain low: whilst we see opportunities to grow our business and are confident that we can do so, our risk appetite remains prudent and our focus remains on assets that afford good levels of security.

Alongside the changes in executive leadership, the Board has continued to evolve. David Gulland has joined us to chair the newly formed Risk and Conduct Committee within Hodge Life and Graeme Hughes has been appointed as Senior Independent Director and will lead the search for my replacement when I stand down at the end of April 2020.

David has an extensive background in life assurance and his actuarial experience will help the Board provide appropriate challenge and oversight as we seek to optimise our capital profile in Hodge Life.

Graeme joins us after a long and successful career at Nationwide where he was the Group Distribution Director; responsible for all sales and service activities across 720 branches and 10,000 staff.

Alun Bowen will continue to chair the Risk and Conduct Committee until his retirement at the end of our next financial year. Alun has been and continues to be someone whose experience and commercial insights are very relevant to our business.

Jonathan Hodge has also stepped down from the Boards of Hodge Limited, the Bank and Hodge Life after 36 years as initially an executive director and from 2006 as the director representing the Shareholder's interests. Jonathan launched the application for a deposit taking licence in 1987 and was the first chairman of the Bank. Jonathan will retain an active interest in each of the businesses through his role as Chairman of The Carlyle Trust Limited. It is however appropriate to record our thanks to Jonathan for his energy, commitment, professionalism, wise and effective counsel over the many years he has served on the boards.

I would like to close what will be my final Chairman's Statement by extending my thanks to my colleagues on the Board for their wise counsel and support, to the executive leadership team and their staff for all their endeavour and commitment which underpins a robust set of results, in spite of all the headwinds, laying strong foundations for our future and finally to Jonathan Hodge for giving me the opportunity to play a part in a business that has been and continues to be unique in its ownership, ethos and approach not just in South Wales but across the financial services industry.

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STRATEGIC REPORT

Our Business and Corporate Social Responsibility

OUR BUSINESS

We are a privately-owned group seeking to make life better for our customers, colleagues and communities by providing specialist lending, savings and retirement solutions in a manner that is fair, friendly and personal.

We offer a full range of later life products assisting our customers prior to, at and post- retirement. Having been in this market since 1965 we have unrivalled expertise which allows us to develop products for customers based on a clear understanding of their needs. We have built on this history by moving into other specialist mortgage markets by launching both professional buy-to-let and holiday let products during the year, further enhancing our range of products for our customers.

We use our considerable experience to ensure that we have ample liquidity and capital to safeguard our customers' savings and to meet all regulatory requirements.

SPECIALIST MORTGAGES

The Group's specialist mortgage business combines our expertise in both residential and later-life lending.

We work in partnership with our trusted network of intermediaries, serving professional landlords through our portfolio buy-to-let mortgages, and personal customers through our later-life mortgages.

Our range of later-life mortgages includes retirement interest only (RIO) mortgages with no fixed-term end date and equity release, these products are available to those over 50.

2019 has been a year of progress, during which we focused on ensuring we put the customer at the heart of everything we do. We rolled out a number of product changes based on feedback from the broker community. Working closely with them to ensure the products we offer deliver for our customers and provide flexibility in a notoriously rigid market. This is essential as we look to evolve our product offering.

We have established a customer forum and continue to work closely with our broker network to ensure the products we design are needed and add value. Our specialist underwriting criteria will also serve to enhance our offering.

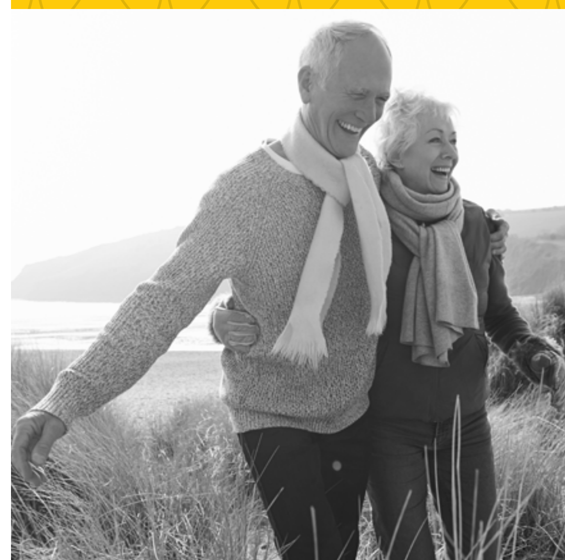
Over the past twelve months we have strengthened our team and, as a result, significantly improved our service. We shall continue to invest in this space in the next twelve months.

LATER LIFE

The later life market continues to grow and with our network of brokers continuing to enter this space, we are well positioned to support and add value.

In the past twelve months alone, we have enhanced our equity release offering and added downsizing protection from day one. This means if our customers choose to downsize their property, they can move without incurring an early repayment charge at any point.

In 2019 we also launched the fixed-for-life RIO which allows customers to choose a loan with a fixed rate for the lifetime of the loan, a market-leading development which demonstrates our commitment to delivering certainty to later-life borrowers.



As the creator of the first equity release product in 1965, the introduction of one of the first RIO mortgages and the first fixed-for-life RIO, we are a true innovator in this space.

COMMERCIAL LENDING

The focus of our commercial lending business is to be a long-term lending partner for our clients.

The past twelve months have been successful for the team, originating £101m of new lending across our established business lines.

It has also been a year of real progress and collaboration with the launch of a new proposition aimed at smaller property development schemes, and the creation of an innovative portfolio mortgage for buy-to-let investors.

Our risk experience at a portfolio level has been generally positive and we have not seen material impact from the recent spate of retail and leisure business failures which have received much media coverage this year.

Notwithstanding political uncertainties, we have found borrower demand for property in the SME space has remained robust. While we continue to be cautious in our appetite, we have found a steady stream of good quality proposals which we have been pleased to support.

Through our property development finance activities, we are proud to have facilitated the construction of many new homes across the country. Not only that, but to have supported in the regeneration of areas in which old buildings have been repurposed into vibrant new mixed-use schemes with community benefits.

We continue to enhance our wider governance and risk protocols which support this performance.

Our core proposition remains the provision of bespoke real estate funding solutions to experienced, serially-active property investors and developers. These clients value direct access to senior people and the responsiveness of a privately-owned bank.

However, during the year, we have also started to build up our presence in the wider commercial finance broker-led market as part of our strategy to grow the size and spread of our client base.

Similarly, we have worked hard to streamline our on-boarding process and further improve client experience, something which is so important for a business looking to build long-term relationships with clients.

The Commercial Lending team has grown significantly this year. Investing in our people and expanding our team of experienced relationship managers allows us to support our future growth plans and to serve our growing client base.

SAVINGS

Customer savings are, and will remain to be, the most important part of our funding base.

During the past year we have continued to invest in our digital offering, leveraging technology to create an enhanced experience for our customers.

Enhancing our on-line savings portal has created a secure, seamless self-serve platform for our customers. We will continue to increase our savings product offerings and invest in our digital capability to ensure our customers enjoy a positive and worry-free experience.

During the next twelve months we aim to expand the range of products that can be arranged online, giving customers even more control over how they engage with us.

While we are excited about these improvements to our digital offering, we recognise there will always be a need for human interaction. Some customers will prefer the human touch at every stage of their journey, while others just need the reassurance that any queries can be answered by a person. We are proud of the team of experts always on hand to support those customers.

We continue to manage over £1bn of our customers' savings balances providing competitive interest rates and an efficient personalised service. The recent expansion of our digital offering to include on-line account servicing has attracted more new customers and resulted in an increased proportion of our savings balances being raised through this channel.

The Group is also a participant in the Bank of England's Term Funding Scheme ('TFS'), which provides a cost-effective source of funding in the form of central bank reserves to support additional lending to the real economy. The TFS balance represents 6.3% of the overall funding from deposits with banks and customers at 31 October 2019.

PROFESSIONAL BUY-TO-LET

As the overhaul of the UK buy-to-Let market continues, Hodge has been able to make the most of our specialist underwriting approach to take advantage of these changes.

During the year we launched our professional buy-to-let mortgage, aimed at those portfolio landlords who are looking for a single lender relationship, flexibility to move properties in and out and the ability to grow.

With the market shifting towards professional landlords, Hodge has been able to focus on bringing innovative products and continues to look at developing our product offering.

HODGE LIFE

Hodge Life's business focuses on the retirement market and, in particular, pension annuities where we offer our products through financial intermediaries.

After a period of uncertainty, following the introduction of Pension Freedoms, this is a market which is recovering well. For many retirees, securing a guaranteed income for life remains an important priority and annuities are a key product to enable this.

We back our annuity liabilities with a range of long-term assets, including equity release mortgages which are a good match for these liabilities given their long-term fixed rates of interest. The mortgages are originated by our mortgages business which means collaborative working is vital to our approach.

The retirement landscape is changing rapidly, with many people working longer and taking a more phased approach to retirement and how they grow their pensions. This change presents a number of new opportunities for Hodge.

The move from final salary pensions to money purchase saving schemes is increasing the amount of money that could be used to purchase annuities which will, in turn, increase the size of our target market.

With the advent of Pension Freedoms came a more holistic approach to financial planning in retirement, and the role of property wealth is being given more consideration. We anticipate these developments encouraging a greater use of equity release alongside annuities and similar products, to provide an appropriate level of retirement income.

People are living longer which is undoubtedly going to put more pressure on the need to pay for long term care and a range of new insurance needs. We are actively investigating opportunities to broaden our product range to meet some of these newly emerging needs.

As with all areas of the business we continue to invest in our product and service capability. We were delighted to be recognised as the 'Best Annuity Provider' at the 2019 Moneyfacts Investment Life and Pensions Awards.

COLLEAGUES

At the heart of our business are our people and we want to create a culture where talent and performance are rewarded, this will always be a key pillar in our strategy.

- **Training and development**

We have maintained our commitment to developing our people throughout 2019, supporting their professional growth across all levels. We've introduced a structured leadership programme for operational managers across the business, designed to develop existing and future leaders.

- **Health and wellbeing**

The Healthy Hodge programme operates a 5-pillar approach to support a healthy body, mind, family, finances and connections. With a range of initiatives including private health care, discounted gym membership, tailored meal plans, mental health support as well as an Employee Assistance Programme our team continue to thrive in their work.

- **Flexible working**

We recognise creating a healthy work-life balance is essential for Hodge.

In 2019 we introduced greater flexibility for our people, empowering and enabling them to manage their work-life balance effectively.

We will continue to invest in solutions that equip the business and our team to succeed in all aspects of their career with Hodge.

- **Gender diversity**

Hodge is proud to have signed HM Treasury's Women in Finance Charter.

Hodge has a target of 45% of women in senior leadership roles by October 2022.

At September 2019 35% of the senior leadership team are women. By signing the charter Hodge has pledged to promote gender diversity by:

- having one member of our senior executive team who is responsible and accountable for gender diversity and inclusion;
- setting internal targets for gender diversity in our senior management;
- publishing progress annually against these targets in reports on our website;
- having an intention to ensure the pay of the senior executive team is linked to delivery against these internal targets on gender diversity.

CORPORATE SOCIAL RESPONSIBILITY (CSR)

This year we made a commitment to make a difference to the lives of others by establishing a corporate social responsibility strategy. This strategy affirms our commitment to supporting our customers, colleagues and the local community in which we operate by behaving responsibly.

CUSTOMERS & COMMUNITY

We've forged strong relationships with local charities where our support is making a difference and we're committed to continuing to collaborate with a range of causes whose aim is to help other people in their community.

- **Age Cymru**

Age Cymru offers a wide range of services that offer invaluable help and guidance to older people. With our commitment, an additional 180 people will be supported and will receive over £40,000 in entitled financial benefits they would not have otherwise claimed.

- **Shelter Cymru**

Shelter Cymru offers free, independent, expert housing advice and support. Through our help, the charity will be able to provide face-to-face housing advice to an additional 220 people at a time of real need.

- **Colleague fundraising and support**

In addition to partnering with charities and donating our time, we hold regular fundraising activities throughout the year providing financial support to additional worthwhile causes. In 2019 we have donated more than £3,000 to a range of local charities that are important to our people.

Chief Executive Officer's Statement

The last year has been one of transformation as we have sought to lay the foundations of a financial services business that can achieve a long term return on shareholder capital of 12%, adapting to the competitive, regulatory and economic environment in which we find ourselves but able to take advantage of the opportunities that arise by being specialists in our chosen markets, particularly those associated with later life, a traditional strength of Hodge.

Steve Pateman,
Chief Executive Officer
19 December 2019

Our results, which are discussed in greater detail in the Chief Financial Officer's Report on Page 16, reflect the challenges of operating in a low interest rate and low growth environment where our performance has been constrained by the impact on capital availability in both the Life and Banking businesses. Our plans for the future will seek to reduce the impact of interest rates on both businesses.

At an operating profit level, the Bank returned £6.5m despite absorbing a significant loss on a development finance transaction in our commercial lending business.

At a profit before taxation level, results were adversely impacted by the fall in interest rates which impacted the swaps that support the legacy equity release and reversionary portfolios, other factors were the sale of £117.4m of equity release mortgages which completed in October resulting in a gain to par of £19.5m but a loss to fair value of £4.6m. We have adjusted the carrying value of the residual equity release portfolio to reflect current market conditions.

These losses were mitigated in part by the gain of £3.1m which arose from selling our holding of corporate bonds as a result of the decision to restructure the treasury portfolio.

The Bank's post tax loss of £5.7m (2018: £5.5m profit) adversely impacted total capital levels as did the actuarial losses on the valuation of the defined benefit pension scheme which now shows a funding gap of £16.6m; however, available capital increased as a result of the sale of the equity release mortgages. Taken together with opportunities to issue Tier 2 capital in 2020, we are confident that we have sufficient capital to support our growing lending ambitions which are a key element of our longer-term strategy.

We will however continue to explore options for exiting our legacy equity release and reversionary portfolios as and when market opportunities arise, allowing us to redeploy capital and liquidity into our core businesses.

The Life business saw reduced earned premiums on new business as we managed our annuity flows within capital capacity, profitability benefited from lower interest rates and updates to mortality and housing equity valuation assumptions. We continue to consider options for improving capital efficacy in Life from both a reinsurance and product perspective.

The strategy anticipates significant growth in assets, particularly mortgages, over the period to 2023 building on our traditional strengths in later life

whilst also adding capability that plays to our strengths as a specialist lender in both the residential and commercial markets.

We believe that there are significant opportunities to expand our later life lending capabilities and we are exploring options for inter-generational products that will allow us to offer solutions to families that are seeking to unlock equity either to supplement retirement income or support the younger generations as they seek to acquire their first or a larger property.

In the last year we have launched a professional buy-to-let product suite which builds on our strengths and experience in both mortgages and commercial lending; we have seen good traction here and at the year-end had extended facilities of £21.3m in this asset class.

We have recently launched a holiday let mortgage range and we will continue to explore adjacent specialist markets as we build a stronger and broader mortgage business.

We have made good progress in building out our existing residential mortgage business in line with our ambition to grow our mortgage Balance Sheet to £1.35 billion as part of the 5-year plan to 2023. Our progress has been underpinned by a significant improvement in our time to offer and decisions in principle resulting from a realignment of our underwriting and back office functions.

We would expect to make further progress when our online mortgage portal is launched in December 2019; this will be followed by a new mortgage servicing platform in mid-2020.

In our commercial lending business originations for the year were £101m. Repayments were higher than anticipated as developments completed and investment balances refinanced elsewhere at better rates. As a result, the year-end Balance Sheet fell a little short of expectations at £326.7m but we have a healthy pipeline and plan to grow our commercial lending business to a Balance Sheet of £750m by 2023 with a continued focus on both development and investment finance.

Whilst we have made good progress in managing a number of legacy exposures within our commercial lending portfolio, we have taken the decision to exit a challenging development facility and we have incurred an additional provision of £4.3m; going forward we would intend to have less significant portfolio concentrations.

We predominantly fund our asset growth with retail savings which have grown to £1.04bn at year end; our customer base has an overt bias towards the later life segments, and we intend to diversify our customer base and distribution channels through greater use of technology as we evolve.

Within our Life business, we had to contain our capacity to write annuities to a lower level than 2018 as low interest rates adversely impacted solvency capital levels: this also impacted our ability to accommodate equity release mortgages. Despite these challenging conditions there was an increase in profit before tax to £14.4m. Profitability benefited from a revision to our assumptions on mortality, house price sales under-performance and expenses to produce an uplift on the previous year.

Whilst we will need to contain annuity and equity release mortgage flow until Solvency capital levels improve, we would anticipate making significant progress on capital efficacy in our Life business in the short term through a combination of reinsurance and product diversification so that we can achieve our longer-term goal of a return on capital in this business of 12% by leveraging our capacity to significantly uplift annuity and lifetime mortgage originations.

Whilst technology will play an increasingly important part in our business evolution and we intend to spend £22.3m over the next 5 years, the ability to apply the human touch to product development, origination, underwriting and service remain as integral to our philosophy as they have done in building the business; similarly the importance that our founder placed on staff engagement and the working environment are at the heart of our employee proposition reflected in staff engagement levels of 81% notwithstanding a significant uplift in employee numbers to 253 (2018: 179) as we lay the investment foundations for the 2023 Plan.

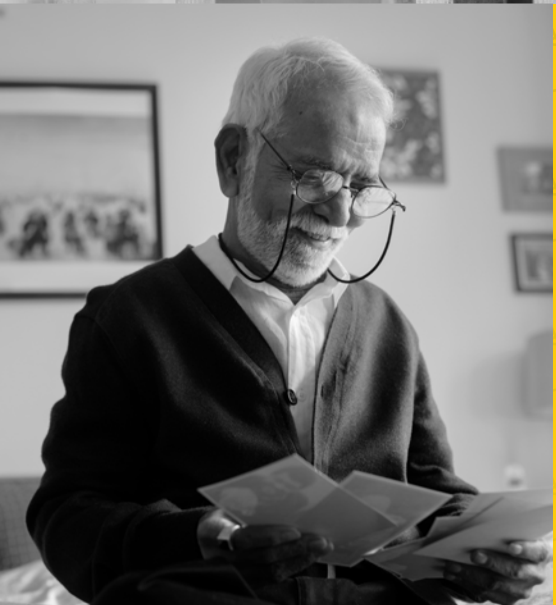
We are currently improving the working environment in One Central Square and exploring new locations as we continue to grow.

Whilst we are owned by The Carlyle Trust Limited, and the dividends that we are able to pay from our profits with due regard for maintaining appropriate capital levels in each business, flow into a number of good causes predominantly within South Wales. We believe that it is important that we as a business put something back into the communities in which we operate and this year we have recently launched our own CSR Programme investing £0.1m across a number of local charities; as our business grows, so will the level of our CSR support.

Hodge is in many ways a unique business: its ownership creates a unique social purpose and an environment which encourages innovation, people development and commercial performance but with an integrity and long-term commitment that is difficult to achieve in other ownership structures.

An awareness, respect for and engagement in that culture is a prerequisite for the team at Hodge and we have shaped our longer-term ambitions around these cultural themes.

Whilst the recent election result has provided clarity and should help stimulate business investment and in turn consumer confidence, the broader economic outlook remains challenged both here in the UK and on a global level. Although there are clearly risks which could impact asset valuations and the earnings required to service liabilities, we believe that there are good opportunities for growth across our businesses within a prudent risk appetite underpinned by a focus on secured lending and we look to the future with a quiet confidence, underpinned by the strength of our people and the long-term commitment of our shareholders.



Chief Financial Officer's Report

David Landen,
Chief Executive Officer
19 December 2019

Despite 2019 being a challenging year, the Group has delivered a set of financial results which have set the foundations for future growth.

KEY PERFORMANCE INDICATORS

The Group monitors several key performance indicators (KPI's) to measure progress against objectives and to demonstrate financial soundness. The table below details these KPI's:

FINANCIAL PERFORMANCE	2019 £m	2018 £m
Net operating income	57.5	53.6
Operating profit	29.5	35.8
Profit before tax	6.6	12.3
Loans and advances to customers	1,242.6	1,242.3
GROUP FINANCIAL RATIOS	%	%
Net interest margin	2.05	1.99
Cost income ratio	39.6	33.4
FINANCIAL SOUNDNESS – HODGE BANK	%	%
Common Equity Tier 1 ratio	22.5	22.3
Leverage ratio	11.1	11.9
Liquidity Coverage Ratio	516.9	236.8
FINANCIAL SOUNDNESS – HODGE LIFE		
Solvency Capital Ratio	165.0	183.0

The Group's performance at a net operating income level has improved in the year whilst the operating profit and profit before tax level has deteriorated due to a planned increase in overheads, a commercial loan impairment, adverse fair value movements and the strategic decision to sell a portfolio of equity release mortgages.

NET OPERATING INCOME

An increase of 7.3% in net operating income due to the growth of our residential mortgage business and as a result of increased realised gains on the reversionary product.

OPERATING PROFIT

The increase in net operating income did not flow in its entirety through to operating profit, mainly due to a significant impairment on commercial lending exposures of £4.3million.

Progress has been made in 2019 to resolve commercial lending exposures in IFRS 9 Stage 2 and 3, with related balances decreasing by £4.0m.

Operating profit was also adversely impacted by planned increases in administrative expenses 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.

We continue to make significant investment in our business, particularly within the digital arena, recognising that any successful financial services business must invest to stay relevant and to meet the aspirations and expectations of its customers.

PROFIT BEFORE TAX

To reduce our volatility to interest rate movements in the future, we took the opportunity to reduce our holding of legacy equity release mortgages and this crystallised a gain of £19.5m compared to the balance outstanding on the mortgages but a loss of £4.6m on the fair value of £122.0m. The liquidity and capital created from this disposal will be deployed into our core businesses to produce fewer volatile returns in the future. We will look for further opportunities to reduce our legacy assets over the coming months.

We mitigated part of this loss by selling our holdings of corporate bonds which yielded a gain of £3.1m reflecting the low interest rate environment.

The overall result is a profit before tax of £6.6m and an increase in shareholder's funds of £0.3m which was depleted further by actuarial losses of £3.3m on the defined benefit pension scheme and adverse adjustments on transition to IFRS 9 of £3.4m.

BALANCE SHEET OVERVIEW	2019 £m	2018 £m	Change %
Liquid assets[1]	599.5	513.1	16.8
Loans and advances to customers	1,242.6	1,242.3	-
Investment properties	170.1	179.1	(5.0)
Other assets[2]	17.9	13.7	30.7
TOTAL ASSETS	**2,030.1**	**1,948.2**	**4.2**
Deposits from banks	72.5	72.5	-
Deposits from customers	1,041.6	994.1	4.8
Provision for long term business	498.7	437.0	14.1
Other liabilities[3]	100.9	128.5	(21.4)
Share capital and reserves	316.4	316.1	0.1
TOTAL LIABILITIES AND EQUITY	**2,030.1**	**1,948.2**	**4.2**

1. Liquid assets: made up of Cash and balances held at central bank, Treasury Bulls, Debt securities and loans and advances to credit institutions
2. Other assets: made up of Intangible assets, Property plant and equipment, Investments, Deferred tax assets and Inventory
3. Other liabilities: made up of Derivative financial instruments, Other liabilities and the net deficit on the Pension scheme

LOANS AND ADVANCES TO CUSTOMERS

The Group continues to focus on its core markets of commercial and residential mortgages. The net lending figure has been driven by record gross lending of residential mortgages which has been offset by redemptions, the equity release portfolio disposal and the successful exit of a number of legacy commercial lending exposures.

FUNDING

Retail savings remain a primary funding source and during the year we have focused on enhancing the services we provide to customers through improving our digital efficiency.

At the year-end savings balances were £1,041.6 million (31 October 2018: £994.1 million); this increase was driven by both our on-line and continued competitive presence.

The Group also provides pension annuities in the open market offering competitive annuity products to our customers, regularly featuring in best buy tables. During the year the Group generated £41.6 million (2018: £47.5 million) of new annuity premiums.

LIQUIDITY

The Group holds liquid assets to meet its financial obligations in both business-as-usual and stressed situations. As at the year-end, the Group held £599.5m of liquid assets (31 October 2018: £513.1 million) which are available to protect it from liquidity stresses.

Banking Segment

Liquidity levels continued to be within board risk appetite and regulatory requirements throughout the period. This includes the Liquidity Coverage Ratio (LCR), which ensures that sufficient high-quality liquid assets are held to survive a short term severe but plausible liquidity stress. The Bank's LCR as at 31 October 2019 was above the regulatory minimum of 100% and increased to 516.9% (2018: 236.8%) due to strong retail deposit performance and the funds received from the disposal of the equity release mortgage portfolio increasing the liquid asset buffer.

Life assurance segment

Hodge Life's liquidity risk appetite sets liquidity requirements based upon a short-term liquidity stress as well as a long-term structural liquidity test. Liquid assets are held to maintain liquidity to meet both tests.

DEFINED BENEFIT PENSION SCHEME

The Group operates a defined benefit scheme available to all employees as part of our commitment to provide competitive remuneration packages. As at 31 October 2019 the scheme had a deficit (the difference between scheme assets and scheme liabilities) of £16.6 million (31 October 2018: £12.8 million); the increase in the deficit was caused by an increase in the scheme liabilities due to a decrease in bond yields which increased the discount rate for scheme liabilities. The Group made contributions to the scheme of £3.0 million in 2019 (2018: £2.0 million).

CAPITAL

The Group holds capital to protect itself, its depositors and annuitants against unexpected losses. The amount of capital required to be held is determined as part of the Group's capital risk appetite which assesses the material risks to which the Group is exposed, how those risks are managed and the level of capital to be held against them.

Bank segment

The Bank's primary measure for assessing capital adequacy is the Common Equity Tier 1 ratio (CET1); this ratio assesses the amount of the highest quality of capital as a proportion of risk weighted assets. The Bank uses standardised risk weights to calculate the risk weighted exposure. As at 31 October 2019 the Bank's CET1 ratio stood at 22.5% (2018: 22.3%).

Leverage

Alongside the CET1 ratio we actively monitor our leverage ratio; this is a capital ratio that excludes the risk weighting of assets. The leverage ratio at 31 October 2019 was 11.1% (2018: 11.9%). At present, we are not captured under the Financial Policy Committee's leverage ratio framework. However, the leverage ratio will become a binding requirement in 2022, albeit the Bank comfortably meets the requirements.

Life assurance segment

Hodge Life's primary metric in assessing capital adequacy is the Solvency Capital Requirement Coverage ratio which was introduced in 2016 as part of the Solvency II package of measures. This ratio assesses available capital resources as a proportion of capital requirements. Hodge Life uses the Standard formula to calculate its capital requirements and as at 31 October 2019, the Solvency Capital Requirement stood at 165% (2018: 183%) the reduction caused by the fall in interest rates.

Solvency II has had the effect of increasing the capital cost of writing new business and we are in the process of preparing our Matching Adjustment and Partial Internal Model (PIM) application to the PRA, which would allow us to increase new business volumes to a more sustainable level. Hodge Life continues to monitor the potential impact resulting from the PRA publication of Policy Statements and Consultation Papers in relation to equity release and other illiquid asset classes as it continues its own process of gaining the requisite approval.

Long-term Viability Statement and Going Concern

HODGE ASSESSMENT OF PROSPECTS

The resilience of our business model is relevant to any consideration of our prospects and viability. We benefit from diversification between our specialist mortgages, portfolio buy-to-let, Hodge Life and our commercial lending businesses, which enables our services to be provided in a capital-effective way allied with our track record in attracting funding from different sources. We assess our prospects on a regular basis through our financial planning process. Our rolling five-year strategy forecasts Hodge's profitability, cash flows, capital and funding requirements and is reviewed by the Board each year.

Our business and financial planning also takes into account our obligations to depositors, annuitants and the funding of our defined benefit pension scheme.

The Board believes that the market for our later life lending products will be strong for at least the next ten years. This is supported by demographic trends and the increasing customer demand to release equity.

Adrian Piper, Chairman
19 December 2019

The market for annuity products is less clear; however, the directors believe there is still a good baseline demand. The reduction in annuity providers has reduced competition and a normalisation of interest rates over the next ten years would make annuities more attractive.

Our commercial lending proposition is more dependent on shorter-term client relationships; however, the team has a good track record of identifying new relationships and converting them into customers. The digitalisation of our savings business will assist in making Hodge less dependent on its existing customer base and our commitment to ensuring that customers can deal with us through a channel of their choice means that the directors are confident that Hodge will continue to retain and attract loyal depositors. Given the long-term nature of many of the business's mortgage products, the directors have also given due regard to the possible impact of climate change on its future prospects.

UK WITHDRAWAL FROM EU

The decision to leave the EU has led to continuing uncertainty throughout 2019. Despite the result of the recent UK general election there is still uncertainty surrounding the withdrawal from the EU. At the date of signing the financial statements, there remains the possibility of a range of outcomes as talks continue between the UK Government and the EU following the election. Further delays and uncertainty are probable but a 'no deal' disorderly exit is considered unlikely.

Hodge response

The Group has tracked political developments and discussions on these matters are commonplace in committees particularly given the material uncertainty and its impact on economic fundamentals. The risks associated with topic are given considerable consideration as to how they may materialise and impact the Group's strategy, customer base and the capital & liquidity implications of these.

Consideration of risks

Consideration of the risks may be summarised as follows:

- **Credit risk –** analysis of the impact on mortgage affordability and house prices caused by adverse economic conditions arising. The loan book has been stressed extensively over a five-year horizon against a range of macro-economic assumptions, some severely adverse;
- **IFRS 9 Stage 1 and Stage 2 –** provision has been run under a variety of economic scenarios including a 100% weighting to the Negative scenario to reflect the worst-case position.
- **Capital –** credit losses and net interest income impacts have been considered including those associated with the Bank of England's publicised scenarios; and
- **Liquidity –** the risks associated with adverse impacts on liquidity have been considered.

Extensive modelling and stress testing around macroeconomic outcomes and Brexit associated risks has determined that the business remains viable and able to meet its risk appetite limits and regulatory obligations.

Hodge has no direct exposures to the EU and doesn't rely on its markets or customer base. In addition, our data storage and transmission has led to no reliance on EU data centres that may lead to disruption.

VIABILITY STATEMENT

The directors have carried out an assessment of the longer-term viability of the Group. The assessment covers a period of five years, as this is the period covered by the Group's rolling five-year strategy and regulatory and internal stress testing. The time period chosen reflects the consideration that the level of uncertainty relating to the assessment increases the longer the period chosen. The pace of change of the economic market and regulatory environments in which the Group operates may undermine the reliability of longer forecasts. The directors have based this statement on a robust assessment of those risks that could threaten the business model, future profitability, solvency, liquidity or capital adequacy of the Group.

In making the assessment, the directors considered a range of information concerning each of its principal risks, individually and collectively, over a range of scenarios, including but not limited to, the Group's rolling five-year Plan and the programme of regulatory and internal stress testing it undertakes, further details of which are as follows:

- The Plan is reviewed by the directors in detail at least annually. The Plan makes certain assumptions about the performance of the Group and the economic, market and regulatory environments in which it operates. The planning process is underpinned by a robust stress testing framework to ensure compliance with the Group's risk appetite.
- Alternative forecasts are also constructed against a number of stress scenarios, including a robust downside scenario as part of the Board's review of Hodge Bank's Internal Capital Adequacy Assessment process (ICAAP). This involves considering a severe stress to the UK economy, with a significant fall in both residential property prices and secondary commercial real estate values and low interest rates for a sustained period. The results of the ICAAP are submitted to and discussed with the PRA. Hodge Life carries out a similar process as part of its ORSA. The principal stress scenarios that have been tested are a significant fall in residential house prices, a significant increase in longevity and sustained low interest rates.
- Liquidity stress tests are conducted as part of the Bank's Internal Liquidity Adequacy Assessment Process (ILAAP). The ILAAP demonstrates that the Bank holds sufficient liquid assets to meet cash outflows during a severe-but-plausible scenario where there is a combined, market-wide and firm specific stress.
- The review also considered all aspects of emerging regulation where there is sufficient clarity to inform the analysis. For example, the assessment of the Bank's capital position reflects the latest understanding of the capital buffer and leverage requirements likely to be imposed on the Bank.

Based on this assessment, the directors confirm that they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due during the period to 31 October 2024. Accordingly, the financial statements continue to be prepared on a going concern basis.

GOVERNANCE
2019

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 Hodge is protected, while at the same time recognising the interests of our wider stakeholders.

The Board's agenda during 2019 was focused on overseeing and supporting executive management to deliver on Hodge's strategic objectives. It is during periods of significant change, which Hodge is currently undergoing, that leadership and good governance are more important than ever.

The Boards of Hodge Limited and those of its regulated subsidiaries, Hodge Bank and Hodge Life comprise two executive and six non-executive directors. In each case 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 Group'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 Group's business and can provide only reasonable and not absolute assurance against material misstatement or loss.

The Group'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 Group 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 to present a summary of audit reports completed during the period and to provide any explanations required by the Committee.

GOVERNANCE FRAMEWORK

Nestor Advisors were engaged to undertake a review of the Board, including governance and individual director development, specifically to:

- Identify improvements to the Board structure, functioning, ability to work as a team, and capacity to challenge;
- Develop shared views on further enhancing board effectiveness;
- Enhance comfort among board members regarding fulfilment of their collective role;
- Bolster confidence of shareholders, regulators and stakeholders in Board governance practices.

Following the review, which had the full participation of the Board, Nestor Advisors provided feedback on their findings, drawing attention to the strength and collegiality of the Board. In addition, the Nestor advisors presented recommendations, including at a high-level:

- Continue to enhance the strategic capability of the Board, without undermining collegiality;
- Strengthen the Board's oversight capability, without cancelling its proximity to the business, and;
- Streamline functioning and support.

As a result of the recommendations the CEO and the Board have initiated several changes to further strengthen the Board.

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

THE BOARD

The Board has ultimate responsibility for the proper stewardship of the Group in all its undertakings. It meets regularly throughout the year to discharge its responsibilities for all important aspects of the Group's affairs, including monitoring performance, considering major strategic issues, approving budgets and business plans and reviewing operational performance. The Board holds regular discussions with the Group's shareholder to ensure a clear understanding of their views and requirements. A shareholder's covenant has been agreed detailing the Shareholder's expectations of the Group.

The Chair is responsible for the leadership and operation of the Board, setting the agenda and the tone of board discussions as well as having responsibility for 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 Group. 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:

Adrian Piper – Chair

Adrian has been a non-executive director since 2010, he was appointed Chairman in July 2017 and is a trustee of the Hodge Foundation.

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, he is the Chair of the Risk and Conduct Committee and a trustee of the Hodge Foundation.

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 Committee of PAO Severstal and Transport for Wales and is a Fellow of the Institute of Chartered Accountants in England & Wales.

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

Helen Molyneux – Non-executive director

Helen joined the Board in June 2015. She is also a non-executive director of the Bank and Hodge Life and Chair of the Remuneration Committee.

Until November 2016, Helen was the CEO of NewLaw Legal, a business she established from scratch, which now employs over 400 people. She is now a non-executive director of the EUI board 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.

Graeme Hughes – Non-executive director

Graeme joined the Board in 2019. He is also a non-executive director of the Bank and Hodge Life.

Graeme has spent the vast majority of his career with the Nationwide Building Society, most recently becoming Group Distribution Director, responsible for all sales and service activities across 720 branches and 10,000 staff. Earlier roles have seen him leading group strategy and planning, as well as human resources and external affairs.

Steve Pateman – Chief Executive Officer

Steve joined the Board in February 2019 on his appointment as CEO.

Steve was previously CEO of Shawbrook Bank where he delivered strong balance sheet and revenue growth. Before that he led the UK banking businesses of Santander after having held a number of senior management roles at Royal Bank of Scotland.

Steve is also Vice President of the Chartered Banker Institute and a non-executive director of the Bank of Ireland.

David Landen – Chief Finance Officer

David joined the Group 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 CFO in 2011. An accountancy graduate from Cardiff University, he is a fellow of the Association of Chartered Certified Accountants.

BOARD COMMITTEES

The Board has established the following standing committees:

- **Audit Committee:** John Barbour (Chair), Jonathan Hodge, Helen Molyneux, Alun Bowen and Graeme Hughes.

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. A report from the Chair of the Audit Committee can be found on page 42.

- **Risk and Conduct Committee:** Alun Bowen (Chair), Jonathan Hodge, Helen Molyneux, John Barbour, Adrian Piper and Graeme Hughes.

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. A report from the Chair of the Risk and Conduct Committee can be found on page 50.

- **Remuneration Committee:** Helen Molyneux (Chair), Jonathan Hodge, Alun Bowen, John Barbour, Adrian Piper and Graeme Hughes.

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 at least twice per year. A report from the Chair of the Remuneration Committee can be found on page 62.

- **Nomination Committee:** Adrian Piper (Acting Chair), Jonathan Hodge, Alun Bowen, Helen Molyneux and John Barbour.

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 Group has an appropriate succession plan for executive and senior management positions.

The Committee meets at least twice per year. A report from the Chair of the Nomination Committee can be found on page 60.

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)
Adrian Piper	2	2	5	5	5	5	4	4	3	3
John Barbour	2	2	5	5	5	5	4	3	3	2
Jonathan Hodge	2	2	5	5	5	5	4	4	3	3
Helen Molyneux	2	2	5	5	5	5	4	3	3	3
Alun Bowen	2	2	5	4	5	5	4	2	3	2
Graeme Hughes	1	1	1	1	1	1	1	1	1	-
Steve Pateman	1	1	-	-	-	-	-	-	-	-
David Landen	2	2	-	-	-	-	-	-	-	-
David Austin	1	1	-	-	-	-	-	-	-	-

Graeme Hughes joined the Board on 19 September 2019
Steve Pateman joined the Board on 7 February 2019
David Austin retired from the Board on 7 February 2019
Jonathan Hodge retired from the Board on 31 October 2019

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

Risk Management

Managing risk effectively is fundamental to our strategy and to operating successfully. Hodge has a strong culture of risk awareness and control and actively monitors and manages the risks of its business, as well as emerging industry risks which may have an impact on those activities, through a robust and embedded risk management framework. The groupwide risk management framework has an integral role in Hodge:

- **Delivering against its strategy within an appropriate risk culture;**
- **Building greater resilience to organisational threats;**
- **Protecting its customers from unfair outcomes.**

The Group's strategy and business model is underpinned by strong risk governance, ensuring alignment with the Board's appetite for risk. A risk management framework, supported by a three lines of defence governance model, ensures strong risk awareness, assessment, monitoring and management across all principal and emerging risks. Risks are managed within the risk appetite set by the Board and stress testing is undertaken to ensure that the capital and liquidity of the Group would enable it to survive severe but plausible market-wide and firm specific stresses.

THREE LINES OF DEFENCE MODEL

The Group operates a three lines of defence model which clearly sets out responsibilities for the management and oversight of risk. The Board retains ultimate responsibility for risk management. The three lines of defence model is summarised on the page opposite:

FIRST LINE OF DEFENCE – DAY-TO-DAY RISK MANAGEMENT	
The first line of defence has responsibility for implementation of the Group's strategy and for the management of risk across the organisation and comprises executive committees, management and staff.	**The first line of defence:** • Owns and manages the Group's risks; • Responsible for compliance with relevant regulation and legislation; • Identifies, manages and mitigates the risks of the Group; • Defines and operates controls; • Assess key risk indicators and market conditions; • Produces management information and reports on risks.

SECOND LINE OF DEFENCE – RISK OVERSIGHT	
The second line of defence is responsible for providing independent oversight and challenge of activities undertaken by the first line and provides guidance on risks relevant to the strategy. This is provided through the Risk function, which is led by the Chief Risk Officer (CRO), who reports to the CEO and has an independent reporting line to the Chairman of the Risk and Conduct Committee. It maintains and reports an aggregate view of risks and performance in relation to risk appetite to the Risk and Conduct Committee. The Risk function is not customer facing and has no responsibility for business targets or performance.	**The second line of defence:** • Designs, interprets and develops executive risk management fund and monitors business as usual adherence to the framework; • Advising the Board on risk appetite; • Provides oversight, challenge and assurance over the management of risks; • Develops compliance policies, supports delivery of regulatory change and monitors and reports on regulatory issues.

THIRD LINE OF DEFENCE – INTERNAL AUDIT	
The third line of defence provides objective assurance on the effectiveness of the Group's governance and risk management processes and controls. This assurance is obtained through the use of internal audit services provided by PwC. Internal audit reports directly to the Chair of the Audit Committee as well as the CEO and is independent of the first and second lines of defence.	**The third line of defence:** • Conducts independent testing and verification of the efficacy of the Group's business model, controls, policies, processes and business line compliance; • Provides assurance that the risk management process is functioning as designed.

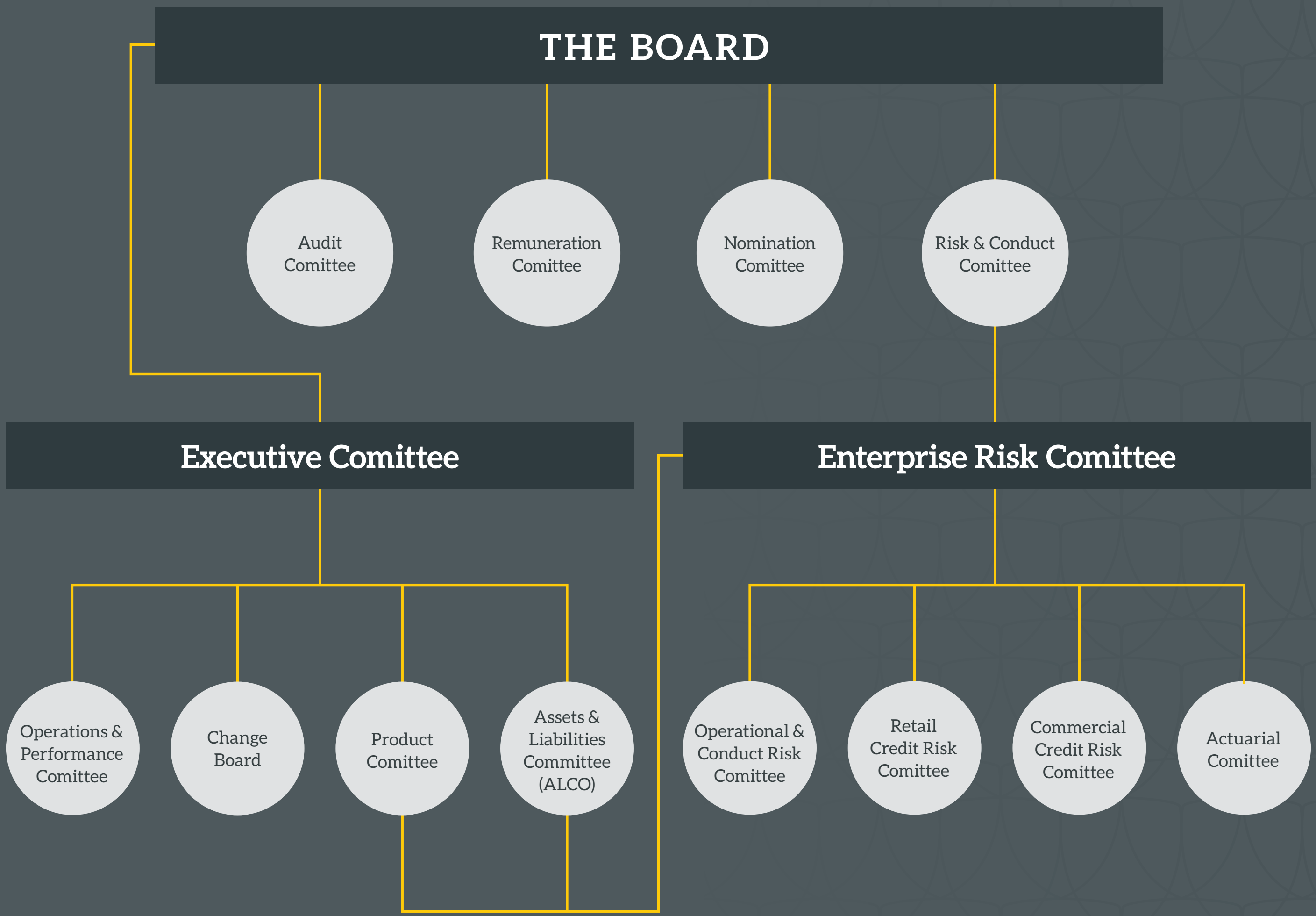
RISK GOVERNANCE

The Board is ultimately responsible for the overall risk governance and effective management of risk within the Group. The Board determines the risk strategy and ensures that risk is monitored and controlled effectively.

The Risk and Conduct Committee is a board committee that reviews, on behalf of the Board, the key risks inherent in the business and the control framework in place to manage such risks, presenting its findings to the Board.

There is a formal structure of risk management policies in place, setting out risk limits and triggers and minimum operating standards, which are aligned to the Board's risk appetite.

Risk governance is supported by a structure comprising six executive committees, each with escalation routes through the Risk and Conduct Committee and board as shown below:



EXECUTIVE COMMITTEES:

Each committee includes appropriate representation from the Executive Committee and risk specialists. The responsibilities of each of the Committees is set out below:

Operations & Performance Committee

Operations & Performance Committee is an executive Committee chaired by the Chief Operations Officer. The Committee's purpose is to provide operational governance across the firm. This governance covers a range of key activities inclusive of oversight of internal and outsourced operations, operational resilience and forward-looking operational impacts to the business.

Change Board

Change Board is an executive committee chaired by the Chief Technology Officer. The purpose of the Change Board is to ensure the Group's Change Programme is aligned with the Group's strategy and business plans and to monitor programme delivery, budget and resources.

Product Committee

Product Committee is an executive committee chaired by the CEO. The purpose of the Committee is to assist and encourage new product developments by developing and recommending new product ideas and significant changes to existing products.

Assets & Liabilities Committee (ALCO)

ALCO is an executive committee, chaired by the Chief Financial Officer. The Committee is responsible for the implementation and maintenance of the overall risk management framework relating to market risks, asset/liability matching, and liquidity and capital management.

Operations & Conduct Risk Committee

Operational & Conduct Risk Committee is an executive committee chaired by the CRO. The purpose of the Committee is to assist the CRO in the development and implementation of a risk management framework to manage the operational and conduct risk profile, and to ensure the adequacy of the internal control environment.

Retail Credit Risk Committee

Retail Credit Committee is an executive committee chaired by the Managing Director of Mortgages. The scope of the Committee covers all retail lending activity.

Commercial Credit Risk Committee

Commercial Credit Committee is an executive committee chaired by the Managing Director of Commercial Lending. The Committee is responsible for the implementation and maintenance of the overall risk management framework relating to commercial credit risk. It is also responsible for reviewing, challenging and if appropriate, approving credit proposals for new commercial lending deals that are below the authority thresholds which require approval by the Board or Special Committee.

Actuarial Committee

The Actuarial Committee is responsible for monitoring the insurance risk exposure of the Group including insurance risk and house price risk. It also monitors and provides input to the methods and assumptions used to undertake actuarial valuations of the Group's assets and liabilities. The Committee meets as required, but as a minimum will meet four times per annum.

RISK STRATEGY

The Group's risk strategy sets out the risk management approach to support the achievement of the Group's strategic ambitions. It sets out which risks will be avoided, mitigated or accepted and is implemented by defining tolerances to the risks it faces through its risk appetite.

RISK CULTURE

The Group prides itself on a strong risk culture, which stems from the Board's approach to and appreciation of the risks faced by the business. This culture is embedded through clear expectations set by the risk appetite and risk management policies, together with effective training for all levels of staff. This is underpinned by an emphasis on good customer outcomes and sustainability of the business.

RISK APPETITE

The Board sets a risk appetite to define the level of risk that the Group is willing to accept or wishes to avoid in order to meet its business objectives. A risk appetite statement is in place that includes both qualitative statements and quantitative measures and addresses each of the key risk types faced by the Group as articulated within the Risk Strategy.

The risk appetite statements are linked to the Group's strategy and supported by a suite of risk metrics, limits and triggers designed to monitor the Group's exposure to the principal risks and together outline parameters within which the Group operates.

The risk appetite statement provides a framework against which all business decision making must be assessed.

TOP AND EMERGING RISKS

In addition to the principal risk categories noted below the Group's top and emerging risks are identified through the Group's risk management processes. These are specific risks within the Group's principal risk categories that are significant to the Group throughout its strategic plan. An emerging risk is a risk that has the potential to have a significant detrimental impact on the Group's performance, but currently the outcome and time horizon is more uncertain or more difficult to predict than for other risks that are inherent in the Group's Balance Sheet.

The top and emerging risks and details of how they are mitigated is set out below:

Current threat/Emerging risk	Principal risk category	Mitigation/Strategic response
UK political and economic uncertainty Continued lack of clarity on the eventual outcome of the EU withdrawal which is subduing investment and purchase activity and therefore macroeconomic fundamentals. In addition, the withdrawal from the EU could lead to changes in the regulatory framework.	• Strategic risk • Market risk • Credit risk	It is anticipated the UK withdrawal from the EU will have limited to no direct impact on the Group as its UK based with no services or relationships with other EEA countries. However, the Group remains exposed to the impact that the withdrawal may have on the UK economy including housing market, interest rates, unemployment and inflation. Economic conditions are actively monitored. Risk appetites have been established for Balance Sheet sensitivity to external factors. Supporting this, is the wider stress testing framework that tests for scenario vulnerabilities and impacts on capital & liquidity required to cover risks.
Market/competitive environment Disruptive technologies, new competitors (traditional and non-traditional) and search for yield have the ability to threaten the current business model and achievement of the Group's strategy.	• Strategic risk • Market risk	Continual monitoring of the competitive environment is undertaken and discussed regularly alongside strategy development meetings. Competitor benchmarking and networking forums allow insight into firm's potential strategic intent. Appropriate market research and a new product development governance process are conducted to ensure strategic initiatives are properly controlled.

Current threat/Emerging risk	Principal risk category	Mitigation/Strategic response
Change & execution risk The Group has committed to a number of strategic change initiatives which are key to the achievement of our strategic objectives. These significant activities increase cost and execution risk.	• Strategic risk • Operational risk	The change programme will deliver additional resilience to the Group's business model and its operational resilience once fully implemented. The change programme has risk management processes in place to ensure safe and controlled delivery of the initiatives required.
Climate risk Financial risks from climate change arise through two primary channels; physical i.e. specific weather events & damage to assets and transition risks i.e. increased regulation to adjust to low carbon economy. These manifest as increasing underwriting, credit, or market risk for firms.	• Strategic risk • Credit risk • Operational risk	A climate change policy has been implemented outlining governance structures, disclosures, risk management approach, SMF responsibility allocated in the business and an internal working group established to develop Hodge's approach and understanding of the risk posed by climate change. Climate change is being addressed specifically as part of the regulatory risk management documents; ORSA & ICAAP.
Operational resilience The firm's key services utilise IT systems and operational processes, failure of these resources can lead to customer disruption, adverse impacts on the firm's reputation and cost associated with remediating these failures.	• Strategic risk	Risk management framework in place across the organisation covering both operational and IT risks helping to identify, measure, manage and monitor these risks. Plans are in place across the firm to minimise and recover from business disruption and information security events.

The Group conducts on-going horizon scanning to identify new risks that could threaten achievement of the strategy and ensure they are captured in the risk management framework as early as possible. The governance structure in place enables a strong awareness of current and emerging risks, which are recorded and monitored to ensure that appropriate mitigation and monitoring strategies are adopted. Mitigating actions are logged, business owners allocated, and warning indicators identified to ensure effective ongoing monitoring. Oversight of emerging risks is provided by the Risk and Conduct Committee.

PRINCIPAL RISKS

These are the most significant risks faced by Hodge which could impact the viability of the Group and delivery of our strategic objectives. Risk appetite limits and triggers as well as key risk indicators are in place for each principal risk and reported to the relevant executive committee. Aggregated reporting is provided to the Risk and Conduct Committee by the Risk function.

CREDIT RISK – the risk that a counterparty will be unable or unwilling to meet a commitment that it has entered into with the Group when it falls due.

Key drivers and appetite	Our approach
Credit risk emerges from commercial lending exposures, residential mortgages to retail customers and from investments held by the Treasury function. The Group is willing to be exposed to a moderate level of risk for an acceptable return.	The Group assesses its exposure to and management of credit risk with reference to three sub-categories: • **Retail credit risk** – the risk of financial loss from residential mortgages due to the customer's failure to service interest or repay capital. • **Commercial credit risk –** the risk of financial loss from a commercial lending customer's failure to settle financial obligations as they fall due or movements in commercial real estate prices. • **Treasury credit risk** – the risk that a debt issuer or counterparty will fail to make payments (either interest or principal) in a timely manner or the credit worthiness of borrowers deteriorate reducing the value of investments. Within each business line there is dedicated first line risk management provided by appropriately skilled credit managers and treasury staff. Pricing of lending products includes a component of margin to cover expected credit losses. Treasury counterparties are restricted to a number of well-established and externally rated institutions. The following mitigation practices are in operation: • Board approved underwriting policies and authorisation mandates are in place for each sub-category in order to direct lending decisions, ensuring that the Group lends responsibly while taking an acceptable level of credit risk. • Strong rating and scoring systems and controls to support lending decisions with the addition of affordability stress tests for individual retail customers. • Limitations on concentration risk across portfolios are implemented via risk appetite limits on large exposures, geographical and sectoral exposures, and loan to income ratios. • Appropriately skilled colleagues are employed by the Group to monitor and manage credit risk within the defined parameters set by the Board. • Portfolio level stress testing and scenario analysis.

This principal risk has a direct link to the longer-term viability statement.

PENSION RISK – The risk of a financial loss due to adverse movements in the value of scheme assets and liabilities.	
Key drivers and appetite	**Our approach**
Pension risk arises due to adverse movements in market factors such as interest rates and inflation, as well as longevity assumptions negatively affecting the value of the scheme assets and liabilities.	The Trustees actively manage risks arising from its defined benefit scheme through the management of the scheme's investment strategy to mitigate the potential mismatch of investments with its obligations under the scheme. The Trustees regularly monitor the scheme deficit and future funding requirements. Every three years, the Trustees of the scheme agree a plan to ensure the scheme eliminates any deficit arising over an acceptable time horizon; the last formal valuation was agreed by the Trustees and approved by the Group in April 2019 and a plan to eliminate the deficit was agreed. The Group regularly monitors actual performance of the scheme against this agreed recovery plan.

LIQUIDITY RISK – the risk that the Group is unable to meet its financial obligations as they fall due or can do so only at excessive cost.	
Key drivers and appetite	**Our approach**
The Group maintains a prudent liquidity profile to ensure it has sufficient liquid resources to meet anticipated outflows in business-as-usual and under stressed conditions.	Treasury provides strong first line risk management expertise in liquidity risk management and risk management processes and has day to day responsibility for the management of liquidity within defined board policies and limits. The following mitigation techniques are in operation: • Maintenance of a liquidity buffer of high-quality liquid assets. • Well matched maturity profile of assets and liabilities. • Composition, credit quality and maturity profile of liquidity portfolio and funding balances in line with agreed policies. • Liquidity stress tests run to ensure the Group maintains adequate levels of liquidity for business purposes even under stress. • Extensive contingency funding plans in place. • Reporting of regulatory liquidity metrics; Liquidity Coverage Ratio, Net Stable Funding Ratio and internal metrics i.e. Overall Liquidity Adequacy Requirement. • Weekly monitoring of liquidity adequacy, portfolio composition and changes and refreshed cashflow forecasts by the Asset and Liability Committee.
This principal risk has a direct link to the longer-term viability statement.	

PROPERTY PRICE RISK – The risk of changes in values caused by market prices or volatility of market prices differing from their expected values.		
Key drivers and appetite	**Our approach**	
Property price risk is driven by commercial lending, reversions, equity release and retirement mortgages and the no negative equity guarantee (NNEG) on equity release and retirement mortgage products. The Group is willing to accept a moderate level of property price risk for an acceptable return but wishes to employ risk management strategies to reduce associated volatility.	The Group has a depth of risk management expertise within its first line underwriting functions to ensure the active management and on-going monitoring of property price risk exposure and Actuarial Committee monitors historical performance and the future outlook for house prices.	The following mitigation techniques are in operation: • Limits on the loan-to-value acceptable for individual loans, • Limits on the exposure to individual borrowers, • Limits on the exposure to individual types of commercial lending, • Geographical concentration limits on lending.
This principal risk has a direct link to the longer-term viability statement.		

INTEREST RATE RISK – the risk that movements in market interest rates result in loss of economic value or reduction to net earnings.		
Key drivers and appetite	**Our approach**	
Interest rate risk arises due to the different repricing characteristics of the Group's assets and liabilities. The Group aims to minimise the interest rate risk that it is exposed to where it is commercially viable to do so.	The Treasury function has day to day responsibility for the management of interest rate risk within defined board policies and limits. Where possible the interest rate structure of assets is matched with liabilities to create a natural hedge to interest rate risk. Where this is not possible interest rate derivatives may be used to mitigate the exposure. A perfect match is not always commercially effective which leads the remaining interest rate risk exposures to be managed within approved limits.	The following mitigation techniques are in operation: • Use of derivatives to mitigate the exposure to interest rate risk, • Specific product characteristics considered for hedging requirements, • Assessment of interest rate risk in line with regulatory requirements, • Various interest rate stress tests are applied to the portfolio, • Well-defined policies for the management of interest rate risk.
This principal risk has a direct link to the longer-term viability statement.		

STRATEGIC RISK – the risk of loss through failure to define, develop and implement an effective and realistic strategic plan.	
Key drivers and appetite	**Our approach**
Strategic risk can arise from changes to the business model and also the risk of the business model or strategy proving inappropriate due to macroeconomic, political, regulatory or other impacts. The risk to delivery of the strategy is deemed to be the principal risk.	Close management and monitoring of the strategic plan along with in-depth stress testing reported regularly through the Group's committee structure to the Board and senior management. This is supported through additional risk reporting and monitoring of the key threats to the business on risk registers and horizon scanning to ensure the business can respond appropriately.

UNDERWRITING RISK INCLUDING: **INSURANCE / MORTALITY RISK** – the risk that longer/shorter policyholder life expectancy results in financial losses for the Group. **LAPSE RISK** – the risk that a high rate of mortgage lapse results in financial losses for the Group.	
Key drivers and appetite	**Our approach**
Insurance risk exposure is driven primarily through annuities and legacy reversions and is partially offset by the exposure to mortality risk driven through equity release and retirement mortgages. The exposure to lapse risk is primarily driven by equity release and retirement mortgages and is heightened in times of low interest rates and increased competitor activity.	Strong expertise is maintained within the first line Actuarial function to support the active management and monitoring of underwriting risk exposure. The Chief Actuary is treated as a first line role rather than formal second line oversight. Additional oversight in this area is provided by an external technical adviser, to help to mitigate potential conflicts of interest and to assist the Board with decision-making on technical actuarial matters.
This principal risk has a direct link to the longer-term viability statement.	

<table>
<tr><th colspan="2">CONDUCT RISK – the risk that the Group's behaviour results in poor outcomes for customers.</th></tr>
<tr><th>Key drivers and appetite</th><th>Our approach</th></tr>
<tr><td>Conduct risk is inherent in any business that provides products or services to customers. Failing to treat customers fairly and deliver good outcomes would have a detrimental impact on the success and sustainability of the Group. The Group is only willing to tolerate negligible levels of conduct risk. The Board recognises that later life customers are at greater risk of vulnerability and so products and services are designed with this in mind.

The Group assesses its exposure to and management of conduct risk with reference to four sub-categories:

• Distribution and sales – products offered by the Group may be unsuitable for certain people or circumstances but purchased regardless. Products may not be the best match for their needs.

• Product servicing – post sale, customers may not be treated fairly by the Group.

• Product design – terms and conditions may include inherent flaws or issues that result in poor outcomes for customers, in aggregate or under certain scenarios.

• Culture and governance – the Group's governance processes are insufficient, weak or poorly designed resulting in a failure to identify the instances of poor outcomes. Culture and management direction may result in deliberate or consequential bias towards Group performance to the detriment of customer outcomes.</td><td>• Distribution and sales – the Board requires that all later life lending products are distributed via independent brokers to ensure that customers receive independent advice. Deposits and commercial lending products are offered on an execution-only basis. Approval processes are in place to ensure that product literature is clear, fair and not misleading and complies with relevant regulation and legislation.

• Product servicing – performance against service levels is monitored and customer feedback used to determine whether good outcomes are achieved. All complaints are thoroughly investigated and responded to promptly. Monitoring is in place to identify and quickly address any trends or systemic issues.

• Product design – a product governance policy is in place to ensure that all new products are subject to an appropriate level of scrutiny and that existing products are subject to regular review to identify any risk of poor customer outcome.

• Culture and governance – reward strategies and incentives are not based on sales targets and mandatory conduct risk and customer outcomes training is in place for all new and existing employees.</td></tr>
</table>

OPERATIONAL RISK – the risk of economic loss from control failures or external events, which result in unexpected or indirect loss to the Group.

Key drivers and appetite	Our approach
The Group accepts that operational risks arising from its people, processes, systems or the external environment are a natural consequence of its business operations but seeks to avoid or mitigate the risk to a minor level wherever practical. The Group assesses its exposure to and management of operational risk with reference to ten core sub-categories: • **Process –** losses from failed transaction processing or process management. • **Model –** models are incorrect or mis-used, leading to inappropriate business decisions. • **Fraud –** losses due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or the Group's policy. • **People –** failure to manage the human resources of the Group in order to maximise its value. • **Compliance –** failure to comply with legal and regulatory requirements. • **Systems –** IT systems do not meet the requirements of the Group or are not maintained to a high standard to ensure agreed availability. • **External –** disruption to business model and/or operations due to political, legal or regulatory changes, adverse publicity or external disasters. • **Change –** failure to successfully deliver change to achieve defined strategic benefits or failure to operate robust change implementation controls resulting in disruption to operational processes and/or the customer journey. • **Security –** failure to manage the physical or information security of the Group leading to disruption to operational processes, customer impact and/or financial loss. • **Third party –** services provided by third parties fail to meet required standards leading to disruption to operational processes, customer impact and/or financial loss.	Operational policies and procedures, supported by staff training, are in place to govern the way in which these risks are managed across the business. Senior management are responsible for understanding the nature and magnitude of risks within each business area, and for implementing appropriate controls to mitigate those risks. Operational losses and near-misses are recorded and analysed to determine whether there are any systemic issues that need to be addressed by the business. Horizon scanning is conducted to identify emerging regulatory and legal developments to ensure that the business can respond appropriately. The Board is mindful that, as the digital capability of the Group increases, the risk associated with cyber-attacks also increases. As such, particular focus continued to be given to this area throughout the year to ensure a robust cyber response.

STRESS TESTING AND PLANNING

A key component of the risk management framework is stress testing and scenario analysis through which the Group assesses the impact of risks that could threaten the business model, future profitability, solvency, liquidity or capital adequacy of the Group. The Board and senior management have engaged in a number of exercises which have considered and developed stress-test scenarios covering a range of groupwide, multi-risk category stress tests, generic and idiosyncratic financial shocks, and operational and conduct risk scenario analysis in addition to the scenarios prescribed by the regulator.

Stress testing is central to the annual business planning process and to the annual review and ongoing development of the Group's risk appetite. It is also core to the adequacy assessment processes for liquidity and capital and for assessing and improving management of the Group's risk profile. The assessment processes for capital and liquidity are articulated through Hodge Bank's Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP) and Hodge Life's Own Risk and Solvency Assessment (ORSA) documents. These activities and associated documents are updated at least annually or following any significant change in the business model or risk profile.

Banking segment

- The ICAAP evaluates the level and quality of capital required by the Bank as defined by the Capital Requirements Directive (CRD IV) to ensure it adequately covers all current and future risks in the business over the medium term. In addition to the assessment these risks may pose to capital, consideration is given to the contingency actions available to the Board to mitigate those risks.

- The purpose of the ILAAP is to consider the Bank's liquidity risk management processes, an element of which is evaluating liquidity positions and requirements in both business-as-usual and stress situations. The ILAAP demonstrates that sufficient liquid assets are held to meet cash outflows during a severe but plausible scenario where there is a combined market-wide and firm-specific stress, resulting in, among other things, a significant outflow of savings accounts. The document also outlines the contingency funding arrangements available for use in a stress.

Life assurance segment

- The ORSA is a firm's own assessment of the risks it faces and the solvency capital requirements that it believes are appropriate. The ORSA is an integral part of the Solvency II regime, bringing together risk management and solvency needs. It is designed to be a continual point of reference for board and help guide decision-making by taking into account the risks the firm faces.

REVERSE STRESS TESTING

The Group also undertakes reverse stress testing which is used to explore potential vulnerabilities of the Group's strategies and plans to extreme events that could cause the business to fail. The reverse stress tests push the severity of the stress scenario to the point at which the firm's business model becomes unviable. These exercises are designed to assess the resilience of the business to adverse competitive, economic or financial developments and ensure that robust, forward-looking capital and liquidity management processes are in place to deal with the identified risks.

The reverse stress tests complement the ICAAP, ILAAP and ORSA and assist management in understanding the full continuum of the levels of stress which the business can tolerate within its current resources and risk appetite. Any plausible scenarios identified with unacceptably high risks will lead the Group to adopt measures to prevent or mitigate those risks through a change in strategy, increased controls and early warning indicators or contingency plans.

RECOVERY PLANNING

There continues to be a strong focus on 'resolvability' from UK and European regulators with requirements issued through the Bank Recovery and Resolution Directive allowing a common approach to be taken. A key element of this directive is the continual maintenance of a formal Recovery Plan and a Resolution Plan which are also submitted to regulators on an annual basis.

The Recovery Plan describes the strategy and a ‘menu of actions’ that could be taken by management to allow the recovery of the Bank from a significant adverse event which would otherwise lead to failure. The Recovery Plan is informed by the outcomes of the stress and scenario testing framework which the Board and senior management use to determine the strategy and actions to support a potential recovery.

The Resolution Plan provides data required by the PRA to be used to facilitate a rapid and orderly resolution in the event that the recovery of the Bank could not be achieved whilst maintaining any critical functions provided by the Bank to the economy.

Operational Resilience

The regulatory direction provided on operational resilience through discussion and consultation papers has led the Group to strengthen its previous approach to business continuity by assessing the firm’s critical services and the supporting processes to identify potential disruptions that could crystallise under various operational scenarios i.e. cyber-attacks or head office unavailability. These detailed assessments have allowed a much greater understanding of where to devote resources to provide effective resilience for these critical services.

Operational resilience coupled with the financial resilience assessed through the Recovery Planning outlined above combines to provide a firmwide resilience framework that approaches and tests resilience of the Group from multiple viewpoints and scenarios.

Chair of the Audit Committee,

Report from John Barbour

John Barbour,
Chairman of the Audit Committee
19 December 2019

The financial year ended 31 October 2019 has been a year of change with the appointment of a new CEO.

In addition, this is the first set of financial statements incorporating the impact of IFRS 9. The Audit Committee thanks all employees involved in the hard work performed to transition the organisation to IFRS 9.

The Audit Committee's agenda continues to include its responsibilities as the 'third line of defence' in Hodge's risk management framework; oversight of the performance and effectiveness of internal and external audit; ensuring the integrity of the financial statements of all companies within the Group; and oversight of Hodge's system of internal control.

FINANCIAL STATEMENT REPORTING ISSUES

The Committee's main responsibility in relation to the Group's financial statements is debating and challenging the judgements made by management and questioning the assumptions and estimates on which they are based. The exercise of appropriate judgement in preparing the financial statements is critical to ensure that Hodge's financial statements are fair, balanced and understandable.

The following are the significant judgements, issues and actions taken by the Committee in relation to the annual report and financial statements. Each of these matters was discussed with EY during the year and, where appropriate, addressed as areas of key audit matters in their audit report.

Area of focus	Role of the Audit Committee	Conclusion/Action taken
Annuities		
The judgement in relation to the longevity of Hodge Life's annuitants is important and material. Although the assessment of mortality is subjective, there is a lot of mortality data available. Hodge makes its assessment in the context of industry data plus the information and experience it has in relation to its own portfolio of annuitants. This year management engaged Hymans Robertson, an actuarial firm, to advise it on its implementation of the CMI table. Hymans Robertson has its own data set and hence was able to advise Hodge Life's management in setting parameters which are appropriate for the lives we are insuring.	The Committee reviewed a paper prepared by the Chief Actuary in relation to longevity. The paper recommended that the mortality tables used for determining longevity should be based on the Continuous Mortality Improvements (CMI) table published in 2018, updating the assumptions adopted the previous year under CMI 2017. It also recommended that the relevant table should be used every year. The Committee challenged the Chief Actuary on his proposal, taking into account the advice provided by Hymans Robertson and also from Oliver Gillespie, the Board's actuarial advisor.	The Committee was satisfied that the use of the latest mortality/longevity basis was supported by industry trends and was also appropriate in the specific circumstances of Hodge Life's annuity portfolio, particularly based on the work carried out by Hymans Robertson on parameters such as smoothing, addition to mortality and the long-term rate of mortality improvement. The Audit Committee recognised however that it was possible that future developments in mortality could see a reversal of some of the assumptions made.

Area of focus	Role of the Audit Committee	Conclusion/Action taken
Equity release mortgages		
Hodge exercises judgement in the valuation of its equity release assets in both Hodge Bank and Hodge Life. The assumptions relating to the timing and quantum of value realised in equity release properties are subjective due to a number of variables, none of which can be estimated with certainty. Realised value is impacted by the timing of individuals: • selling their property due to downsizing; • moving into long-term care; • refinancing the mortgage with another lender; or • their death Other assumptions arise in relation to determining an appropriate value for the NNEG embedded in equity release products. Future house price inflation (specifically relating to the type of properties that are held by Hodge) and longevity are key variables, as is the assumption regarding the discount rate used to value its equity release mortgages. In addition, the sale towards the end of the financial year of part of the equity release portfolio in Hodge Bank at a loss involved a re-assessment of the valuation of the carrying value of the remaining equity release portfolio.	The Committee reviewed a paper produced by the Chief Actuary, which included a detailed analysis of the Group's lapse experience relating to refinancing, downsizing and moving into long-term care. It also challenged the basis of the assumption made in relation to long-term house price inflation and longevity. It obtained information from the Board's actuarial advisor. The Committee reviewed a paper prepared by management in relation to the carrying value of the remaining equity release portfolio in the context of the sale of part of the portfolio at a loss justifying that the valuation adopted in the financial statements was appropriate.	The Committee concluded that the assumptions included in the valuation of the equity release mortgage portfolio of Hodge Bank and Hodge Life were appropriate.

Area of focus	Role of the Audit Committee	Conclusion/Action taken
Commercial lending		
Hodge Bank implemented its new IFRS 9 compliant policy for loan loss provisions on 1 November 2018 and the financial statements for the year ended 31 October 2019 are the first to include the results of the new process. In addition, Hodge Bank has launched several new products this year which have required an assessment as to how they would be accounted for under IFRS 9 and appropriate changes were made to both the policy and Hodge Bank's systems. The Board and the Audit Committee receives regular information from management and received a detailed report on its assessment of the loan loss provision required at the year-end.	The Committee has been actively involved in challenging management to ensure that the IFRS 9 process is fully embedded in the Commercial Lending Department as well as in the Finance Department. As part of the 2018/19 internal audit plan it had requested that an internal audit review be carried out on the controls around the manual intervention involved in the process. This report was satisfactory.	The Committee challenged the basis of some of the judgements made by management in its year-end assessment of loan loss provisions. The Audit Committee also reviewed in detail the disclosures made in the financial statements, particularly given the complexity and technical nature of the standard. The Committee was satisfied that the loan loss provisions in the financial statements were appropriate and that the disclosures were clear, complete and appropriate.
Expenses		
Assumptions have to be made in relation to the future growth of Hodge Life's business and the current and future cost base, to assess the costs included in both asset valuations and provisions for future liabilities. The Audit Committee received a paper on the proposed change in allocating expenses between internal companies.	The Committee reviewed a paper prepared by the Chief Actuary on the expense assumptions and also took advice from the Board's actuarial advisor. The Committee reviewed the paper prepared by the Chief Actuary on the change in allocation and challenged the methodology for allocating the costs and gained assurance from the Chief Financial Officer that it was at a market rate of allocation.	The Committee confirmed that it was satisfied that the revised expense charging basis was a more appropriate basis and supported by the evidence received from the market. It was also satisfied on the assumptions made by the Chief Actuary in relation to expenses.

Area of focus	Role of the Audit Committee	Conclusion/Action taken
Derivatives		
Hodge Bank has a substantial number of derivative financial instruments, relative to its Balance Sheet size. These hedge the risk to changes in interest rates and yield curves. The majority of these derivatives are valued at fair value as at the Balance Sheet date. A proportion of interest rate derivatives are accounted for under IAS 39 hedge accounting rules. Significant changes in rates can affect their effectiveness as a hedge, which might lead to income volatility or a different accounting treatment.	The Committee obtained confirmation from management that the valuation of derivatives at the year-end are in accordance with the amounts recognised by the relevant counterparties and that the hedge effectiveness calculations had been carried out appropriately. Management were also able to evidence, for all the derivatives settled in the year, that the value attributed by counterparties prior to breaking the derivative was in line with the valuation held by the Group.	The Committee was satisfied that the fair value of the derivatives was appropriately reflected in the financial statements and that, where hedge accounting was applied, it was effective.
Long term viability		
The directors make a statement in the Annual Report as to the long-term viability of Hodge. The Committee provides advice to the Board on the form and content of the statement, including the underlying assumptions.	The Committee reviews the Board's assessment of long-term viability through consideration of the Group's rolling five-year strategy, the Bank's assessment of capital (ICAAP), the Bank's assessment of liquidity (ILAAP) and Hodge Life's assessment of its own risk and solvency (ORSA).	The Committee agreed to recommend the long-term viability statement to the Board.
Fair, balanced and understandable reporting		
Hodge endeavours to ensure that its external reporting is fair, balanced and understandable. The Committee undertakes an assessment on behalf of the Board in order to provide the Board with assurance that it can make the statement recommended by the Financial Reporting Council's Corporate Governance Code.	The Committee assessed, via discussion with, and challenge of, management (including the Chief Executive and CFO), as to whether disclosures in Hodge's published financial statements were fair, balanced and understandable.	Having evaluated all of the available information and the assurances provided by management The Committee concluded, and were able to recommend to the Board, that Hodge's published report and financial statements were fair, balanced and understandable.

EXTERNAL AUDIT

The initial three-year appointment of EY came to an end in December 2018. It was agreed that EY would be appointed for another three-year term. Andy Blackmore continues as Hodge's audit partner, enabling Hodge to benefit from the experience he and his team have gained over the last four years.

A formal review of the effectiveness and audit quality of EY was carried out in 2019, including an assessment of the professional scepticism and objectivity of the EY team. The Committee is responsible for assessing the objectivity and independence of EY. This responsibility was discharged through the Audit Committee meetings and during private meetings with EY.

The Financial Reporting Council's Audit Quality review team carried out a review of EY's audit of the Group for the year ended 31 October 2018 with no significant findings.

The Committee has a policy whereby all services which are not covered in the audit are approved by the Committee. Hodge continues to examine non-audit fees in light of the Ethical Standard issued by the Financial Reporting Council (FRC). The Audit Committee asked EY to assist it on one matter outside of the annual statutory audit and Solvency II audit: finalisation of the assurance on the model validation for the MA/PIM project that commenced last year. The payments made to EY for non-audit fees in the year ended 31 October 2019 was £85,000 (2018: £100,000). This reflects a non-audit fee to audit fee ratio of 39%, the average for the last three financial years is 69%. As promised in my report last year the average non-audit fee for the last three financial years is below the 70% limit set by the FRC.

INTERNAL AUDIT

The Group's internal audit function has been outsourced to PwC. This has worked well as it has enabled the Group to access a far wider group of specialists, for example in cyber security, regulatory change and emerging legislation (such as data protection) compared with trying to build our own internal capability.

The three-year appointment of PwC expires in December 2019 and the Committee felt it appropriate to conduct a tender for the internal audit. Six firms were identified as having the capability of providing and supporting a Head of Internal Audit with the following attributes:

- A deep grounding and knowledge of the UK financial services sector;
- A good working knowledge of emerging business and regulatory issues;
- Able to ensure that appropriate skilled resources are brought to bear on the internal audit of Hodge from wherever in the UK this skill resides;
- Able to provide the Committee with informal benchmarking, comparing Hodge with similar companies in the financial sector to questions from the Audit Committee;
- Available throughout the three-year term of the appointment.

After meetings with management and contribution by members of the Audit Committee, three firms were asked to present to the Audit Committee in September. As a result, Deloitte has been appointed as the new Internal Audit firm. Hodge remains of the strong opinion that attempting to create an in-house capability to perform the internal audit function is neither cost effective nor does it provide the necessary level of expertise required to stay abreast of changes in the marketplace. The internal audit selection process further reinforced this view.

The Committee scrutinises and agrees Internal Audit's plans, including agreeing the areas of focus, which this year included a review of the Group's operational resilience, change management and IT operations and commercial lending data quality. Internal Audit also reviewed some of the major returns required by the regulator, such as the ORSA and ICAAP, enabling the Group to benefit from PwC's experience of similar returns prepared by other companies.

The Committee tracks the implementation of the recommendations of Internal Audit, in conjunction with PwC, and is satisfied that these are being implemented on a timely basis.

The Committee also reviewed the effectiveness of the Internal Audit service using a self-assessment questionnaire completed by management and members of the Committee during the year and discussed the outcome with PwC.

INTERNAL CONTROL

The Audit Committee has responsibility on behalf of the Board for Hodge's systems of internal control. The Audit Committee discharges this responsibility by discussing and challenging reports issued by Internal Audit. Further, through my membership of the Risk and Conduct Committee, I am made aware of any issues raised by the second line of defence assurance team which monitors the implementation of its and Internal Audit's recommendations. Collectively these reports provide assurance that there are effective internal controls within the Group.

The Audit Committee also discusses any control observations raised by EY.

The Audit Committee continues to encourage management to reduce the volume of manual internal controls and automate as many controls as possible to reduce operational risk.

WHISTLEBLOWING

I am the Whistleblowing Champion for Hodge and have reviewed the integrity, independence and effectiveness of Hodge's whistleblowing policies and procedures and also those policies and procedures intended to protect whistle-blowers from being victimised and I am satisfied that these are appropriate.

COMMITTEE COMPOSITION AND MEETINGS

The Committee's membership is designed to provide the depth of financial expertise and commercial acumen it needs to fulfil its responsibilities. Alun Bowen is the designated financial expert on the Committee. The Committee, on behalf of the Board, has retained the services of Oliver Gillespie of Milliman to advise it specifically on actuarial issues.

Committee meetings were attended by the Chief Executive, CFO, Head of Risk, Head of Compliance, Managing Director of Hodge Life, Head of Commercial Lending, the Chief Actuary, representatives of internal audit and the external auditors and other members of the business as appropriate.

During the year private meetings were held with the Lead Audit Partner from EY, the Head of Internal Audit from PwC and Oliver Gillespie of Milliman, without management present.

INTERACTION WITH REGULATORS

As Chair of the Audit Committee I meet with the members of Hodge's regulatory team at the PRA, without management present, during their annual visit to Hodge.

COMMITTEE PERFORMANCE

The Committee updated its self-assessment of its performance and concluded that the changes from previous assessments had now been appropriately implemented. One of the issues outstanding was training for members of the Committee. During the year the Audit Committee received formal training on IFRS 9, Solvency II and IFRS 17.

LOOKING AHEAD

One of the most critical issues going forward remains the achievement of the Matching Adjustment and PIM permissions for Hodge Life's equity release assets from the PRA. Oversight on behalf of the Board is being provided by the Audit Committee.

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GOVERNANCE

Chair of the Risk and Conduct Committee,

Report from Alun Bowen

Alun Bowen,
Chair of the Risk and Conduct Committee
19 December 2019

In my report last year, I commented that the Committee's work was driven by a number of challenges, arising from regulatory change, an evolving market and external threats.

This year again there was a lot of uncertainty and a higher degree of regulatory interaction than hitherto both in Hodge Bank and Hodge Life.

Separation of the Committee

Since the Risk and Conduct Committee was formed some time ago, the Committee has had a common membership covering both Hodge Bank and Hodge Life. There were good reasons for this as Hodge Bank and Hodge Life had similar assets on their Balance Sheets: such as equity release mortgages; and reversionary interests in residential property. They also have common systems and infrastructure.

However, to increase the level of detailed oversight for both regulated entities, the Board of Hodge Limited established separate Risk and Conduct Committees for Hodge Bank and Hodge Life with effect from 1 July 2019. In addition to the benefits of clear lines of responsibility this new structure enabled better oversight of detailed projects within the Bank and Life company, which are discussed later in this report.

Although this separation only formally took place nine months into the financial year, I have been delighted that David Gulland, who joined the Board's of Hodge Bank and Hodge Life earlier in the year, has chaired the Hodge Life Risk and Conduct Committee since July. We work closely together to ensure that there is appropriate separation of responsibilities between the two committees, however, we also make sure that when discussing the many issues which are of mutual interest to Hodge Bank and Hodge Life that the meetings are as time effective as possible, whilst respecting the fact that the two companies can have different perspectives.

In next year's Annual Report there will be separate commentary from the chairs of the Risk and Conduct Committee of Hodge Bank and Hodge Life. For clarity in this year of transition, David and I have agreed that it would be better to have one report, although David has been involved with me in producing this report.

My responsibilities

My prescribed responsibilities as Chair of the Risk and Conduct Committee are to safeguard the independence of, and oversee the performance of, both the risk and compliance functions.

Simon Bowen, who is not related to me, has developed strongly as the Head of Risk and the Board took the decision earlier in the year that he become the CRO. A dedicated risk officer has been recruited for Hodge Life, who will report to the CRO and the Hodge Life Risk and Conduct Committee. I have regular one-to-one meetings and discussions with Simon to ensure that his views are communicated directly to me, independently of management.

Last year an experienced Head of Compliance was appointed whose initial task was to ensure compliance with GDPR and the subsequent follow through. This year he has been active in ensuring that the compliance function is fit for purpose and has had a particular focus on ensuring that, particularly with Hodge Bank's increasing activity in mortgage business, that the Mortgage Conduct of Business rules are fully embedded, and that Hodge complies with the letter of the source book as well as the spirit.

I also hold one-to-one meetings with the members of the risk team who undertake assurance reviews to ensure that the work they are doing, as part of the second line of defence, is as effective as possible and enable them to air any issues and views. I am confident that we have a risk team which is carrying out robust work and adding value to the business.

Activity during the year

In last year's report I commented that the Committee would:

Issue	Progress
Continue to look at the quality and quantity of risk information it is provided with.	Enhanced and more focused, risk reports are now produced by the CRO for Hodge Bank and for Hodge Life. Committee members and I have commented that these are more insightful than hitherto and enable greater focus on the most important risk and conduct topic while still providing sufficient background detail on other matters.
Consider whether the Committee has sufficient meetings to cover issues appropriately.	As commented elsewhere, the number of board meetings has increased and there is now a Risk and Conduct Committee coinciding with each board meeting and since July there have been separate Hodge Bank and Hodge Life Risk and Conduct Committee meetings.
Ensure that the risk information relating to BREXIT was appropriate to handle issues that might arise after the United Kingdom had left the European Union, which was planned for March 2019.	Hodge was well prepared for the planned BREXIT date in March and October and this planning has continued in anticipation of a future leaving date.
Continue to monitor the Balance Sheets of Hodge Bank and Hodge Life to ensure that, as far as possible, management's plans to reduce economic volatility are fulfilled.	**Hodge Bank** Volatility has been significantly reduced now that management's plans to sell a proportion of Hodge Bank's legacy assets and the unwinding of the related derivatives have been satisfactorily concluded. **Hodge Life** The significant reduction in long-term bond yields and interest rates has had a significant impact on Hodge Life and in particular, the Board's targeted Solvency Coverage Ratio (SCR). Management has implemented a number of actions including reducing the amount of new business and exploring reinsurance arrangements to ensure that the targeted SCR is achieved.

I also commented in last year's report that Hodge had a number of projects underway and that the effective management of risk in these projects would be important. The Change Board that was established last year in the first line of defence to ensure that this risk is managed, appears to be working effectively. This is even more important as the number and the complexity of Hodge's projects continues to increase. These include; the building of the residential mortgage business which has a high technology input; the sale of a significant part of Hodge Bank's historic assets, the investigation of a longevity swap and the potential application for the use of a PIM for Hodge Life.

The Committee receives an excellent comprehensive report at each meeting setting out the risks and challenges of each major project and an assessment of its status, allowing The Committee to discuss and challenge management's assessment of each project.

The significant matters addressed by the Committee during the year are summarised below:

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Interest rate risk		
Hodge Bank A significant amount of volatility arises in Hodge Bank as a result of its legacy business, primarily equity release mortgages and reversionary interests in residential property, together with the related interest rate derivatives.	**Hodge Bank** The Risk and Conduct Committee in conjunction with the Board approved management's plans to sell a significant part of Hodge Bank's equity release mortgage portfolio and break the related derivatives. Although this resulted in a loss being recognised in the financial statements it had been agreed that it was very important to reduce the volatility within Hodge Bank's Balance Sheet.	**Hodge Bank** The Risk and Conduct Committee is satisfied that management has achieved a significant reduction in volatility but continues to encourage management to explore ways of reducing interest rate volatility in the legacy portfolio.
Hodge Life The current low and turbulent interest rate environment makes close management of Hodge Life's SCR a challenge.	**Hodge Life** The Risk and Conduct Committee has supported management's actions to reduce new business activity in order to endeavour to stabilise the SCR which has reduced significantly in the year. It has also encouraged management to explore other options to increase the SCR, such as reinsurance and the judicious use of derivatives.	**Hodge Life** The Risk and Conduct Committee is satisfied that management is focused on taking action to improve Hodge Life's SCR and monitors progress carefully. It is planned that significant progress will be made in the next financial year.
Operational Resilience		
Ensuring that if there is a disruption (from cyber-attacks or other operational issues) that Hodge can respond, recover and minimise the impact for customers.	The Risk and Conduct Committee ensured that management had fully considered the PRA's initiative in providing greater focus on operational resilience. The Committee checked that the changes in Hodge's systems and business, increasing digitalisation and use of suppliers, had not resulted in any increased risk that Hodge is not resilient to disruption. Management has engaged fully with the Committee on its plans and at each meeting (and since July for Hodge Bank and Hodge Life separately) there is an update on the progress made on implementing the operational resilience programme.	The Risk and Conduct Committee is satisfied with the progress that has been made. The intention is to close the remaining gaps early in the new financial year.

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Risk appetite and stress testing		
This involves considering the level of risk Hodge chooses to take in pursuit of its business objectives, including testing whether Hodge's financial position and risk profile provides sufficient resilience to withstand the impact of severe economic stress.	The Committee has assessed the risk context for Hodge's Strategic Plan, including general economic and financial conditions and how these are reflected in the Strategic Plan. The Committee approved a Group Risk Strategy to ensure that Hodge's Strategic Plan is closely linked with its risk appetite. It also held a risk workshop, with executive management, and debated the key risks and macro-economic factors facing Hodge and determined plausible stress test scenarios for further work. The Committee also reviewed the mandated and internal stress tests and approved revised limits and triggers.	The Committee recommended the proposed Risk Appetite to the Board. In previous years it had emphasised to management that the mix of new business written by Hodge Bank should become more capital efficient. The actions resulting in an increasing level of mortgage and portfolio buy-to-let business has meant that the blend of new business is now more capital efficient. The Committee has in the past also encouraged Hodge Bank management to investigate ways the commercial lending business might become less capital intensive. The actions taken and those proposed by management, which are work-in-progress should make a significant difference. The Committee continues to encourage management to implement its plans for increasing the capital efficiency of Hodge's business and monitors progress closely. For Hodge Bank, it has also encouraged management to develop more granular and robust measures of risk to monitor the newer lines of business. The Committee will continue to monitor progress in this area over the coming year.

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Capital and funding		
Ensuring there is sufficient capital to meet Hodge's regulatory requirements and to support shareholder expectations. A high percentage of longer-term assets and liabilities in both Hodge Bank and Hodge Life are held at fair value and hence subject to market volatility. Changes in, for example, the yield curve can lead to volatility in the financial results and increased capital requirements.	**Hodge Bank** The Committee debated on a regular basis, capital performance against plan and regulatory requirements. It also reviewed the implementation of management's plans, to reduce as far as possible the volatility on longer-term assets and liabilities held at market value. **Hodge Life** The Committee continued to monitor the work being carried out by Hodge Life on its Matching Adjustment and PIM application. Given the industry-wide issues with equity release mortgages a decision was taken to slow down the pace of the project. Reinsurance strategies were considered as a further way of improving the capital position of the Company.	The Committee recommended to the respective boards the approval of Hodge Bank's ICAAP and Hodge Life's ORSA and their subsequent submission to the regulator. The Committee supported the forecast capital and the actions identified by management to manage the Group's capital position and the actions taken to reduce volatility. However, it also encouraged management to continue to explore the options available to further reduce portfolio volatility.
Liquidity		
Ensure there is sufficient liquidity so that Hodge can meet its obligations, as they fall due, and meet regulatory requirements.	Assessed on a regular basis liquidity performance against both internal and regulatory requirements.	The Committee recommended to the respective boards the approval of Hodge Bank's ILAAP and the liquidity aspects of Hodge Life's ORSA. For Hodge Life the implications of the PRA's new expectations around liquidity management will be monitored but are not expected to lead to any significant changes.

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Risk management framework		
The framework's policies, talent and tools in place to support effective risk management and oversight.	The Committee regularly reviews the maturity of the risk management framework and management's plans to continue to enhance it. The Committee provided management with input on the quality and relevance of risk information being provided to both the Hodge Bank Committee and the Hodge Life Committee and recommended improvements, which have been implemented.	The Committees will continue to track the planned improvements in the risk management framework and the information provided to each of the Committees. The Committees also recognise that management information needs to be dynamic and respond quickly to market, regulatory and internal changes.
Cyber security		
The threat of individuals or organisations penetrating Hodge's digital and other business systems for the purpose of compromising data or committing fraud. Hodge's increasing digital presence, combined with the increased threat of cyber risk generally, means that our digital security capability needs continuing enhancement.	Reviewed the actions proposed by management in Hodge's digital journey to ensure that cyber security risk is minimised. Received presentations from a third party on its assessment of Hodge's cyber security maturity.	The Committee was encouraged at the continuing pace of progress and that a number of 'gaps' had now been closed. The Committee will continue to keep cyber security under review due to the ever-changing cyber security landscape.

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
Conduct risk		
The risk of detriment to customers from the inappropriate supply of financial services.	Continued to review all Hodge's products on a cyclical basis to ensure that product features remain appropriate and reviewed management's proposed actions to address any issues identified during the reviews. Reviewed the processes to identify vulnerable customers ensuring that the assistance provided to them is relevant to their circumstances. Reviewed Hodge's complaints record, and the actions taken by management to resolve issues. Reviewed the work carried out to ensure compliance with the Mortgage Conduct of Business Rules and the suggested actions arising from the review.	The Committee was satisfied that Hodge's product range and any actions proposed are appropriate in the current economic and regulatory climate. It was pleased with the relatively low number and minor nature of the complaints received and the speedy and effective action taken by management to resolve issues. The Committee was satisfied that the review of compliance with the Mortgage Conduct of Business Rules was well carried out and the proposed actions should result in further improvement in compliance.
Credit, house price, longevity, pension, regulatory and emerging risks		
Significant risks that could have a material impact on Hodge's business and also its capital requirements.	Received regular reports on the impact of these risks and the work being carried out by management to manage these risks and the investigations carried out to ensure that the data is as robust as possible. Evaluated the potential impact of regulatory developments on Hodge's risk profile. Debated extensively each area of material risk, the trends and the controls in place. Engaged with Hodge's actuarial adviser as to developments in longevity and the approach taken by Hodge's in-house actuarial team in relation to its review of assumptions. Evaluated emerging risks and their potential effect on the business. Increased the composition of the Committee to bring additional experience to the discussions. Supported and actively participated in the recruitment of a Head of Risk for Hodge Life.	The Committee was satisfied that there was sufficient focus on the key risks facing the business and that actions proposed by management were being effectively implemented. It was also satisfied, based on its own experience, with support from its actuarial adviser, that the approach being adopted by the in-house actuarial team is appropriate and in accordance with best practice.

Area of focus	Action taken by the Risk and Conduct Committee	Conclusion or further action taken
New products		
The risk that the organisation has carried out insufficient research on the product and hence is taking on risk where it has little knowledge or information.	During the year Hodge Bank launched several new products including portfolio buy-to-let; holiday let, smaller development loans and a fixed for life retirement interest only mortgage. The Committee assessed the risk of these products and encouraged management in the case of the holiday buy-to-let product to ensure that that the potential impact of climate change be taken into account particularly for seaside locations. In relation to the fixed for life product it challenged management to ensure that the interest rate hedge for this product was as effective as possible given its potential duration.	The Committee was satisfied that management had demonstrated that the new products launched during the year were adjacent or similar to its existing products and hence were consistent with the strategy of being a niche player and that management had taken into account the risks of these products and had developed appropriate risk mitigation strategies prior to launch. The Committee for Hodge Bank will ensure that detailed risk metrics are in place for all new products so that the nature of the risk being taken on is suitably controlled.
Business Continuity Plan and Recovery and Resolution Plan		
The policies and procedures in place to ensure that Hodge can meet its regulatory and business obligations in the event of a major change in circumstances.	The Recovery and Resolution Plan prepared by management has been significantly updated since the previous version, as the nature of Hodge's business changes. The Committee discussed the current state of business continuity plans and the extent they had been tested in practice.	The Committee encouraged management to ensure that the Recovery and Resolutions Plans were practical and focused on Hodge's particular circumstances. The Committee was satisfied with the current status of business continuity planning.

RISK INFORMATION PROVIDED TO THE COMMITTEE

The Hodge Bank and Hodge Life Risk and Conduct Committee receive regular reports on risk management issues and track a wide range of metrics through a monthly report produced by the CRO. This report provides an overview of the Group's risk profile compared with the Group's Risk Appetite. The CRO's report contains commentary on the Group's principal risks and includes a risk appetite dashboard which highlights at a glance those areas that might require attention. It also flags emerging risks, and the processes for identifying emerging risks have been enhanced during the year.

INTERACTION WITH MANAGEMENT

The Committee is mindful of the need to hold management directly accountable when issues have arisen and been reported by the CRO, Head of Compliance or other parties. Members of Senior Management attend Committee meetings for deeper discussions in such instances.

INTERACTION WITH REGULATORS

As Chair of the Risk and Conduct Committee I met with members of Hodge's regulatory team at the PRA, without management present, during their annual visit to Hodge.

COMMITTEE PERFORMANCE

The Committee carried out a self-assessment of its performance and also an assessment was carried out by an independent facilitator. Both reviews concluded that the changes recommended from previous assessments had been appropriately implemented. It was agreed that a review of the operation of the separate committees would be carried out after they have had an opportunity of 'bedding in'.

LOOKING AHEAD

As the Chair of the Hodge Bank Risk and Conduct Committee I will be encouraging the Committee to focus on the following areas during the next financial year:

- Ensuring that the remaining gaps in both the operational resilience and the cyber security programmes are closed and that they are appropriate to address the new types of disruption that might appear during the year.
- Continuing to encourage management to reduce volatility in the remaining legacy business.
- Monitor management's plans to transition away from LIBOR are carried out with appropriate speed and managed from a risk perspective.
- Ensuring that management's plans are effective for managing a Balance Sheet, which at the end of the year will be quite different from that in previous years.
- Carrying out reviews of the new products launched in the last eighteen months to ensure that they are performing in line with expectation.

David Gulland, as Chair of the Hodge Life Risk and Conduct Committee will be focusing on the following:

- Working with management to further strengthen the overall risk management framework for Hodge Life including an increased detail in how the solvency position is monitored.
- Overseeing from a risk perspective the proposed longevity transaction.
- Providing overall governance to the potential application for a PIM for use in determining capital requirements.
- Ensuring that Hodge Life is fully compliant with the PRA's expectations around liquidity management as set out in their Supervisory Statement 5/19.

Chair of the Nomination Committee,

Report from Jonathan Hodge

Jonathan Hodge,
Retiring Chair of the Nomination Committee
19 December 2019

The last twelve months have been about looking to the future and ensuring that our board and Executive team are set up for success.

The Nomination Committee agenda has therefore concentrated on further strengthening the Board of Hodge and, along with our CEO, re-focused our Executive team.

We were delighted to welcome Steve Pateman to Hodge as CEO in January 2019. Steve, with the Nomination Committee's support and oversight, very quickly set up his leadership team during the first quarter of his tenure. The new Executive Committee was extended to introduce a range of specialist capabilities and expertise, including a dedicated Chief Operations Officer, a Chief Marketing Officer and a Managing Director for our Mortgages business.

The Executive Committee are fully motivated to delivering our 2023 strategy and the Nomination Committee will ensure that they receive the Board's full co-operation and support for their personal development, whilst continuing to drive strong performance in the delivery of our strategy. More recently, during July 2019, the Committee has reviewed plans for future development and succession of our leaders at Hodge and this investment will continue into 2020.

A key focus for the Nomination Committee during this year has been to undertake a review of board governance, composition and effectiveness. In January 2019, we engaged Nestor Advisors as independent specialists to review our board effectiveness and offer ideas for continuous improvement. Nestor Advisors have significant experience in consulting with boards globally, with the aim of enhancing board effectiveness and performance.

To summarise, Nestor advisors found that the Board "currently packs significant knowledge, skills and experience among its members". Working with board members, we were also able to agree themes for further development of their knowledge and skills and have now planned a schedule of development activities for the coming twelve months. The Board will now meet 10 times a year in order to oversee their expanding agenda.

Their report also supported our emerging view that we need to grow the size of our board to respond to the increasing commercial complexity and expanded responsibilities that sit with the Board. In addition, the Nomination Committee has recognised that there is a need to introduce further governance independence between the Bank's Board and Hodge Life's Board.

During 2019, the Nomination Committee oversaw the recruitment of two additional independent roles to the Board. The first appointment was David Gulland who joins us as an actuarial specialist, bringing additional risk and conduct experience with him too. David will chair the newly formed Risk and Conduct committee for Hodge Life. We also welcome Graeme Hughes, who has built a prestigious executive career at Nationwide Building Society. Graeme has assumed responsibility for the Senior Independent Director role at Hodge.

As we enter into 2020, the Nomination Committee's focus will continue to be on board composition and the recruitment of additional Non-Executive Directors ('NED'). The initial recruitment arises from the retirement of two of our long-standing board members, Alun Bowen (Chair of Risk and Conduct Committee) and Adrian Piper (Chair). I have had the absolute pleasure of working professionally with Adrian and Alun for many years and I would therefore like to personally express my huge gratitude for their contribution and loyalty to Hodge's success and wish them well for their future plans and family time. The Nomination Committee will lead the search for both vacancies, supported by our specialist NED recruitment and selection advisors, Ridgeway Partners. The Chair of Risk and Conduct Committee will be for the Bank's Board.

We also hope that through these appointments that we enhance our diversity profile at board level. As part of this commitment, the Nomination Committee approved for Hodge to sign up to the `Women in Finance' charter from September 2019. A number of supporting activities accompany this ambition, which are backed by the `Wonder' team at Hodge, our colleague diversity network.

As you can see, we are significantly enhancing our board and Executive team and the Nomination Committee will continue to shape and oversee this investment to ensure we have effective board governance and performance. As I share these changes with you, I note that my own personal decision to retire from the Board of Hodge is one further change that we will work through with the Board and the CEO. I have very much enjoyed Chairing the Nomination Committee but as I plan my hand-over of this role to Adrian Piper as my successor, I know that I am leaving the team with strong foundations and future plans that will set us all up for success.

Chair of the Remuneration Committee

Report from Helen Molyneux

Helen Molyneux,
Chair of the Renumeration Committee
19 December 2019

During the last twelve months, the Remuneration Committee completed the important task of shaping and agreeing a reward strategy for Hodge that sets out our guiding principles and direction for the Group's reward policies, practices and offerings.

Our reward strategy will ensure that we are clear about what we are trying to achieve when it comes to rewarding and recognising our colleagues.

The strategy is founded on the strong belief that our people deserve to be rewarded and recognised fairly, responsibly and competitively in return for their contribution to Hodge's long-term success. It makes a commitment that the total reward offering encourages our people to work together to achieve success and is valued by our people because it offers benefits that meet their personal and family needs. Our success at Hodge needs to be sustainable and it is important to reward performance that supports longer term delivery of the 5-year plan.

Aligned to the commitments, the Remuneration Committee have approved a number of changes to our reward offering:

Firstly, we are introducing flexible benefits to our colleagues from 1 April 2020. We appreciate that our colleagues are at different stages of their life and should have access to benefits that can be tailored for them and their families. This is very much aligned to current external reward practices and will support our attraction as a responsible and modern employer.

Secondly, we took the opportunity to anchor future variable pay reward schemes to this strategy. As a result, we have introduced a non-contractual reward scheme for a group of our strategic leaders that will recognise long-term performance against the 2023 plan. This reviews performance against the delivery of the plan in September 2023 with deferred payments built in and complete remuneration committee discretion for any vested payments. A broad range of performance themes feature, including risk management oversight and customer experience.

For all our colleagues, subject to the rules of the scheme, we have introduced the non-contractual Annual Reward Plan that will recognise and pay out against performance with a value of anything from 0% to 12% and a further 5% for exceptional performers. This scheme runs for the duration of our accounting year 2019/20.

Legacy variable incentive reward schemes have or will be closed out by the end of 2019. This includes the former Executive long-term incentive scheme.

In next year's Remuneration Committee agenda, we will also look to undertake a Gender Pay audit, the headlines and any supporting actions of which will be shared publicly. As Chair, I remain committed to ensuring our reward offering is fair and inclusive.

More generally, the employment market in Cardiff and South West is buoyant and therefore we need to ensure our total reward and employer proposition remains competitive and appealing to current and future colleagues. We will manage this against our need to ensure that any reward decisions are affordable, support effective customer outcomes and risk controls, whilst being proportionate in their design. Alignment to our new reward strategy will assist this ambition. The Remuneration Committee have built some strong foundations this year, which we will continue to evolve during the next twelve months.

Directors' Report

From David Landen, on behalf of the Board of Directors

David Landen,
Director
19 December 2019

The directors present their report together with the audited financial statements for the year ended 31 October 2019.

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

GROUP STRATEGY
Page 04

FINANCIAL PERFORMANCE REVIEW
Page 16

RISK MANAGEMENT POLICIES
Page 28

DERIVATIVE FINANCIAL INSTRUMENTS
Note 25

DIRECTORS AND DIRECTORS' INTERESTS

The directors who held office during the year were as follows:

Adrian Piper *	Chairman
Stephen Pateman (CEO)	Appointed February 2019
David Landen (CFO)	
Alun Bowen*	
Jonathan Hodge*	Retired October 2019
Helen Molyneux*	
John Barbour*	
Graeme Hughes*	Appointed September 2019
David Austin*	Retired February 2019

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

*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 immediate parent of Hodge Limited, The Carlyle Trust Limited. None of the other directors held any interests in the shares of any Group companies.

POLITICAL CONTRIBUTIONS

The Group made no political contributions during either year.

POST BALANCE SHEET EVENTS

On 5th December 2019, the Group agreed to buy a portfolio of buy-to-let loans from a third party for £20.6m. There are no other post Balance Sheet events.

DIVIDEND

No dividends have been declared or paid during the year.

QUALIFYING THIRD-PARTY INDEMNITY PROVISIONS

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

RE-APPOINTMENT OF AUDITORS

A resolution for the re-appointment of EY as auditor of the Company is to be proposed at the forthcoming Annual General Meeting of the Company's parent, The Carlyle Trust Limited.

EMPLOYEES

The Group 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 Group.

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

IBOR REFORM

In July 2017, the UK Financial Conduct Authority (FCA) announced a transition away from LIBOR as the key interest rate index used in calculating floating or adjustable rates for loans, bonds, derivatives and other financial contracts. The FCA's intention is that, at the end of 2021, it will no longer seek to persuade, or compel, banks to submit rates for calculation of LIBOR. The Bank is currently assessing the impact of this change on its financial instruments which use LIBOR as their benchmark interest rate, this work will continue through 2020 as the impact on markets becomes clearer.

Statement of Directors' Responsibilities

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 Group financial statements in accordance with International Financial Reporting Standards and Interpretations (collectively IFRSs) issued by the International Accounting Standards Board (IASB) as adopted by the European Union ('adopted IFRSs') and those parts of the Companies Act 2006 that are applicable to companies that prepare financial statements in accordance with IFRS. The Company has 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 Group and parent Company and of their profit or loss for that period. In preparing each of the Group and parent Company 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 IFRS or UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements;
- Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and 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 its 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 Group and to prevent and detect fraud and other irregularities.

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

Each of the directors who is a director at the date of the approval of this Annual Report confirms to the best of their knowledge:

1. The Group and parent Company financial statements prepared in accordance with IFRS and FRS 101, give a true and fair view of the assets, liabilities, financial position and profit of the Group and the Company.
2. The Strategic Report includes a fair view of the development and performance of the business and the position of the Group together with the description of the principal risks and uncertainties that it faces.
3. The Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for the shareholder to assess the Group's position and performance, business model and strategy.
4. 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 Group'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 Group's auditor is aware of that information.

AUDITOR'S REPORT 2019

Independent Auditor's Report to the Member of Hodge Limited

OPINION

In our opinion:

- Hodge Limited's group financial statements and parent Company financial statements (the 'financial statements') give a true and fair view of the state of the Group's and of the parent Company's affairs as at 31 October 2019 and of the Group's profit for the year then ended;
- The Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- The parent Company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- The financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements of Hodge Limited which comprise:

Group	Parent Company
Consolidated Income Statement for the year then ended	Company Balance Sheet as at 31 October 2019
Consolidated Statement of Comprehensive Income for the year then ended	Company Statement of Changes in Equity for the year then ended
Consolidated Balance Sheet as at 31 October 2019	Related notes 1 to 36 to the financial statements (except for the sections of notes 2 and 36 which are marked as unaudited), including a summary of significant accounting policies
Consolidated Statement of Changes in Equity for the year then ended	
Consolidated Statement of Cash Flows for the year then ended	
Related notes 1 to 36 to the financial statements, (except for the sections of notes 2 and 36 which are marked as unaudited), including a summary of significant accounting policies	

The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union. The financial reporting framework that has been applied in the preparation of the parent Company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice), including FRS 101 'Reduced Disclosure Framework'.

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 Group and parent 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, 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 Group's or the parent 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	The risk that inappropriate actuarial assumptions are used in the valuation of equity release mortgages, reversionary interest in properties and annuity liability technical provisions;
	The risk that inappropriate property/collateral valuations are applied in the calculation of the IFRS 9 Expected Credit Loss ('ECL') provision;
	The risk that there is incomplete identification of loan assets held at amortised cost with significant increases in credit risk (Stage 2) or credit impairment (Stage 3) on a timely basis, including due to incorrect application of the internal risk and S&P scorecard ratings applied in the commercial loan book;
	The risk of incorrect valuation of derivatives.
Audit scope	We performed an audit of the complete financial information of both subsidiaries of the Group, being Julian Hodge Bank Limited and Hodge Life Assurance Company Limited.
Materiality	Overall group materiality of £6.3m which represents 2.0% 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

The risk that inappropriate actuarial assumptions are used in the valuation of equity release mortgages, reversionary interest in properties and annuity liability technical provisions (Investments (equity release mortgages): £620.4m, 2018: £685.2m, investment properties – reversionary interest in properties: £170.1m, 2018: £179.1m, long term business provision: £498.7m, 2018: £437.0m).

The valuation of the equity release assets, reversionary interest in properties and annuity liabilities 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.

Inappropriate assumptions may lead to a material misstatement in the financial statements.

The equity release mortgages are disclosed as loans and advances to customers in note 16 of the financial statements, with the principal assumptions and sensitivity analysis of changes to key assumptions disclosed in note 31(d).

The reversionary interest in properties are disclosed as investment properties in note 20 of the financial statements, which also includes sensitivity analysis of changes to key assumptions.

The annuity liabilities are disclosed as long-term business provisions – liabilities arising from insurance contracts in note 26 of the financial statements, which also includes sensitivity analysis of changes to key assumptions.

Our response to the risk

We performed a walkthrough to understand the assumption setting process and tested controls within the process.

Utilising our actuarial specialists, we assessed and challenged the assumptions used within the valuation of equity release mortgages, reversionary interest in properties and the annuity liability valuations to ensure that they are in line with peer companies, internal experience analysis and the requirements of financial reporting and regulatory standards. The key assumptions we focussed our audit work on were as follows:

No Negative Equity Guarantee
We have considered each of the assumptions used within the NNEG calculation, considering a combination of historic and projected future house price growth, the potential variability in house price growth and the allowance made for the property dilapidations within the portfolio.

Voluntary early redemption
We compared the voluntary early redemption assumptions in the valuation with observed experience in the portfolio and with those used by peer companies in the sector.

Particular attention was paid to the implications for experience in light of the increased competition in the market over the last 3-4 years and the relevance of historic data to future VER assumption setting in light of these changes.

Discount rate
We assessed the discount rate assumption used in the valuation of equity release mortgages, reversionary interest in properties and the long-term business provision was consistent with discount rates used by other companies in the sector, relative liquidity levels and customer rates available in the market.

Policyholder mortality/longevity
We assessed the mortality assumptions by considering management's experience analysis and comparing 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.

Expenses
We tested current and forecast expense levels to evaluate if the unit costs and inflation assumptions used within the valuation were reasonable.

We tested the allocation of expenses between Hodge Life Assurance Company Limited and Julian Hodge Bank Limited.

Key observations communicated to the Audit Committee

Overall, we consider the assumptions that are used in the valuation of the equity release mortgages, reversionary assetsinterest in properties and annuity liability technical provisions to be within a reasonable range, with the majority of assumptions towards the middle of the range, and the discount rate for Hodge Bank's equity release mortgages at the optimistic end of the acceptable range.

Risk
The risk that inappropriate property/collateral valuations are applied in the calculation of the IFRS 9 Expected Credit Loss ('ECL') provision (Stage 3 credit impairment provision on loans and advances to customers): £7.3m (2018: £3.6m) The assessment of the expected credit loss provision is inherently judgemental, with the valuation of the collateral a key input to the calculation of the provision. The loan collateral is disclosed in note 32 of the financial statements.
Our response to the risk
We performed a walkthrough to understand the provisioning process and tested the controls over the valuation of collateral. For a sample of Stage 3 loans we utilised our property valuation team specialists to perform an independent valuation of the collateral used within the ECL provision calculation. The sample we tested in our audit covered £20.8m, 97% (2018: £30.2m, 91%) of the collateral value for the Stage 3 loans.
Key observations communicated to the Audit Committee
The controls within the process were tested and were found to be operating effectively. For the sample of Stage 3 property loan collateral selected for testing, each item was evaluated and the valuation of the collateral was determined to be within an acceptable range.

Risk
The risk that there is incomplete identification of loan assets held at amortised cost with significant increases in credit risk (Stage 2) or credit impairment (Stage 3) on a timely basis, including due to incorrect application of the internal risk and S&P scorecard ratings applied in the commercial loan book (gross loan balance for commercial loans): £326.7m (2018: £354.3m). The loan impairment is disclosed in note 17 of the financial statements.
Our response to the risk
We performed a walkthrough to understand the IFRS 9 estimate credit loss process and tested the controls for the assignment of risk ratings which are used to determine the staging of the loans. We tested the S&P scorecard ratings and a sample of internal risk ratings to ensure the inputs to the staging calculation were appropriate. Using the S&P scorecard ratings and internal risk ratings, we reperformed the staging assessment to verify the accuracy of the staging formulas within the estimated credit loss model.
Key observations communicated to the Audit Committee
The controls within the process were tested and were found to be operating effectively. No material exceptions were identified in the testing of the year end staging assessment.

Risk
The risk of incorrect valuation of derivatives: £80.4m (2018: £107.6m). The Group holds a significant number of 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. Due to the significance of the financial instruments and the related estimation uncertainty this is considered a key audit risk. The financial statement value is the counterparty valuation, which is assessed for reasonableness by management. The fair value of these derivative financial instruments is disclosed in note 25 of the financial statements.
Our response to the risk
Utilising our derivative valuation specialists, we reperformed the valuation ofindependently valued a sample of derivative financial instruments. We compared our independent valuation to management's valuation and considered whether management's value was within an acceptable thresholdrange. The sample selected covered £70.9m (2018: £85.6m) of the total population.
Key observations communicated to the Audit Committee
The valuation of the sample selected was determined to be within an acceptable range.

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 each entity within the Group. Taken together, this enables us to form an opinion on the consolidated financial statements. We take into account size, risk profile, the organisation of the Group and effectiveness of controls, including controls and changes in the business environment when assessing the level of work to be performed.

In assessing the risk of material misstatement to the Group financial statements, and to ensure we had adequate quantitative coverage of significant accounts in the financial statements we performed a full scope audit of both Julian Hodge Bank Limited and Hodge Life Assurance Company Limited. Together with the parent entity this represents 100% of the consolidated group. All audit work performed for the purposes of the audit was undertaken by the Group audit team.

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 Group to be £6.3m (2018: £6.4m), which is 2.0% (2018: 2.0%) of equity. We believe equity to be the most appropriate basis as the key stakeholders (including the principal shareholder and the PRA for the regulated subsidiaries) are focused on the financial strength and solvency position of the business, which is represented in the financial statements by equity.

We determined materiality for the Parent Company to be £1.6m (2018: £1.3m), which is 2.0% (2018: 1.6%) of equity. We believe equity to be the most appropriate basis as the Parent Company is a holding Company with limited trading activity.

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 Group's overall control environment, our judgement was that performance materiality was 75% (2018: 75%) of our planning materiality, namely £4.7m (2018: £4.8m) for the Group. We have set performance materiality at this percentage because our prior year audit experience indicates a lower risk of misstatements, both corrected and uncorrected.

Audit work at component locations for the purpose of obtaining audit coverage over significant financial statement accounts is undertaken based on a percentage of total performance materiality. The performance materiality set for each component is based on the relative scale and risk of the component to the Group as a whole and our assessment of the risk of misstatement at that component. In the current year, the allocated performance materiality for Julian Hodge Bank Limited was £2.6m (2018: £2.6m) and for Hodge Life Assurance Company Limited was £3.1m (2018: £3.4m).

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 (2018: £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 Group and the parent 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 by the parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- The parent Company 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 66, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Group and parent 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 Group or parent 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 Group and determined that the most significant were the regulations, license conditions and supervisory requirements of the Prudential Regulation Authority ('PRA') and the Financial Conduct Authority ('FCA').
- We understood how the Group is complying with those frameworks by making enquiries of management, internal audit, and those responsible for legal and compliance matters. We also performed a review of regulatory correspondence and reviewed minutes of the Board and Executive Risk Committees held; and gained an understanding of the Group's approach to governance, demonstrated by the Board's approval of the Group's governance framework and the Board's review of the Group's risk management framework ('RMF') and internal control processes.
- We assessed the susceptibility of the Group's financial statements to material misstatement, including how fraud might occur by considering the entity level controls that the Group has established to address risks identified by the Group, or that otherwise seek to prevent, deter or detect fraud. We also considered performance and incentive plan targets and their potential to influence management to manage earnings.
- Based on this understanding we designed our audit procedures to identify non-compliance with such laws and regulations. Our procedures involved making enquiry of those charged with governance, senior management and internal audit 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 Group's methods of enforcing and monitoring compliance with such policies and inspecting significant correspondence with the FCA and PRA.
- The Group operates in the banking and insurance industries which are considered as highly regulated environments. 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.

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 Group on 30 November 2017 to audit the financial statements for the year ending 31 October 2017 and subsequent financial periods.
- The period of total uninterrupted engagement including previous renewals and reappointments is 3 years, covering the years ending 31 October 2017 to 31 October 2019.
- Non-audit services prohibited by the FRC's Ethical Standard were not provided to the parent Company or Group and we remain independent of the parent Company and Group in conducting the audit.
- The audit opinion is consistent with the additional report to the Audit Committee.

Use of our report

This report is made solely to the Company's member, 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 member 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 member as a body, for our audit work, for this report, or for the opinions we have formed.

Ernst & Young LLP

Andy Blackmore
Senior statutory auditor

For and on behalf of Ernst & Young LLP,
Statutory Auditor, Bristol

20 December 2019

Notes:

1. The maintenance and integrity of the Hodge 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.

FINANCIAL STATEMENTS 2019

Consolidated Income Statement

For the year ended 31 October 2019

	Notes	2019 £m	2018 £m
Interest receivable and similar income	5	69.9	66.6
Interest payable and similar charges	6	(28.2)	(27.8)
Net interest income		**41.7**	**38.8**
Fees and commissions receivable		0.6	2.4
Fees and commissions payable		(0.9)	(1.8)
Net fee and commission income		**(0.3)**	**0.6**
Earned premiums	7	41.6	47.5
Impact of new insurance contracts	26	(42.4)	(48.8)
Investment income		16.9	15.4
Gross claims and benefits paid		(26.9)	(24.5)
Impact of gross claims and benefits paid on the provision for long-term business	26	26.9	24.5
Other operating income		-	0.1
NET OPERATING INCOME		**57.5**	**53.6**
Administrative expenses	9	(22.8)	(17.9)
Depreciation and amortisation		(1.3)	(0.9)
Impairment (losses)/gains on loans and advances to customers	17	(3.9)	1.0
OPERATING PROFIT		**29.5**	**35.8**
Other fair value gains/(losses)	8	24.9	(27.7)
Gains arising from the derecognition of financial assets managed at amortised cost	14	3.1	-
Loss on disposal of loans and advances to customers	16	(4.6)	-
Movement in long-term business provision	26	(46.3)	4.2
PROFIT BEFORE TAXATION	**10**	**6.6**	**12.3**
Tax on profit	11	(0.6)	(1.9)
PROFIT FOR THE FINANCIAL YEAR		**6.0**	**10.4**

Consolidated Statement of Other Comprehensive Income

For the year ended 31 October 2019

	Notes	2019 £m	2018 £m
Profit for the financial year		6.0	10.4
Items that will not be reclassified subsequently to profit and loss:			
Re-measurement of defined benefit pension plan	28	(3.3)	0.6
Deferred tax thereon	21	0.6	(0.1)
Movement of pension scheme reimbursement asset	22	0.5	(0.1)
Deferred tax thereon	21	(0.1)	-
Items that may be transferred to the Income Statement Available-for-sale investments:			
Fair value movements taken to reserves		-	(1.8)
Deferred tax thereon	21	-	0.3
TOTAL OTHER COMPREHENSIVE INCOME		**(2.3)**	**(1.1)**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		**3.7**	**9.3**

The results for the year ended 31 October 2019 relate entirely to continuing operations.
The notes on pages 88 to 155 form part of these financial statements.

Consolidated Balance Sheet

For the year ended 31 October 2019

	Notes	2019 £m	2018 £m
Assets			
Cash and balances held at central banks	12	321.9	153.2
Treasury bills	13	55.5	99.6
Debt securities	14	134.8	148.4
Loans and advances to credit institutions	15	87.3	111.9
Loans and advances to customers	16	1,242.6	1,242.3
Intangible assets	18	5.8	3.1
Property, plant and equipment	19	1.9	2.2
Investment properties	20	170.1	179.1
Deferred tax assets	21	3.0	2.2
Other assets	22	7.2	6.2
TOTAL ASSET		**2,030.1**	**1,948.2**

	Notes	2019 £m	2018 £m
Liabilities			
Deposit from banks	23	72.5	72.5
Deposits from customers	24	1,041.6	994.1
Derivative financial instruments	25	80.4	107.6
Provisions for long term business – liabilities arising from insurance contracts	26	498.7	437.0
Other liabilities	27	3.9	8.0
Other provisions		-	0.1
Pension scheme deficit	28	16.6	12.8
Total liabilities		**1,713.7**	**1,632.1**
Share capital and reserves			
Called-up share capital	29	66.0	66.0
Other reserves		250.4	250.1
Total equity		**316.4**	**316.1**
TOTAL EQUITY AND LIABILITIES		**2,030.1**	**1,948.2**

These financial statements were approved by the Board of directors on 19 December 2019 and were signed on its behalf by:

David Landen,
Director

Company Balance Sheet

For the year ended 31 October 2019

	Notes	2019 £m	2018 £m
Assets			
Shares in group undertakings	34	82.0	82.0
TOTAL ASSETS		**82.0**	**82.0**

	Notes	2019 £m	2018 £m
Share capital and reserves			
Called-up share capital	29	66.0	66.0
Other reserves		16.0	16.0
Total equity		**82.0**	**82.0**
TOTAL EQUITY AND LIABILITIES		**82.0**	**82.0**

These financial statements were approved by the Board of directors on 19 December 2019 and were signed on its behalf by:

David Landen,
Director

Consolidated Statement of Changes in Equity

For the year ended 31 October 2019

Group	Called up share capital £m	Retained earnings £m	Available-for-sale reserve £m	Pension reserve £m	Total £m
2019					
At beginning of year	66.0	256.1	2.7	(8.7)	316.1
IFRS 9 adoption impact (note 2)	-	(0.7)	(2.7)	-	(3.4)
RESTATED BALANCE	**66.0**	**255.4**	**-**	**(8.7)**	**312.7**
Profit for the financial year	-	6.4	-	(0.4)	6.0
Other comprehensive income	-	-	-	(2.3)	(2.3)
AT END OF YEAR	**66.0**	**261.8**	**-**	**(11.4)**	**316.4**

Group	Called up share capital £m	Retained earnings £m	Available-for-sale reserve £m	Pension reserve £m	Total £m
2018					
At beginning of year	66.0	245.3	4.2	(8.7)	306.8
Profit for the financial year	-	10.8	-	(0.4)	10.4
Other comprehensive income	-	-	(1.5)	0.4	(1.1)
AT END OF YEAR	**66.0**	**256.1**	**2.7**	**(8.7)**	**316.1**

Company Statement of Changes in Equity

For the year ended 31 October 2019

Company	Called up Share Capital	Retained earnings	Total
2019			
At beginning of year	66.0	16.0	82.0
IFRS 9 adoption impact (note 2)	-	-	-
RESTATED BALANCE	**66.0**	**16.0**	**82.0**
Profit for the financial year	-	-	-
AT END OF YEAR	**66.0**	**16.0**	**82.0**

Company	Called up Share Capital	Retained earnings	Total
2018			
At beginning of year	66.0	-	66.0
Profit for the financial year	-	16.0	16.0
AT END OF YEAR	**66.0**	**16.0**	**82.0**

Consolidated Statement of Cash Flows

For the year ended 31 October 2019

	Notes	2019 £m	2018 £m
Cash flows from operating activities		**91.6**	**71.2**
Taxation paid		(0.2)	(2.2)
NET CASH INFLOW FROM OPERATING ACTIVITIES		**91.4**	**69.0**
Cash flows from investing activities			
Proceeds from sale of treasury bills	13	83.0	41.7
Purchase of treasury bills	13	(92.4)	(45.5)
Disposals due to restructuring exercise	13	53.4	-
Purchases of debt securities	14	(34.5)	(55.4)
Proceeds from sale of debt securities	14	18.8	36.0
Disposals due to restructuring exercise	14	28.1	-
Additions to intangible assets	18	(3.5)	(2.0)
Additions to plant property and equipment	19	(0.2)	(0.6)
NET CASH INFLOW/(OUTFLOW) FROM INVESTING ACTIVITIES		**52.7**	**(25.8)**
Cash flows from financing activities			
Issue of share capital		-	-
NET INFLOW FROM FINANCING ACTIVITIES		**-**	**-**
Net increase in cash and cash equivalents		144.1	43.2
Cash and cash equivalents at start of year		265.1	221.9
CASH AND CASH EQUIVALENTS AT END OF YEAR		**409.2**	**265.1**
Cash held at central banks repayable on demand	12	321.9	153.2
Loans and advances to credit institutions repayable on demand[1]	15	87.3	111.9
CASH AND CASH EQUIVALENTS AT YEAR END		**409.2**	**265.1**

[1] Loans and advances to credit institutions includes collateral held by swap counterparties of £79.5 million (2018: £83.6 million) which is pledged against the market value of derivative instruments and comprises of interest-bearing cash deposits. Collateral that has been pledged and held is not restricted and is returned at the end of the contract.

A) Analysis of the balance of cash and cash equivalents

2019	Notes	At 31 October 2018 £m	Cash flow £m	At 31 October 2019 £m
Cash held at central banks repayable on demand	12	153.2	168.7	321.9
Loans and advances to credit institutions repayable on demand	15	111.9	(24.6)	87.3
		265.1	144.1	409.2

2018	Notes	At 31 October 2017	Cash flow £m	At 31 October 2018 £m
Cash held at central banks repayable on demand	12	87.0	66.2	153.2
Loans and advances to credit institutions repayable on demand	15	134.9	(23.0)	111.9
		221.9	43.2	265.1

B) Reconciliation of operating profit to operating cash flows

	Notes	2019 £m	2018 £m
Cash flows from operating activities			
Profit before tax		6.6	12.3
Depreciation of plant property and equipment	10	0.5	0.4
Amortisation of intangible assets	10	0.8	0.5
Impairment provision credit for losses on loans	10	3.8	(1.0)
Net Income Statement (gains)/losses on treasury bills	13	(0.1)	1.3
Net Income Statement losses on debt securities	14	(1.8)	0.6
Net change in loans and advances to customers	16	(4.1)	(87.4)
Net change in investment property	20	9.0	26.1
Net change in other assets	22	(1.4)	(0.2)
Net change in deposits from banks	23	-	69.7
Net change in deposits from customers	24	47.5	52.3
Net change in derivatives	25	(27.2)	(23.6)
Net change in provision for long term business liabilities	26	61.7	20.1
Net change in other liabilities	27	(4.1)	(0.1)
Net change in other provisions		(0.1)	(0.2)
Net change in pension scheme deficit	28	0.5	0.4
NET CASH INFLOW FROM OPERATING ACTIVITIES		**91.6**	**71.2**

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES

Basis of preparation

The Group financial statements have been prepared in accordance with International Financial Reporting Standards and Interpretations (collectively IFRSs) issued by the International Accounting Standards Board (IASB) as adopted by the European Union ('adopted IFRSs') and those parts of the Companies Act 2006 that are applicable to companies that prepare financial statements in accordance with IFRS.

The preparation of the Group financial statements in compliance with adopted IFRS requires the use of certain critical accounting estimates. It also requires management to exercise judgement in applying the Group's accounting policies. The areas where significant judgements and estimates have been made in preparing the financial statements and their effect are disclosed in note 3.

The Company is a privately-owned company incorporated and registered in England and Wales.

The Company financial statements were prepared in accordance with Financial Reporting Standard 101 Reduced Disclosure Framework ('FRS 101').

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;
- Disclosures in respect of transactions with members of a group;
- 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 Company has taken advantage of Section 408 of the Companies Act 2006 and has not included its own Income Statement in these financial statements. The parent company profit for the year after taxation includes a profit of £nil (2018: profit of £16 million) which is dealt with in the financial statements of the parent company.

Changes in presentation

Following a review of the financial statements of the Group in the current year, the Board has decided to change the presentation of the Income Statement through the inclusion of the operating profit line. Operating profit is one of the key performance measures that internal stakeholders review to understand the performance of the Group and as such its inclusion is deemed to supplement and enhance the information provided to external stakeholders. The prior period disclosures have been updated to ensure that there is consistency in the disclosures made.

The classification of transactions and balances included within the financial statements has been reviewed in the current period to enhance the understandability of the financial statements to its users. Where transactions and balances have been presented differently in the current period, the prior period comparative has been updated to ensure consistency with the current period classification.

New standards and interpretations not yet adopted

A number of IASB pronouncements have been issued but are not yet effective for this financial year. The standards considered most relevant to the Group are as follows;

IFRIC 23 – Uncertainty over Income Tax Treatments

IFRIC 23 is effective for annual reporting periods beginning on or after 1 January 2019 and the impact of adoption is deemed to be immaterial.

IFRS 16 – Leases

IFRS 16 'Leases' was issued in January 2016 and introduces a comprehensive model for the identification of lease arrangements and accounting treatments for both lessors and lessees and will supersede the current lease guidance including IAS 17 'Leases' and the related interpretations. The expected impact of adoption has been determined to be immaterial as the Group has no significant lease transactions.

1. ACCOUNTING POLICIES (continued)

IFRS 17 – Insurance Contracts
IFRS 17, 'Insurance Contracts' was issued in May 2017 and is effective for the Group for the annual period commencing 1 November 2022. The standard will be applied retrospectively, subject to the transitional options provided for in the standard and provides a comprehensive approach for accounting for insurance contracts including their valuation, Income Statement presentation and disclosure. The Group has mobilised a project team to assess the financial and operational implications of the standard and work will continue throughout 2020 to ensure technical compliance and to develop the required system capability to implement the standard.

Changes in Accounting Policy

Adoption of new and revised standards and interpretations

On 1 January 2018, a number of new and revised standards issued by the International Accounting Standards Board, and endorsed for use in the EU, came into effect. New and revised standards adopted in the period that are deemed significant to the Group are outlined opposite:

IFRS 9 – Financial Instruments

On 1 November 2018, the Group adopted the requirements of IFRS 9 as issued in July 2014 and the amendments to IFRS 9 'Prepayment Features with Negative Compensation'. The new standard replaces IAS 39 'Financial Instruments: Recognition and Measurement'. To reflect the difference between IFRS 9 and IAS 39, consequential amendments were also made to other standards including IFRS 7 'Financial Instruments: Disclosures' and IAS 1 'Presentation of Financial Statements'. The Group adopted these consequential amendments, along with IFRS 9, on 1 November 2018.

IFRS 9 introduces new requirements for the classification, measurement and impairment of financial assets and liabilities. The key changes to the Group's accounting policies are as follows:

Classification of financial assets
Under IFRS 9 there are three principal classification categories for financial assets being measured at either:

- Amortised cost,
- Fair value through other comprehensive income (FVOCI), and
- Fair value through profit or loss (FVTPL).

Impairment of financial assets

IFRS 9 replaces the incurred loss model implemented under IAS 39 with an expected credit loss (ECL) model which results in earlier recognition of credit losses. The new model applies to all financial assets not held at FVTPL, together with financial guarantee contracts and loan commitments.

Transition

The Group has adjusted the opening balance of retained earnings to reflect the application of the new requirements of IFRS 9. In accordance with the transition requirements, comparative information is not restated. As such, the comparative information for the year ended 31 October 2018 is reported under the requirements of IAS 39 and is not comparable to the information presented for the period ended 31 October 2019. The accounting policies under IAS 39 can be found within the financial statements for the year ended 31 October 2018.

IFRS 15 Revenue from Contracts with Customers

On 1 November 2018, the Group adopted the requirements of IFRS 15. The new standard replaces IAS 18 Revenue, IAS 11 Construction Contracts and related interpretations.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

Changes in accounting policies

IFRS 15 establishes the principles to apply when reporting information about the nature, amount, timing and uncertainty of revenue and cash flows from a contract with a customer. The standard introduces a five-step revenue recognition model to be applied to all contracts with customers to determine whether, how much, and when revenue is recognised.

IFRS 15 does not apply to financial instruments or lease contracts, which fall under other IFRSs. Interest receivable, the main source of revenue for the Group, falls outside the scope of IFRS 15.

Transition

The Group assessed its non-interest revenue streams that fall under the scope of IFRS 15 and determined that the impact on the amount or timing of revenue to be recognised as a result of the adoption of IFRS 15 is immaterial. As such, there is no adjustment to the opening balance of retained earnings or related tax balances.

Summary of Significant Accounting Policies

Measurement convention

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

Basis of consolidation

The Group consolidates the assets, liabilities and results of the Company and all its subsidiary companies.

Subsidiaries are all entities controlled by the Company. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the subsidiary and has the ability to affect those returns, through its power over the entity and voting rights.

The financial statements of subsidiaries are included in the consolidated financial statements from the date on which control commences until the date when control ceases.

The Company's investment in its subsidiaries is recognised on the Balance Sheet at cost. Intra-group transactions and balances and unrealised gains on transactions between intra-group companies are eliminated in the consolidated accounts.

Interest receivable and interest payable

Under IFRS 9, interest income and expense are recognised in the Income Statement for all instruments measured at amortised cost using the effective interest rate method. The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset to the gross carrying amount of a financial asset.

The Group estimates future cash flows considering all contractual terms of the financial instrument. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial instrument. The net incremental transactional income/cost is amortised over the period to the contractual maturity date for commercial loans and to the end of the fixed term for residential and buy-to-let mortgages, no adjustment is made for prepayments.

The gross carrying amount of a financial asset is the amortised cost of a financial asset before adjusting for any loss allowance. For credit-impaired financial assets, a credit-adjusted effective interest rate is calculated using estimated future cash flows including loss allowance.

If an asset subsequently cures, the amount by which the provision has increased due to suspended interest is not recognised as interest income but as a reversal of the credit loss allowance.

Revenue Recognition

Investment income – Consists of realised gains on financial assets and liabilities held at FVTPL.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

Realised gains and losses on financial assets and liabilities held at fair value represent the difference between the proceeds received, net of transaction costs and the original cost.

Fees and commissions – Income primarily relate to fees for originating mortgages on behalf of third-parties. Fee income is recognised when performance obligations attached to the fee or commission have been satisfied.

Premium income – Premiums received in respect of pension annuity insurance contracts are recognised as revenue when they become payable by the policyholder when the policy commences and are shown before deduction of commission. All premium revenue is in respect of single premium insurance business.

Insurance contracts – The Group's insurance products consist entirely of annuity products. Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly over time.

Deferred acquisition costs

As the Group's products are single premium contracts, acquisition expenses are expensed to the Income Statement as incurred.

Financial Instruments

Recognition

Financial assets and liabilities are recognised when the Group becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of financial assets are recognised on trade date.

Financial assets

Under IFRS 9, there are three principal classification categories for financial assets: measured at amortised cost, FVOCI and FVTPL.

The Group has determined that under IFRS its financial assets are classified as follows:

- **Amortised cost –** Residential, buy-to-let and commercial loans, loans and advances to credit institutions, non-index-linked treasury bills, debt securities and other assets.
- **FVTPL –** Lifetime mortgages including retirement mortgages and equity release mortgages, index-linked treasury bills and debt securities recognised at fair value to prevent an accounting mismatch.

The Group does not hold any financial instruments that are classified and measured at FVOCI.

To classify financial assets the Group performs two assessments to evaluate the business model in which financial assets are managed and their cash flow characteristics.

The 'business model assessment' is performed at a portfolio level and determines whether the Group's objective is to generate cash flows from collecting contractual cash flows, or by both collecting contractual cash flows and selling financial assets.

The assessment of cash flow characteristics determines whether the contractual cash flows of the financial asset are solely payments of principal and interest on the principal amount outstanding (SPPI). The SPPI test is performed at an instrument level based on the contractual terms of the instrument at initial recognition. For the purposes of the SPPI test, principal is defined as the fair value of the financial asset at initial recognition. Interest is defined as consideration for the time value of money and credit risk associated with the principal amount outstanding and for other basic lending risks and costs (e.g. liquidity risk and administrative costs), as well as a reasonable profit margin.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

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

- It is held within a business model whose objective is to hold assets to collect contractual cash flows; and
- Its contractual terms give rise on specified dates to cash flows that are SPPI.

Financial assets not classified as measured at amortised cost or FVOCI are classified as FVTPL.

On initial recognition, the Group may irrevocably designate a financial asset as FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

Subsequent to initial recognition, financial assets are reclassified only when the Group changes its business model for managing financial assets. Where this is the case, the Group reclassifies all affected financial assets in accordance with the new business model. The reclassification is applied prospectively.

Initial measurement of financial assets is as follows:

- Financial assets at FVTPL: initially measured at fair value.
- All other financial assets: initially measured at fair value plus incremental direct transaction costs.

Subsequent measurement of financial asset categories held by the Group is as follows:

- Financial assets at FVTPL: subsequently measured at fair value with gains and losses recognised in the Income Statement.
- Financial assets at amortised cost: subsequently measured at amortised cost using the effective interest rate method.

Financial liabilities

Under IFRS 9, there are two principal classification categories for financial liabilities: measured at amortised cost and FVTPL.

The Group has determined that under IFRS its financial liabilities are classified as follows:

- FVTPL – Derivatives
- Amortised cost – Other liabilities

Initial measurement of financial liabilities is as follows:

- Financial liabilities at FVTPL: initially measured at fair value
- Amortised cost: initially measured at fair value less incremental direct transaction costs.

Subsequent measurement of financial liability categories held by the Group is as follows:

- Financial liabilities at FVTPL: subsequently measured at fair value with gains and losses recognised in the Income Statement.
- Financial liabilities at amortised cost: subsequently measured at amortised cost using the effective interest rate method.

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 Group 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 Group has transferred substantially all the risks and rewards of the asset; or
- The Group has neither transferred nor retained substantially all the risks and rewards of the asset but has transferred control of the asset.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

Where an existing financial asset is replaced by another to the same customer 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 asset and the recognition of an asset.

(ii) Financial liabilities
Financial liabilities are de-recognised when the obligation is discharged, cancelled or has expired.

Fair value of financial instruments

On initial recognition, the best evidence of the fair value of a financial instrument is normally transaction price (i.e. the fair value of the consideration given or received). If the Group determines that the fair value on initial recognition differs from the transaction price, the Group accounts for such differences as follows:

- If fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets, then the difference is recognised in the Income Statement on initial recognition (i.e. day 1 profit or loss);
- In all other cases, the fair value will be adjusted to bring it in line with the transaction price (i.e. day 1 profit or loss will be deferred by including it in the initial carrying amount of the asset or liability). Subsequently, the deferred gain or loss will be released to the Income Statement on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

The Group uses a fair value hierarchy that categorises financial instruments into three different levels as detailed in note 31. Levels are reviewed at each reporting date and this determines whether transfers between levels are required.

Equity release and retirement mortgages

Loans and advances to customer held at fair value include retirement and equity release mortgages and are classified as FVTPL due to the existence of an embedded derivative in the form of a NNEG which forms part of the terms and conditions applicable to these products.

On initial recognition, the fair value of these lifetime 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 against the lifetime mortgage balance and recognised uniformly over the expected life of the loan into the Income Statement. Any changes to assumptions used in the calculation of this deferred reserve will result in a recalculation which is then spread over the expected total life of the loan from inception. If the difference between the fair value and the transaction price is a loss either upon initial recognition or as a result of a recalculation, it is expensed to the Income Statement.

On subsequent measurement, the value of lifetime mortgages is calculated by projecting the cash flows expected to be generated by the portfolio on redemption, allowing for credit losses caused by the no-negative equity guarantee using a variant of the Black Scholes option pricing method. These cash flows are then discounted at the swap yield plus a margin to reflect the illiquidity of lifetime mortgage assets. An allowance for possible early redemption of the lifetime mortgages has been determined by reference to historic rates of lapse within the portfolio.

Embedded derivatives

The NNEG is an embedded derivative. The Group does not separate the NNEG embedded derivative from the host instrument. The fair value of lifetime mortgages takes into account an explicit provision in respect of the NNEG which is calculated using a variant of the Black Scholes option pricing model. Further details are disclosed in note 31(d).

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

Measurement of Expected Credit Loss (ECL)

Under IFRS 9, impairment of financial assets is calculated using a forward looking ECL model. The Group records an allowance for ECLs ('loss allowance') for all financial assets not held at FVTPL. There is no ECL required for loan commitments held at FVTPL.

Measurement of ECLs depends on the 'stage' of the financial asset, based on changes in credit risk occurring since initial recognition, as described below:

- Stage 1: when a financial asset is first recognised it is assigned to Stage 1 and a 12-month ECL is recognised. If there is no significant increase in credit risk from initial recognition the financial asset remains in Stage 1.
- Stage 2: if there is a significant increase (doubling of the probability of default plus 45bps) in credit risk from initial recognition of a financial asset it is moved to Stage 2 and a lifetime ECL is recognised.
- Stage 3: when there is objective evidence of impairment and the financial asset is considered to be in default, it is moved to Stage 3 and a lifetime ECL is recognised.

A 12-month ECL is defined as the portion of lifetime ECL that will result if a default occurs in the 12-months after the reporting date, weighted by the probability of that default occurring.

A lifetime ECL is defined as ECLs that result from all possible default events over the expected behavioural life of a financial instrument.

For loan commitments, where the loan commitment relates to the undrawn component of a facility, it is assigned to the same stage as the drawn component of the facility. For pipeline loans, the loan commitment is assigned to Stage 1.

If the contractual cash flows on a financial asset have been renegotiated or modified and the financial asset was not derecognised, an assessment is made to consider whether there has been a significant increase in the credit risk of the financial instrument.

The Group does not hold any purchased or originated credit-impaired assets or financial guarantee contracts.

Significant increase in credit risk

The Group applies a series of quantitative, qualitative and backstop criteria to determine if there has been a significant increase in credit risk:

- Quantitative criteria: this considers the increase in an account's 12-month PD at the reporting date compared to the 12-month PD when the account was originated.
- Qualitative criteria: this includes the observation of specific events such as short-term forbearance, payment cancellation, historical arrears or extension to customer terms.
- Backstop criteria: IFRS 9 includes a backstop that 30-days past due is an indicator of a significant increase in credit risk. The Group considers 30-days past due to be an appropriate backstop measure and does not rebut this presumption.

The Group undertakes a review of the forward-looking economic scenarios at least annually and more frequently if required.

Definition of default and credit-impaired assets

The Group's definition of default is fully aligned with the definition of credit-impaired. The Group applies both a qualitative and quantitative criterion to determine if an account meets the definition of default. These criteria include:

- When the borrower is more than 90-days past due; and
- Qualitative factors to comply with the internal rating systems risk grading approach adopted by the Group.

Inputs into the assessment of whether a financial instrument is in default and their significance may vary over time to reflect changes in circumstances.

Write offs

Loans and debt securities are written off (either partially or in full) when there is no realistic prospect of recovery.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

Presentation of loss allowances in the Balance Sheet

Loss allowances for financial assets measured at amortised cost are presented as a deduction from the gross carrying amount of the financial asset.

Hedge accounting

The Group has elected to continue to apply hedge accounting requirements of IAS 39. All derivatives entered into by the Group are for the purposes of providing an economic hedge. Where the criteria set out in IAS 39 are met, the Group uses hedge accounting and designates the hedging derivative as hedging fair value risks.

At inception of the hedge relationship, the Group 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.

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

Offsetting financial assets and financial liabilities

In accordance with IAS32 Financial Instruments; the Group reports derivative financial instruments on a net basis as there is a legally enforceable right to set-off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. A table is provided within note 25 which demonstrates the amounts which have been offset in the Balance Sheet.

Loans and advances to credit institutions and Treasury bills includes collateral pledged against the market value of derivative instruments. The collateral is subject to an enforceable master netting arrangement but does not qualify for netting under the requirements of IAS 32 as the Group has no intention to settle on a net basis.

Investment properties – Reversionary interests in properties

Reversionary interests in properties are included in the financial statements initially at cost and subsequently at fair value, with any change therein recognised in the Income Statement within other fair value gains and losses.

The current market value of the underlying property 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 derecognised 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 or losses on derecognition are recognised in the Income Statement in the year of disposal within investment income.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

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.

Intangible assets have finite lives and are assessed for indicators of impairment at each Balance Sheet date.

An intangible asset is impaired where there is objective evidence that, as a result of one or more events that occurred after initial recognition, the estimated recoverable value of the asset has been reduced. The recoverable amount of the intangible assets is deemed to be its value in use. If there is objective evidence of impairment, an impairment loss is recognised in the Income Statement.

Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation and any accumulated impairment losses

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

Taxation including deferred tax

Corporation tax on profits for the year comprises current and deferred taxation. Where group relief is received or surrendered from or to a group company, the corresponding liability or asset is settled in full.

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 recognised in the Income Statement.

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.

Long term business provision – liabilities under insurance contracts

The long-term business provision has been determined by the Board of Directors, on advice from the Chief Actuary. The estimation process used in determining the long-term business provision involves projecting annuity payments and the costs of maintaining the contracts.

Notes to the Financial Statements

For the year ended 31 October 2019

1. ACCOUNTING POLICIES (continued)

Employee benefits

i) Pensions

The Group operates a defined benefit pension scheme for members of staff. The Company's subsidiary undertakings Julian Hodge Bank Limited and the Hodge Life Assurance Company Limited 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 Group.

The Group'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 Group'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 Group has recognised a reimbursement asset in respect of its pension scheme deficit which relates to retired employees that were contracted to the Group's ultimate parent, The Carlyle Trust Limited (note 28). 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 Group'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.

iv) Pension reserve

The pension reserve consists of the net position of the defined benefit scheme liability, the reimbursement asset and the net deferred tax position relating to both of these items.

Notes to the Financial Statements

For the year ended 31 October 2019

2. IFRS 9 ADOPTION

The impacts of adopting IFRS 9 and transition disclosures are provided in the following sections.

Classification and measurement

Financial assets

Classification of financial assets under IFRS 9 is dependent on the outcome of two assessments which evaluate the business model in which financial assets are managed (the 'business model assessment') and their cash flow characteristics (the 'SPPI test').

The following table demonstrates the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Company's financial assets.

Financial asset	2018 £m	IAS 39 classification Business model	Business model	Cash flows meet SPPI test?	IFRS 9 C&M Basis
Cash and balances held at central banks	153.2	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Treasury bills	72.6	FVTPL	Recognised at FV to prevent accounting mismatch	N/A	FVTPL (1)
Treasury bills – non-index linked	27.0	Available for Sale (FVOCI) and Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Debt securities	87.5	Available for Sale (FVOCI) and Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Debt securities	60.9	FVTPL	Recognised at FV to prevent accounting mismatch	N/A	FVTPL (3)
Loans and advances to credit institutions	111.9	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Residential mortgages and commercial loans	452.5	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost
Retirement mortgages	103.8	Amortised Cost	Recognised at FV due to existence of NNEG	×	FVTPL (2)
Equity release mortgages	685.2	FVTPL	Recognised at FV due to existence of NNEG	×	FVTPL (2)
Amounts owed by parent and fellow subsidiaries	0.8	Amortised Cost	Held to collect contractual cash flows	✓	Amortised cost
Other assets	6.2	Amortised Cost	Held to collect contractual cash flows	✓	Amortised Cost

Notes to the Financial Statements

For the year ended 31 October 2019

2. IFRS 9 ADOPTION (continued)

1. These items are held at FVTPL to avoid an accounting mismatch with the derivatives they are held against in Hodge Bank and the provision for long-term liabilities in Hodge Life, which are also held at FVTPL.

2. The equity release and retirement mortgages are designated at fair value due to the existence of an embedded derivative – the 'no-negative equity guarantee' – which causes these assets to fail the SPPI assessment.

3. These items are held at FVTPL to avoid an accounting mismatch as the provision for long-term liabilities is also held at FVTPL.

The following table sets out the impact of adopting IFRS 9 on the statement of financial position carrying amounts and retained earnings as at 1 November 2018. Only balances impacted by the transition to IFRS 9 are included in the table; all other balances are unchanged.

	2018 Carrying amount £m	Remeasurement / Reclassification £m	Carrying Amount at 1 November 2018 £m
Assets			
Residential mortgages and commercial loans (1)	452.5	(2.2)	450.3
Retirement mortgage (2)	103.8	1.3	105.1
Treasury bills – non-index linked (3)	27.0	(0.2)	26.8
Debt securities (3)	87.5	(3.1)	84.4
Deferred tax asset (4)	2.2	0.8	3.0
Equity			
Retained earnings	256.1	(0.7)	255.4
Available for sale reserve	2.7	(2.7)	-

1. These remeasurements arise from the recognition of the expected credit loss provision.

2. These remeasurements arise from the reclassification of the retirement mortgage portfolio from amortised cost to FVTPL.

3. These remeasurements arise from the reclassification of the non-index linked treasury bills and debt securities from available-for-sale (FVOCI) to amortised cost.

4. The deferred tax adjustment is spread for tax purposes, on a straight-line basis over the following ten years with the first accounting period beginning on 1 November 2018. This is with the exception of financial instruments maturing in the first accounting period, which are taxed or relieved in full in that accounting period.

Notes to the Financial Statements

For the year ended 31 October 2019

2. IFRS 9 ADOPTION (continued)

Impairment of financial assets

The most significant impact from adopting IFRS 9 on the Group's financial statements results from the new impairment requirements as detailed in note 1 'Impairment of financial assets'.

On the adoption of IFRS 9 on 1 November 2018, the increase in the loss allowance (before tax) was £2.2 million.

The following table reconciles the closing impairment allowance for financial assets in accordance with IAS 39 as at 31 October 2018, to the opening loss allowance determined in accordance with IFRS 9 as at 1 November 2018:

	Impairment Allowance at 31 Oct 18 £m	IFRS 9 Transition Adjustment £m	Loss allowance at 1 Nov 2018 £m	Stage 1 £m	Stage 2 £m	Stage 3 £m
Residential mortgages	-	-	-	-	-	-
Commercial loans	3.7	2.2	5.9	2.0	0.3	3.6
Debt Securities	-	-	-	-	-	-
Total	3.7	2.2	5.9	2.0	0.3	3.6

An assessment was made on the implementation date and at 31 October 2019 on the Company's Expected Credit Loss (ECL) provision and it was determined to be £nil. There were also no changes in the classification and measurement of financial liabilities on the Company's Balance Sheet.

Regulatory Capital (unaudited)

The Bank's regulator has issued guidelines regarding transition requirements when adopting IFRS 9. The guidelines allow a choice of two approaches to recognise the impact of adopting IFRS 9 on regulatory capital:

- **Transitional:** This involves phasing in the full impact using transitional factors published in Regulation (EU) 2017 / 2395; or
- **Full adoption:** Recognising the full impact on the day of adoption.

The Bank has elected the transitional approach and will phase in the full impact using the EU regulatory transitional arrangements. This permits the Group to add back to their capital base a proportion of the impact that IFRS 9 has upon their loss allowances during the first five years of use. The proportion that the Group may add back starts at 95% in the current year and reduces to 25% by year five.

The impact in relation to loss allowances is the sum of the increase in loss allowances on day one of IFRS 9 adoption plus any subsequent increase in ECLs in the non-credit – impaired book thereafter. Any add-back must be tax-affected and accompanied by a recalculation of capital deduction thresholds, exposure and risk weighted assets.

Under the EU regulatory transitional arrangements, the add back is £2.2 million. This results in an increase in Common Equity Tier 1 capital and total regulatory capital of £2.2 million. The corresponding impact of the transitional adjustment to risk-weighted assets is an increase of £2.2 million.

Notes to the Financial Statements

For the year ended 31 October 2019

3. JUDGEMENT IN APPLYING ACCOUNTING POLICIES AND CRITICAL ACCOUNTING ESTIMATES

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

Judgements

Fair values of financial instruments

The Group 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 notes 25 and 31.

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.

Where observable market data is unavailable, unobservable inputs are used in the actuarial valuation models to value equity release and retirement mortgages. The key assumptions used, and the related sensitivities are outlined in note 31.

Estimates and assumptions

Value of reversionary investment properties

All gains and losses arising from reversionary interests in property are largely dependent on property prices and longevity of the tenant. The assumptions used are disclosed in note 20.

Pension scheme assumptions

Estimation uncertainty surrounds the measurement of the pension scheme liabilities. The assumptions used as part of the valuation include the rate of salary increase, the discount rate applied to scheme liabilities and inflation. The assumptions used are disclosed in note 28.

Measurement of insurance liabilities arising from annuity insurance contracts.

The estimation of the ultimate liability arising from insurance contracts is a key group accounting estimate. For insurance contracts, the liabilities are calculated using a projection of cash flows after making assumptions about matters such as mortality and expenses. Discount rates used to value the liabilities are set with reference to the risk adjusted yields on the underlying assets. The most critical non-economic assumptions are mortality rates in respect of annuity business written and levels of future expenses. Such assumptions are based on recent actual experience, supplemented by industry information where appropriate.

Impairment losses on loans and advances to customers

IFRS 9 has a single impairment model that applies to all financial instruments in its scope. Under this model, an entity must recognise either a 12-month or lifetime ECL. ECLs are the present value of all cash shortfalls over the expected life of the financial instrument. The key assumptions used, and the related sensitives, are outlined in note 32.

Notes to the Financial Statements

For the year ended 31 October 2019

3. JUDGEMENT IN APPLYING ACCOUNTING POLICIES AND CRITICAL ACCOUNTING ESTIMATES (continued)

Value of lifetime mortgages including the value of the no-negative equity guarantee

Estimation uncertainty surrounds the measurement of the fair value of lifetime mortgages and the liability arising from the no-negative equity guarantee. 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 31.

Change in accounting estimates

There is significant judgement in the methodologies and assumptions applied in estimating the fair value of both lifetime mortgages and the provision for long-term business. The methodologies and assumptions contain unobservable inputs resulting in the fair value being classified as a Level 3 estimate within the IFRS 13 fair value hierarchy. Changes have been made to the methodology used to calculate the expense assumption as a result of a project to rationalise expenses across the Group. The impact of these changes is disclosed within notes 26 and 31 respectively and have been accounted for prospectively as a change in accounting estimate.

Notes to the Financial Statements

For the year ended 31 October 2019

4. SEGMENTAL INFORMATION

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

The Group operates within the banking and annuity life assurance services sector wholly within the United Kingdom.

As at 31 October 2019	Commercial	Residential	Buy-to-let	Hodge Life	Other	Reclass and consolidation adjustments	Total
Interest receivable and similar income	19.7	22.4	0.1	-	6.1	21.6	69.9
Interest payable and similar charges	(8.0)	(19.5)	(0.1)	-	(0.5)	(0.1)	(28.2)
Fees and commissions receivable	-	-	-	-	0.7	(0.1)	0.6
Fees and commissions payable	-	(0.1)	-	-	-	(0.8)	(0.9)
Earned premiums	-	-	-	41.6	-	-	41.6
Impact of new insurance contracts	-	-	-	(42.4)	-	-	(42.4)
Investment income	-	7.5	-	12.3	(0.3)	(2.6)	16.9
Gross claims and benefits paid	-	-	-	(26.9)	-	-	(26.9)
Impact of gross claims and benefits paid	-	-	-	26.9	-	-	26.9
Administrative expenses	(4.6)	(8.0)	(0.2)	(7.4)	(3.6)	1.0	(22.8)
Depreciation and amortisation	(0.2)	(0.2)	-	-	(0.8)	(0.1)	(1.3)
Impairment losses on loans and advances to customers	(3.5)	(0.1)	(0.3)	-	-	-	(3.9)
OPERATING PROFIT	**3.4**	**2.0**	**(0.5)**	**4.1**	**1.6**	**18.9**	**29.5**

The £18.9m (2018: £18.9m) profit presented in the 'Reclass and consolidation adjustments' segment mainly relates to interest receivable on equity release mortgages and is reclassified from other fair value gains which is presented below operating profit.

Total assets by business segments	2019 £m	2018 £m
Commercial	315.2	348.3
Residential	524.4	578.2
Buy-to-let	20.9	-
Hodge Life	663.6	590.8
Other	506.0	430.9
	2,030.1	**1,948.2**

Notes to the Financial Statements

For the year ended 31 October 2019

4. SEGMENTAL INFORMATION (continued)

As at 31 October 2018	Commercial	Residential	Buy-to-let	Hodge Life	Other	Reclass and consolidation adjustments	Total
Interest receivable and similar income	19.3	21.0	-	-	5.7	20.6	66.6
Interest payable and similar charges	(9.0)	(18.5)	-	-	(0.2)	(0.1)	(27.8)
Fees and commissions receivable	-	-	-	-	2.5	(0.1)	2.4
Fees and commissions payable	-	-	-	-	(1.1)	(0.7)	(1.8)
Earned premiums	-	-	-	47.5	-	-	47.5
Impact of new insurance contracts	-	-	-	(48.8)	-	-	(48.8)
Investment income	-	6.3	-	10.6	0.1	(1.6)	15.4
Gross claims and benefits paid	-	-	-	(24.5)	-	-	(24.5)
Impact of gross claims and benefits paid	-	-	-	24.5	-	-	24.5
Other operating income	-	-	-	-	0.1	-	0.1
Administrative expenses	(3.5)	(5.5)	-	(6.7)	(3.0)	0.8	(17.9)
Depreciation and amortisation	(0.2)	-	-	-	(0.7)	-	(0.9)
Impairment gains on loans and advances to customers	1.0	-	-	-	-	-	1.0
OPERATING PROFIT	**7.6**	**3.3**	**-**	**2.6**	**3.4**	**18.9**	**35.8**

5. INTEREST RECEIVABLE AND SIMILAR INCOME

	2019 £m	2018 £m
Loans and advances to customers	62.6	60.6
Loans and advances to credit institutions	2.3	1.7
Interest and other income on treasury bills and debt securities	5.0	4.3
	69.9	**66.6**

Notes to the Financial Statements

For the year ended 31 October 2019

6. INTEREST PAYABLE AND SIMILAR CHARGES

	2019 £m	2018 £m
On customer accounts	16.0	13.9
On defined benefit pension scheme	0.4	0.4
On term funding scheme	0.5	0.3
On derivative financial instruments	11.3	13.2
	28.2	**27.8**

7. EARNED PREMIUMS

Earned premiums, all of which relate to direct insurance contracts, are individual, single premiums from annuity business.

All premiums are derived from contracts concluded in the United Kingdom. Commissions payable in respect of direct insurance amounted to £0.7m (2018: £0.6m).

	2019 £m	2018 £m
Earned premiums	41.6	47.5
	41.6	**47.5**

8. OTHER FAIR VALUE GAINS/(LOSSES)

	2019 £m	2018 £m
(Losses)/gains on derivatives designated as fair value (note 25)	(28.4)	15.0
Movement in fair value of equity release and retirement mortgages	54.4	(32.3)
Reversal of unrealised gains on disposal of investment properties	(14.9)	(14.5)
Movement in fair value of investment properties (note 20)	12.2	5.3
Movement in fair value of debt securities and treasury bills (notes 13 & 14)	1.3	(1.3)
Movement in fair value of hedged items attributable to hedged risk	0.3	0.1
	24.9	**(27.7)**

Fair value losses on available-for-sale investments of £nil (2018: £(1.8m)) have been taken to the Statement of Other Comprehensive Income.

Notes to the Financial Statements

For the year ended 31 October 2019

9. ADMINISTRATIVE EXPENSES

	2019 £m	2018 £m
Staff costs		
Wages and salaries	9.1	6.8
Social security	1.1	0.8
Pension costs	2.2	1.6
	12.4	**9.2**
Other administrative expenses	10.4	8.7
	22.8	**17.9**

Directors and employees

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

	2019 £m	2018 £m
Provision of finance and banking	169	147
Provision of life assurance services	41	32
	210	**179**

Staff costs include remuneration in respect of directors as follows:

	2019 £m	2018 £m
Fees	0.3	0.3
Aggregate emoluments as executives	0.7	0.5
	1.0	**0.8**

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

	2019 £m	2018 £m
Aggregate emoluments	0.3	0.2
	0.3	**0.2**

The pension accrued for the highest paid director was £31,669 (2018: £nil). Retirement benefits are accruing to one director in 2019 (2018: one) and there was one director in the defined benefit scheme.

Notes to the Financial Statements

For the year ended 31 October 2019

10. PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION

	2019 £m £000	2018 £m £000
Profit on ordinary activities before taxation is stated after charging:		
Remuneration of the auditor and its associates		
Audit of these financial statements	17	17
Audit of financial statements of subsidiaries	202	118
Audit of pension scheme	11	10
Other assurance fees	-	85
Non audit fees	85	100
Depreciation	491	377
Amortisation	801	453
Impairment provision expense/(credit)	3,861	(1,007)

11. TAX ON PROFIT

	2019 £m	2018 £m
Analysis of charge in year		
UK corporation tax		
Current tax on income for the year	0.9	2.2
Prior period adjustment	(0.8)	(0.4)
Total current tax	**0.1**	**1.8**
Deferred tax (note 21)		
Original reversal/timing difference	(0.7)	(0.8)
Current year	0.8	0.9
Prior period adjustment	0.4	0.2
Other	-	(0.2)
Total deferred tax	**0.5**	**0.1**
TAX ON PROFIT ON ORDINARY ACTIVITIES	**0.6**	**1.9**

Notes to the Financial Statements

For the year ended 31 October 2019

11. TAX ON PROFIT (continued)

The total tax charge for the year is lower (2018: lower) than the blended rate of corporation tax in the UK. The differences are explained below.

	2019 £m	2018 £m
Total tax reconciliation		
Profit on ordinary activities before tax	6.6	12.3
Current tax at 19.00% (2018: 19.00%)	**1.3**	**2.3**
Investment properties	-	(0.1)
Index linked gilt RPI movement	(0.2)	(0.3)
Other	(0.1)	0.2
Adjustments in respect of previous years	(0.4)	(0.2)
TOTAL TAX CHARGE (SEE ABOVE)	**0.6**	**1.9**

A reduction in the UK corporation tax rate to 17% (effective 1 April 2020) was substantively enacted on 6 September 2016. This will reduce the Group's future tax charge accordingly. The deferred tax asset at 31 October 2019 has been calculated based on these rates.

12. CASH AND BALANCES HELD AT CENTRAL BANKS

	2019 £m	2018 £m
Repayable on demand:		
Deposits with central banks	321.9	153.2
	321.9	**153.2**

13. TREASURY BILLS

	2019 £m	2018 £m
Treasury bills – at amortised cost	21.9	11.2
Treasury bills – available-for-sale	-	13.2
Treasury bills – fair value through profit and loss	30.4	72.6
Fair value adjustment – hedge accounting	3.2	2.4
Fair value adjustment – available-for-sale	-	0.2
	55.5	**99.6**

Notes to the Financial Statements

For the year ended 31 October 2019

13. TREASURY BILLS (continued)

The movement in treasury bills is summarised as follows:

	2019 £m	2018 £m
At start of period	99.6	97.3
Adjustment on transition to IFRS 9	(0.2)	-
Additions	92.4	45.5
Disposals due to maturity	(83.0)	(41.7)
Disposals due to restructuring exercise	(53.4)	-
Gains/(losses) from hedge accounting – Income Statement	0.8	(0.4)
Losses from changes in fair value – Income Statement	(0.7)	(0.9)
Losses from changes in fair value – OCI	-	(0.2)
AT 31 OCTOBER	**55.5**	**99.6**

Of this amount £nil (2018: £29.5m) has been provided as collateral for derivative financial instruments (note 25). Collateral that has been pledged is not restricted.

Of this amount £10.7m (2018: £26.7m) has been pledged as collateral under the Term Funding Scheme ('TFS'). Collateral that has been pledged is restricted.

During the year, the Group performed a one-off restructuring exercise which resulted in the disposal of a portfolio of treasury bills held at FVTPL. The disposal was carried out at fair value and therefore the profit on disposal was £nil.

14. DEBT SECURITIES

	2019 £m	2018 £m
Debt securities – at amortised cost	56.4	6.9
Debt securities – available-for-sale	-	76.9
Debt securities – fair value through profit and loss	77.8	60.9
Fair value adjustment – hedge accounting	0.6	0.7
Fair value adjustment – available-for-sale	-	3.0
	134.8	**148.4**

Notes to the Financial Statements

For the year ended 31 October 2019

14. DEBT SECURITIES (continued)

	2019 £m	2018 £m
At 1 November	148.4	131.2
Adjustment on transition to IFRS 9	(3.1)	-
Additions	34.5	55.4
Disposals due to maturity	(18.8)	(36.0)
Disposals due to restructuring exercise	(28.1)	-
Losses from hedge accounting – Income Statement	(0.1)	(0.2)
Gain/(loss) from changes in fair value – Income Statement	2.0	(0.4)
Losses from changes in fair value – OCI	-	(1.6)
AT 31 OCTOBER	134.8	148.4

Of this amount £37.7m (2018: £nil) has been pledged as collateral under the TFS. Collateral that has been pledged is restricted.

During the year, the Group disposed of a portfolio of debt securities held at amortised cost. The profit generated on disposal was £3.1m.

The Group holds debt securities for liquidity purposes and intends to hold the portfolio to maturity. A decision was made to dispose of a portfolio of debt securities and to reinvest the proceeds in high quality liquid assets. This is viewed as a one-off restructuring exercise and therefore the business model assessment for the remaining assets remains unchanged.

15. LOANS AND ADVANCES TO CREDIT INSTITUTIONS

	2019 £m	2018 £m
Repayable on demand	7.8	28.3
Collateral held by swap counterparties	79.5	83.6
	87.3	111.9

The collateral is pledged against the market value of derivative instruments and comprises interest-bearing cash deposits (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 (2018: £nil).

Notes to the Financial Statements

For the year ended 31 October 2019

16. LOANS AND ADVANCES TO CUSTOMERS

	2019 £m	2018 £m
Loans and advances – classified at amortised cost		
Commercial	315.2	348.3
Residential	178.8	104.2
Retirement	-	103.8
Buy-to-let	20.8	-
	514.8	**556.3**
Amounts owed from parent	3.3	0.8
Fair value adjustment for hedged risk	0.5	-
Loans and advances (equity release and retirement mortgages) – classified as FVTPL (note 31)	724.0	685.2
	1,242.6	**1,242.3**

Of this amount £57.9m (2018: £64.7m) has been pledged as collateral under TFS. Collateral that has been pledged is restricted.

During the year, there was a restructuring exercise which resulted in the disposal of a portfolio of equity release mortgages to a third party. The consideration on the sale was £117.4m and the carrying value on the Balance Sheet was £122.0m, resulting in a loss on disposal of £4.6m.

The amounts owed from parent is a loan which accrues a market rate of interest.

	2019 £m	2018 £m
Loans and advances to customers held at amortised cost		
Gross balances	526.3	562.3
Less: Provision for impairment[1] (note 17)	(9.8)	(3.7)
Less: Loan fee deferral	(1.7)	(2.3)
NET BALANCE	**514.8**	**556.3**

[1] The impairment provision has been calculated in accordance with IFRS 9 in 2019 with the comparative being calculated in accordance with IAS 39.

Notes to the Financial Statements

For the year ended 31 October 2019

17. IMPAIRMENT PROVISIONS ON LOANS AND ADVANCES TO CUSTOMERS

IFRS 9	Stage 1 £m	Stage 2 £m	Stage 3 £m	Total £m
2019				
At 1 November 2018	-	0.1	3.6	3.7
Impact of adopting IFRS 9	2.0	0.2	-	2.2
Restated balance at 1 November 2018	**2.0**	**0.3**	**3.6**	**5.9**
Utilised on redemption	-	-	-	-
Income Statement				
Amounts written back during the year	-	(0.2)	(0.6)	(0.8)
Charge for loan impairment	0.4	-	4.3	4.7
	0.4	**(0.2)**	**3.7**	**3.9**
AT 31 OCTOBER 2019	**2.4**	**0.1**	**7.3**	**9.8**

IAS 39	Specific £m	Collective £m	Total £m
2018			
At 1 November 2017	6.2	0.2	6.4
Utilised on redemption	(1.7)	-	(1.7)
Income Statement			
Amounts written back during the year	(1.3)	(0.1)	(1.4)
Charge for loan impairment	0.4	-	0.4
	(0.9)	**(0.1)**	**(1.0)**
AT 31 OCTOBER 2018	**3.6**	**0.1**	**3.7**

The impact of modifications to contractual cash flows that has not resulted in derecognition is immaterial in 2019.

Methodology and assumptions used to calculate the IFRS 9 ECL provision is disclosed in note 32.

Notes to the Financial Statements

For the year ended 31 October 2019

18. INTANGIBLE ASSETS

	Computer software 2019 £m	2018 £m
Cost:		
At start of period	3.9	2.0
Disposals	-	(0.1)
Additions	3.5	2.0
At 31 October 2019	**7.4**	**3.9**
Amortisation:		
At start of period	(0.8)	(0.3)
Amortisation	(0.8)	(0.5)
At 31 October 2019	**(1.6)**	**(0.8)**
Net book value:		
AT 31 OCTOBER 2019	**5.8**	**3.1**

£1.3m (2018: £0.1m) of expenditure relating to intangible projects was expensed during the year as it did not meet the development criteria of IAS 38 and has therefore been expensed as incurred.

Notes to the Financial Statements

For the year ended 31 October 2019

19. PROPERTY, PLANT AND EQUIPMENT

	Short leasehold improvements £m	Fixtures, fittings and equipment £m	Total £m
Cost:			
At 1 November 2018	2.1	0.8	2.9
Additions	-	0.2	0.2
Disposals	-	(0.1)	(0.1)
At 31 October 2019	**2.1**	**0.9**	**3.0**
Depreciation:			
At 1 November 2018	(0.4)	(0.3)	(0.7)
Depreciation	(0.2)	(0.3)	(0.5)
Disposals	-	0.1	0.1
At 31 October 2019	**(0.6)**	**(0.5)**	**(1.1)**
Net book value:			
AT 31 OCTOBER 2019	**1.5**	**0.4**	**1.9**
At 1 November 2018	1.7	0.5	2.2

20. INVESTMENT PROPERTIES

Group	2019 £m	2018 £m
At 1 November 2018	179.1	205.2
Disposals	(21.2)	(31.4)
Fair value adjustments	12.2	5.3
AT 31 OCTOBER 2019	**170.1**	**179.1**

The historical cost of the reversionary interests in properties is £72.0m at 31 October 2019 (2018: £78.2m).

The amounts recognised in the Income Statement in respect of investment properties were as follows:

	2019 £m	2018 £m
Rental income from investment properties	-	0.1
	-	**0.1**

Notes to the Financial Statements

For the year ended 31 October 2019

20. INVESTMENT PROPERTIES (continued)

Reversionary interests are categorised as Level 3 assets 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. The 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 the PCMA00/PCFA00 mortality tables and include an allowance for future mortality improvements.

Expenses

Assumptions for future policy expense levels are based on the Group's recent expense analyses. Expenses are modelled as an amount per policy per annum that incorporates an annual inflation rate allowance of 4.01% (2018: 4.23%).

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 2019) was 1.78% (31 October 2018: 2.62%).

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 Group has estimated the net decrease in profit before tax for the period arising from changes to these inputs as follows:

	Delay in mortality or entry into long term care by 10% £m	Expenses +10% £m	Property prices -10% £m
At 31 October 2019	(1.4)	(0.2)	(15.6)
At 31 October 2018	(2.1)	(0.2)	(15.9)

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.

Notes to the Financial Statements

For the year ended 31 October 2019

21. DEFERRED TAX

	2019 £m	2018 £m
At 1 November	2.2	2.2
IFRS 9 implementation adjustment	0.8	-
Adjusted Opening Balance	**3.0**	**2.2**
Charge to the Income Statement	(0.5)	(0.2)
Credit to the Statement of Other Comprehensive Income	0.5	0.2
AT 31 OCTOBER	**3.0**	**2.2**

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

	2019 £m	2018 £m
Accelerated capital allowances	(0.2)	0.1
Other timing differences	1.0	0.9
Timing differences on available-for-sale reserve	-	(0.5)
Timing differences on reimbursement asset	(0.5)	(0.4)
Defined benefit pension scheme	2.7	2.1
AT 31 OCTOBER	**3.0**	**2.2**

The provision held against the deferred tax asset is £nil (2018: £nil).

22. OTHER ASSETS

Group	2019 £m	2018 £m
Prepayments and accrued income	2.0	1.8
Pension reimbursement asset	2.9	2.4
Corporation tax debtor	0.4	1.3
Group relief	1.1	-
Other assets	0.8	0.7
AT 31 OCTOBER	**7.2**	**6.2**

Notes to the Financial Statements

For the year ended 31 October 2019

23. DEPOSITS FROM BANKS

	2019 £m	2018 £m
Repurchase agreement	2.5	2.5
Term funding scheme	70.0	70.0
	72.5	**72.5**

24. DEPOSITS FROM CUSTOMERS

	2019 £m	2018 £m
Deposits from customers	1,036.3	991.6
Amounts owed to parent and fellow subsidiaries	4.6	2.7
Fair value adjustment for hedged risk	0.7	(0.2)
	1,041.6	**994.1**

The amounts owed to parent and fellow subsidiaries are deposit accounts which accrue a market rate of interest.

25. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

Interest rate swaps are used by the Group 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	
	2019 £m	2018 £m	2019 £m	2018 £m
Cost: Derivative liabilities held for hedging purposes and designated fair value hedges:				
Interest rate swaps	310.7	383.1	78.8	105.2
RPI index linked interest rate swaps	55.0	55.0	(1.8)	(1.1)
Derivatives held in fair value hedges	293.7	234.8	3.4	3.5
TOTAL RECOGNISED DERIVATIVE LIABILITIES	**659.4**	**672.9**	**80.4**	**107.6**

Notes to the Financial Statements

For the year ended 31 October 2019

25. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (continued)

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

Type of Hedge	Risk	Activity
Interest rate swap	Sensitivity to changes in interest rates	Fixed rate savings products, fixed rate residential mortgages, fixed rate debt securities, fixed rate treasury bills 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 2019, the fixed interest rates vary from 0.4% to 5.4% (2018: 0.9% 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.

	2019 £m	2018 £m
Movement in fair value of interest rate swaps	(28.0)	15.0
Breakage costs	(0.4)	-
	(28.4)	15.0

The Group agreed to exit a number of interest rate swaps during the year which were held at fair value of £52.6m (2018: 6.8m).
£0.4m breakage costs were incurred on disposal.

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

	2019		2018	
	Book Value £m	Hedged Fair Value £m	Book Value £m	Hedged Fair Value £m
Treasury bills	21.9	3.2	24.4	2.4
Debt securities	56.4	0.6	83.8	0.7
Loans advances to customers	514.9	0.4	556.3	-
Deposits from customers	(1,036.1)	(0.8)	(991.6)	0.2
		3.4		3.3

At the 31 October 2019, there was a hedge ineffectiveness of £0.1m (2018: £0.2m).

Notes to the Financial Statements

For the year ended 31 October 2019

25. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING (continued)

Offsetting

In accordance with IAS32 Financial Instruments; the Group reports derivative financial instruments on a net basis as there is a legally enforceable right to set-off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. A table is provided below which demonstrates the amounts which have been offset in the Balance Sheet:

	Amounts subject to netting arrangements		
	Gross amounts £m	Amounts offset £m	Net amounts reported on Balance Sheet £m
2019			
Derivative financial assets	2.5	(2.5)	-
Impact on total assets	**2.5**	**(2.5)**	**-**
Derivative financial (liabilities)	(82.9)	2.5	(80.4)
Impact on total (liabilities)	**(82.9)**	**2.5**	**(80.4)**
2018			
Derivative financial assets	1.6	(1.6)	-
Impact on total assets	**1.6**	**(1.6)**	**-**
Derivative financial (liabilities)	(109.2)	1.6	(107.6)
Impact on total (liabilities)	**(109.2)**	**1.6**	**(107.6)**

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 Financial Statements

For the year ended 31 October 2019

26. PROVISIONS FOR LONG TERM BUSINESS – LIABILITIES ARISING FROM INSURANCE CONTRACTS

	2019 £m	2018 £m
At 1 November	437.0	416.9
Gross claims and benefits paid	(26.9)	(24.5)
Impact of new insurance contracts	42.4	48.8
Fair value movement on existing liabilities		
Expense cash flows and discount unwind	9.4	7.9
Mortality experience	(1.2)	(1.1)
Interest rate loss/(gain)	46.9	(5.4)
Movement in illiquidity premium	6.4	(0.4)
Change in expense inflation	(1.3)	0.3
Impact of methodology and assumption changes		
Expense policy assumption change	(7.6)	-
CMI mortality assumption change	(6.4)	(5.5)
AT 31 OCTOBER	**498.7**	**437.0**

The long-term business provision for insurance contracts has been calculated using estimation techniques for each contract, by use of a prospective calculation on the basis set out below.

a) Rates of interest

Principal assumptions:

The interest rates used to discount liabilities comprise three parts: a risk-free yield curve, an allowance for illiquidity based on the yield on the assets backing the liabilities less an appropriate deduction for risk.

As at 31 October 2019 and 2018 the risk-free yield curve is the GBP curve published by EIOPA.

The average discount rate for each product assumed to be the 15-year point on the yield curve based on the average duration of the portfolio at 31 October 2019 and 2018.

Rates of interest	2019 %	2018 %
Pension business annuities	2.2	3.2
Reversionary scheme and renewable reversionary scheme	1.6	2.5
Purchased life annuities	1.6	2.5
Mortgage scheme annuities	1.0	1.8

Notes to the Financial Statements

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26. PROVISIONS FOR LONG TERM BUSINESS – LIABILITIES ARISING FROM INSURANCE CONTRACTS (continued)

b) Mortality tables

The mortality table used to calculate the technical provisions for annuity liabilities is the PCMA/PCFA00 table. This table is adjusted from 2000 by calendar year for mortality improvements based on the CMI 2018 mortality projection model. The mortality tables are further adjusted to reflect recent mortality experience by multiplying the mortality rates by a percentage factor which varies by the duration in force of the contract.

c) Provision for expenses

An explicit provision for expenses based on an amount per policy per annum has been determined from recent experience analysis. This provision increases with an annual inflation rate of 4.01% (2018: 4.23%). At 31 October 2018, a £1.3m provision for expense overruns was held in addition to the basic provision for per-policy expenses. This has been released during the current year as these costs are now covered within the basic provision.

d) Sensitivity analysis

Changes to inputs used in the valuation could give rise to significant changes in the value of the provisions. The Group has estimated the net increase/(decrease) in profit before tax for the period to changes to these inputs as follows:

	Increase in mortality by 10% £m	Expenses +10% £m	Interest rates +100bps £m
At 31 October 2019	(14.4)	(2.9)	54.3
At 31 October 2018	(11.3)	(3.0)	45.6

The interest rate sensitivity of insurance contracts should be considered in conjunction with the offsetting interest rate sensitivity of financial instruments.

27. OTHER LIABILITIES

	2019 £m	2018 £m
Due within one year:		
Other taxation and social security	0.2	0.4
Amounts owed in relation to insurance contracts	0.5	3.4
Amounts owed in relation to mortgages administered for third parties	0.9	0.6
Other creditors	0.4	0.4
Accruals	1.9	3.2
	3.9	8.0

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For the year ended 31 October 2019

28. PENSION SCHEME

The 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 the Trustees and are held in a fund that is separate and independent of other Group 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 Group 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 scheme liabilities. This would detrimentally impact the Balance Sheet and may give rise to increased charges in future periods. The Group 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 2019 is 23 years (2018: 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 2019. These have been based upon the results of the 1 April 2019 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 2022.

The Group's total expense for the year amounted to £3.0m (2018: £2.0m). The Group has agreed that it will aim to eliminate the pension scheme deficit over the next 10 years and additional contributions of £1.0m (2018: £0.5m) were paid into the scheme in the year ended 31 October 2019. Funding levels are monitored on an annual basis and the Group has agreed to maintain the contribution rate at 23.3% from 1 April 2019.

The IAS 19 valuation as at 31 October 2019 has been produced by a qualified independent actuary and is based on the results of the valuation as at 1 April 2019.

GMP equalisation

On 26 October 2018, in a long-awaited ruling, the High Court determined that defined benefit pension schemes will be required to equalise benefits for the effect of inequalities between males and females in respect of Guaranteed Minimum Pensions (GMP) accrued after 17 May 1990. The Group has made an additional provision of £0.7m to cover the cost of equalising the scheme.

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:

Notes to the Financial Statements

For the year ended 31 October 2019

28. PENSION SCHEME (continued)

	2019 £m	2018 £m
Fair value of plan assets	27.3	24.2
Present value of defined benefit obligations	(43.9)	(37.0)
DEFICIT	**(16.6)**	**(12.8)**

Movements in present value of defined benefit obligation

	2019 £m	2018 £m
Present value of scheme liabilities at start of the period	37.0	37.2
Interest cost	1.1	1.0
Current service cost	1.8	1.6
Member contributions	0.3	0.2
Actuarial loss on defined benefit obligation of which:		
due to experience	(1.9)	-
due to demographic assumptions	0.4	(0.4)
due to financial assumptions	5.4	(1.6)
Benefits paid	(0.9)	(1.0)
Past service cost	0.7	-
PRESENT VALUE OF SCHEME LIABILITIES AT END OF THE PERIOD	**43.9**	**37.0**

Movements in fair value of plan assets

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

	2019 £m	2018 £m
Market value of assets at the beginning of the year	24.2	24.2
Interest income	0.7	0.6
Actuarial gain/(loss)	0.6	(1.4)
Member contributions	0.3	0.2
Employer contributions	2.4	1.6
Benefits paid	(0.9)	(1.0)
MARKET VALUE OF ASSETS AT THE END OF THE YEAR	**27.3**	**24.2**

Notes to the Financial Statements

For the year ended 31 October 2019

28. PENSION SCHEME (continued)

Expense recognised in the Income Statement

	2019 £m	2018 £m
Current service cost – staff costs	1.8	1.6
Net interest expense – other finance costs	0.4	0.4
Past service cost	0.7	-
Other admin costs	0.1	-
	3.0	2.0

The total amount recognised in the Statement of Other Comprehensive Income in respect of actuarial gains and losses is a loss of 3.3m (2018: gain of £0.6m) before tax.

Cumulative actuarial losses reported in the Statement of Other Comprehensive Income are losses of £11.4m (2018: losses of £8.1m) before tax.

Plan assets

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

	Fair Value	
	2019 £m	2018 £m
Quoted equity investments	4.4	1.2
Diversified growth funds	17.8	19.0
Private investments	2.5	2.3
Bonds	1.6	1.4
Cash	1.0	0.3
TOTAL MARKET VALUE OF ASSETS	27.3	24.2

The actual return on assets was £1.3m (2018: £0.7m)

Future contributions

The Group expects to contribute approximately £3.9m (2018: £2.0m) to its defined benefit scheme in the next financial year.

Notes to the Financial Statements

For the year ended 31 October 2019

28. PENSION SCHEME (continued)

Major assumptions

The major assumptions underpinning the defined benefit obligation are:

	2019 %	2018 %
Rate of increase in salaries	4.0	4.4
Pension increases – RPI capped at 5.0% per annum	2.9	3.3
Rate of CARE revaluation	2.0	2.4
Discount rate applied to scheme liabilities	2.0	2.9
RPI inflation assumption	3.0	3.4

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:

	2019	2018
Current pensioners age 65 – male	86.6	86.7
Current pensioners age 65 – female	88.9	88.6
Future pensioners age 65 (current age 45) – males	87.6	87.8
Future pensioners age 65 (current age 45) – females	90.0	89.9

Sensitivities

The Group 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%	1.0
Rate of Inflation (RPI or CPI)	0.1%	0.9
Life expectancy	1 year	1.4

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 from one another.

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28. PENSION SCHEME (continued)

History of plan Balance Sheets

	2019 £m	2018 £m	2017 £m	2016 £m	2015 £m
Fair value of plan assets	27.3	24.2	24.2	25.7	24.7
Present value of funded defined benefit obligations	(43.9)	(37.0)	(37.2)	(39.2)	(29.1)
DEFICIT	**(16.6)**	**(12.8)**	**(13.0)**	**(13.5)**	**(4.4)**

History of experience gains and losses

	2019	2018	2017	2016	2015
Difference between the expected and actual return on scheme assets:					
Present value of funded defined benefit obligations	**£0.6m**	£(1.4)m	£0.1m	£0.5m	£0.2m
Percentage of year-end scheme assets	**2.2%**	5.6%	-	1.5%	0.7%
Experience gains and losses on scheme liabilities:					
Amount	**£1.9m**	-	-	£(0.4)m	-
Percentage of year end present value of scheme liabilities	**(4.4)%**	-	-	1.0%	-
Total amount recognised in Statement of Comprehensive Income:					
Losses before tax	**£(3.3)m**	£0.6m	£0.4m	£(9.1)m	£(0.6)m
Percentage of year end present value of scheme liabilities	**7.5%**	1.6%	1.1%	23.0%	2.0%

Notes to the Financial Statements

For the year ended 31 October 2019

29. CALLED UP SHARE CAPITAL

	2019 £m	2018 £m
Authorised, allotted, called-up and fully paid:		
66,045,191 (2018: 66,045,191) ordinary shares of £1 each	66.0	66.0
	66.0	**66.0**

30. FINANCIAL COMMITMENTS AND CONTINGENT ASSETS/LIABILITIES

	2019 £m	2018 £m
Loan commitments		
expiring in less than one year	26.0	33.4
expiring in more than one year	47.3	66.7
	73.3	**100.1**

Capital commitments

The Group had contracted capital commitments amounting to £nil at 31 October 2019 (2018: £nil).

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For the year ended 31 October 2019

31. 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 2019	At amortised cost £m	Fair value through profit and loss £m	Total £m
Assets			
Cash and balances held at central banks	321.9	-	321.9
Treasury bills	25.1	30.4	55.5
Debt securities	57.0	77.8	134.8
Loans and advances to credit institutions	87.3	-	87.3
Loans and advances to customers	518.6	724.0	1,242.6
Other assets	7.2	-	7.2
Total financial assets	**1,017.1**	**832.2**	**1,849.3**
Total non-financial assets			180.8
Total assets			**2,030.1**
Liabilities			
Deposit from banks	72.5	-	72.5
Deposit from customers	1,041.6	-	1,041.6
Derivative financial instruments	-	80.4	80.4
Other liabilities	3.9	-	3.9
Total financial liabilities	**1,118.0**	**80.4**	**1,198.4**
Total non-financial liabilities			515.3
Share capital and other reserves			316.4
TOTAL EQUITY AND LIABILITIES			**2,030.1**

Notes to the Financial Statements

For the year ended 31 October 2019

31. FINANCIAL INSTRUMENTS (continued)

a) Categories of financial assets and liabilities (continued)

As at 31 October 2018	At amortised cost £m	Loans and receivables £m	Available-for-sale £m	Fair value through profit and loss £m	Total £m
Assets					
Cash and balances held at central banks	153.2	-	-	-	153.2
Treasury bills	13.7	-	13.3	72.6	99.6
Debt securities	7.6	-	79.9	60.9	148.4
Loans and advances to credit institutions	111.9	-	-	-	111.9
Loans and advances to customers	0.8	556.3	-	685.2	1,242.3
Other assets	6.2	-	-	-	6.2
Total financial assets	**293.4**	**556.3**	**93.2**	**818.7**	**1,761.6**
Total non-financial assets					186.6
Total assets					**1,948.2**
Liabilities					
Deposit from banks	72.5	-	-	-	72.5
Deposit from customers	994.1	-	-	-	994.1
Derivative financial instruments	-	-	-	107.6	107.6
Other liabilities	8.0	-	-	-	8.0
Total financial liabilities	**1,074.6**	**-**	**-**	**107.6**	**1,182.2**
Total non-financial liabilities					449.9
Share capital and other reserves					316.1
TOTAL EQUITY AND LIABILITIES					**1,948.2**

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 Group has access at that date.

The table on page 130 summarises the fair value of the Group'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.

Notes to the Financial Statements

For the year ended 31 October 2019

31. FINANCIAL INSTRUMENTS (continued)

b) Fair value estimation (continued)

Where applicable, the Group 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 Group determines fair value using other valuation techniques.

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

As at 31 October 2019	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through profit or loss				
Treasury bills	30.4	-	-	30.4
Debt securities	77.8	-	-	77.8
Loans and advances to customers	-	-	724.0	724.0
TOTAL FINANCIAL ASSETS AT FVTPL	**108.2**	**-**	**724.0**	**832.2**
Financial liabilities at fair value through profit or loss				
Derivative financial instruments	-	80.4	-	80.4
TOTAL FINANCIAL LIABILITIES AT FVTPL	**-**	**80.4**	**-**	**80.4**

As at 31 October 2018	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through profit or loss				
Treasury bills	72.6	-	-	72.6
Debt securities	60.9	-	-	60.9
Loans and advances to customers	-	-	685.2	685.2
TOTAL FINANCIAL ASSETS AT FVTPL	**133.5**	**-**	**685.2**	**818.7**
Financial liabilities at fair value through profit or loss				
Derivative financial instruments	-	107.6	-	107.6
TOTAL FINANCIAL LIABILITIES AT FVTPL	**-**	**107.6**	**-**	**107.6**

Notes to the Financial Statements

For the year ended 31 October 2019

31. FINANCIAL INSTRUMENTS (continued)

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 FVTPL.

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.

d) Level 3 assets and liabilities measured at fair value

Loans and advances to customers – equity release and retirement mortgages:
Loans and advances to customers include £724.0m (2018: £685.2m) of assets which have been classed as FVTPL as they relate to equity release and retirement mortgages.

	Fair Value		Book Value	
	2019 £m	2018 £m	2019 £m	2018 £m
Loans and advances (equity release and retirement mortgages) – classified as FVTPL	724.0	685.2	548.9	544.3
	724.0	685.2	548.9	544.3

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.

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For the year ended 31 October 2019

31. FINANCIAL INSTRUMENTS (continued)

d) Level 3 assets and liabilities measured at fair value (continued)

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.

	2019 £m	2018 £m
At start of period	79.8	74.7
Addition on transition to IFRS 9 – retirement mortgages	18.8	-
Disposal of equity release portfolio	(8.8)	-
Amounts deferred in the period	8.9	10.4
Amounts recognised in the Income Statement in the period	(14.3)	(5.3)
AT END OF PERIOD	**84.4**	**79.8**

Reconciliation of the opening and closing recorded amount of Level 3 equity release and retirement mortgages:

	2019 £m	2018 £m
At start of period	685.2	692.5
Addition on transition to IFRS 9 – retirement mortgages	105.2	-
Disposal of equity release portfolio to a third party	(122.0)	-
Total gains in the Income Statement arising on fair value movements	81.6	0.3
Loans advanced	33.2	39.7
Redemptions	(59.2)	(47.3)
AT END OF PERIOD	**724.0**	**685.2**

The £81.6m increase in fair value is predominantly driven by the fall in benchmark interest rates over the year. The 15-year point on the EIOPA yield curve used for discounting the future mortgage cash flows has fallen by 84bps from 1.62% to 0.78%. This is partially offset by smaller relative reductions in past and assumed future HPI.

Equity release and retirement mortgages – principal assumptions

Principal assumptions underlying the calculation of equity release and retirement 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

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For the year ended 31 October 2019

31. FINANCIAL INSTRUMENTS (continued)

d) Level 3 assets and liabilities measured at fair value (continued)

or the last remaining customer for a joint contract. Mortality assumptions have been derived by reference to PCMA00/PCFA00. This table is adjusted from 2000 by calendar year for mortality improvements based on the CMI 2018 mortality projection model. The mortality tables are further adjusted to reflect recent mortality experience by multiplying the mortality rates by a percentage factor.

Lapses

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

Expenses

Assumptions for future policy expense levels are based on the Group's recent expense analyses. Expenses are modelled as an amount per policy per annum that incorporates an annual inflation rate allowance of 4.0% (2018: 4.2%).

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 2019) was 1.8% (2018: 2.6%).

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 the subsequent movement in the Nationwide Monthly House Price Index with an annual underperformance assumption. The future property price is based on the Future House Price Index with an annual underperformance assumption.

The property growth and volatility assumed at 31 October 2019 were 3.08% (2018: 3.28%) and 13.0% (2018: 13.0%) respectively.
The value of the no-negative equity guarantee as at 31 October 2019 was £20.7m (2018: £20.4m).

Sensitivity analysis

Changes to unobservable inputs used in the valuation technique could give rise to significant changes in the fair value of the assets. The Group has estimated the net decrease in profit before tax for the period arising from changes to these inputs as follows:

	Interest rates +100 BP £m	Maintenance expenses +10% £m	Property inflation -100bps £m	Property prices -10% £m	Lapses +10% £m	Increase in mortality by 10% £m
At 31 October 2019	**(79.1)**	**(0.6)**	**(11.7)**	**(6.3)**	**(16.7)**	**(7.2)**
At 31 October 2018	(81.6)	(1.2)	(11.5)	(6.2)	(14.2)	(7.2)

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.

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31. 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 Group uses past performance of each asset and liability class along with management judgement to forecast likely cash flow requirements.

As at 31 October 2019	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
Assets						
Cash and balances held at central banks	321.9	-	-	-	-	321.9
Treasury bills	15.0	-	5.0	16.7	18.8	55.5
Debt securities	3.5	6.0	7.0	71.5	46.8	134.8
Loans and advances to credit institutions	87.3	-	-	-	-	87.3
Loans and advances to customers	69.8	32.6	39.0	292.4	808.8	1,242.6
Other assets	7.2	-	-	-	-	7.2
TOTAL FINANCIAL ASSETS	**504.7**	**38.6**	**51.0**	**380.6**	**874.4**	**1,849.3**
Liabilities						
Deposit from banks	2.5	-	-	70.0	-	72.5
Deposit from customers	168.8	182.4	292.6	394.4	3.4	1,041.6
Derivative financial instruments	0.2	(1.7)	0.5	10.2	71.2	80.4
Other liabilities	3.9	-	-	-	-	3.9
TOTAL FINANCIAL LIABILITIES	**175.4**	**180.7**	**293.1**	**474.6**	**74.6**	**1,198.4**
LOAN COMMITMENTS LIABILITIES	**4.8**	**0.9**	**2.4**	**59.3**	**5.9**	**73.3**

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31. FINANCIAL INSTRUMENTS (continued)

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

As at 31 October 2018	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
Assets						
Cash and balances held at central banks	153.2	-	-	-	-	153.2
Treasury bills	13.5	5.0	2.6	68.5	10.0	99.6
Debt securities	6.8	4.3	10.8	71.2	55.3	148.4
Loans and advances to credit institutions	111.9	-	-	-	-	111.9
Loans and advances to customers	51.3	12.9	46.3	289.7	842.1	1,242.3
Other assets	6.2	-	-	-	-	6.2
TOTAL FINANCIAL ASSETS	**342.9**	**22.2**	**59.7**	**429.4**	**907.4**	**1,761.6**
Liabilities						
Deposit from banks	2.5	-	-	70.0	-	72.5
Deposit from customers	299.1	80.2	284.4	330.4	-	994.1
Derivative financial instruments	-	-	0.3	9.1	98.2	107.6
Other liabilities	8.0	-	-	-	-	8.0
TOTAL FINANCIAL LIABILITIES	**309.6**	**80.2**	**284.7**	**409.5**	**98.2**	**1,182.2**
LOAN COMMITMENTS LIABILITIES	**23.4**	**1.4**	**8.6**	**50.1**	**16.6**	**100.1**

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31. FINANCIAL INSTRUMENTS (continued)

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

The table below analyses the Group'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.

	Book value £m	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
As at 31 October 2019							
Financial liabilities							
Deposit from banks	72.5	2.5	-	-	71.2	-	73.7
Deposit from customers	1,041.6	169.0	183.1	296.3	411.4	3.7	1,063.5
Derivative financial instruments	80.4	2.5	0.3	4.8	46.3	128.4	182.3
Other liabilities	3.9	3.9	-	-	-	-	3.9
TOTAL FINANCIAL LIABILITIES	**1,198.4**	**177.9**	**183.4**	**301.1**	**528.9**	**132.1**	**1,323.4**
As at 31 October 2018							
Financial liabilities							
Deposit from banks	72.5	2.5	-	-	71.7	-	74.2
Deposit from customers	994.1	299.2	80.8	288.2	342.5	-	1,010.7
Derivative financial instruments	107.6	2.4	0.8	4.1	41.7	75.7	124.7
Other liabilities	8.0	8.0	-	-	-	-	8.0
TOTAL FINANCIAL LIABILITIES	**1,182.2**	**312.1**	**81.6**	**292.3**	**455.9**	**75.7**	**1,217.6**

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 settled net.

g) Foreign currencies

The Group holds no financial assets or liabilities denominated in foreign currencies.

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For the year ended 31 October 2019

32. 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 Group's Executive Risk Committee which reports to the Risk and Conduct Committee, which ensures adherence to the Group's risk management policy and framework.

Risk management objectives

Risk is inherent in all aspects of the Group's business. Within the Group, a risk management framework is in place to ensure that all material risks faced by the Group 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 Group is exposed to credit risk, liquidity risk, house price risk, interest rate risk, conduct risk, operational risk and insurance 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 Group.

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

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

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

The primary driver of credit risk within equity release and retirement 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 the 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 Group 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 Group takes security in the form of a legal charge over the property against which loans are advanced. The Group's low risk approach to new business lending is reflected in the loan to value profile of the commercial property and residential property books.

The Group manages 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, buy-to-let portfolio credit risk and credit risk in relation to treasury financial instruments is described in the relevant sections on pages 138-139.

Expected Credit Loss Provisioning

Expected credit losses are the discounted product of the Probability of Default (PD), Exposure at Default (EAD), and Loss Given Default (LGD), defined as follows:

- PD is the likelihood of a borrower defaulting on its financial obligation either in the next 12 months or over the remaining lifetime of the obligation.

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

The calculation of PD is specific to each portfolio as set out below:

Portfolio	Methodology for determining the PD
Residential mortgages	Calculated at an individual account level using the customer's credit score which is linked to historical default rates.
Commercial loans and portfolio buy-to-let	Calculated by making an assessment at an individual account level using a scorecard approach to determine the credit rating of the individual exposure which is linked to historical default rates of comparable entities. A credit cycle overlay model of a credit rating agency is used to calculate the forward-looking PD. The economic assumptions used within this model are obtained from multiple external sources.
Debt securities and treasury bills	Calculated at an individual security level using the external credit agency rating of the security which is linked to the historical default rates of comparable securities.

Key Economic Scenario Assumptions

The key economic assumptions used in the model to determine the forward-looking PD are as follows:

Economic Assumption	Year 1 %	Year 2 %	Year 3 %	Year 4 %	Year 5 %
UK GDP Growth	1.2	1.7	1.8	1.8	1.8
UK Unemployment Rate	4.0	3.0	4.1	4.3	4.2
% Change in S&P 500 Index[1]	12.0				
% Change in Energy Index	(3.1)	1.8	1.9	1.9	2.0
% Change in Non-Energy Index	0.1	1.6	1.7	1.7	1.8
% Change in Proportion of Downgrades[1]	0.1				

[1] These are the historical annual changes rather and therefore these are only input for Y1 and then updated annually.

• EAD is based on the amounts the Group expects to be owed at the time of default.

There are no significant judgements in determining the exposure at default.

• LGD represents the Group's expectation of the extent of loss on defaulted exposures.

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

The calculation of LGD is specific to each loan portfolio as set out below:

Portfolio	Methodology for determining the PD
Residential mortgages	Calculated by using the Black Scholes model to reflect that the portfolio is secured against the underlying property as this will calculate the theoretical value of the total loss, should all policies default.
Commercial loans and portfolio buy-to-let	Calculated by using an external credit rating agency's ECL model which provides an unbiased estimate of the LGD by blending different probabilities of the economic states occurring (positive, neutral and negative).
Debt securities and treasury bills	Calculated monthly on an individual security level using a credit rating agency's published average nominal recovery rate.

The LGD model produces an estimate of the point-in-time LGD reflecting the current and expected position in the current credit cycle. The model is designed to produce LGD estimates under three distinct scenarios, reflecting expectations of general economic conditions.

The three distinct scenarios used to reflect the expectations of the wider economy that feed into the LGD model are:

Scenario	Methodology for determining the LGD	Weighting
Positive	The Group has positive economic expectations over the short-term for the UK economy. This is predicated on expectations of positive GDP growth and low and sustained unemployment (amongst other positive indicators), above that which is usually experienced in the average part of the credit cycle.	25.0%
Neutral	This selection is appropriate in cases where the expectations are of little or no GDP growth. Stagnating growth in other relevant factors are also expected. This phase is typically between a trough and peak of a credit cycle.	50.0%
Negative	This selection signals the expectation of an impending economic downturn, typically signalled by the expectation of consecutive quarter-on-quarter declines in GDP. Other signals may also be useful in forecasting a downturn period.	25.0%

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

The UK government has agreed a flexible extension with the EU in relation to Brexit until the 31 January 2020. The Prime Minister has negotiated a deal with the EU to prevent a disorderly exit and this deal has been approved by Parliament, but the process of turning the deal into legislation has been put on hold until after the general election. The economic forecasts outline that the UK is entering a period of low GDP growth and sustained low unemployment.

It is the view of the Group that a higher weighting should be applied to the Neutral scenario which is appropriate in cases where the expectations are of little or no GDP growth. It remains uncertain whether the outcome of Brexit will result in either an orderly or disorderly Brexit and as such it is the view of the Group that equal weightings should be applied to both the Positive and Negative economic scenarios.

A sensitivity analysis has been performed to review the worst-case scenario and the impact on the LGD. A 100% weighting for a Negative scenario produces an ECL provision for Stage 1 and Stage 2 of £4.9m.

Loans and advances to residential customers

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

2019	£m	%
Fully secured by a first charge on residential property	738.3	100.0
	738.3	**100.0**
Fair value adjustments	164.5	
	902.8	**100.0**

2018	£m	%
Fully secured by a first charge on residential property	751.3	100.0
	751.3	**100.0**
Fair value adjustments	142.0	
	893.3	**100.0**

The cumulative change in fair values due to credit risk amounts to losses of £7.2m (2018: £20.4m), and the change in the year is a profit of £2.0m (2018: £8.1m).

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 along with credit scores. All residential loans and receivables have an LTV of less than 70% when advanced.

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

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

Residential: performance

The gross exposure on loans and advances to residential customers held at amortised cost and its exposure to credit risk in line with the internal modelling of the Group for the period ending 31 October 2019 is disclosed below:

Stage	Description	Credit Score	Gross Loan Balance £m	ECL provision £m
Stage 1	Satisfactory	>= 676	176.6	-
Stage 2	Watchlist	< = 675	1.9	(0.1)
Stage 3	Default	N/A[1]	-	-
			178.5	
Less: Loan fee deferral			0.4	
Provisions for impairment			(0.1)	
TOTAL			**178.8**	

[1] Any loan that is 90-days past due is classified as being in default and is categorised in Stage 3.

Performance risk is measured by those accounts in arrears. Total arrears balance as at 31 October 2019 amounted to £nil (2018: £nil). The Group has no accounts where forbearance options have been utilised. There are no residential loans and receivables that are classified as Stage 3.

The gross exposure on loans and advances to residential customers held at amortised cost and its exposure to credit risk in line with the internal modelling of the Group for the period ending 31 October 2018 is disclosed below:

Stage	Description	Credit Score	Gross Loan Balance £m	ECL provision £m
Stage 1	Satisfactory	>= 676	104.1	-
Stage 2	Watchlist	< = 675	-	-
Stage 3	Default	N/A[1]	-	-
			104.1	
Less: Loan fee deferral			0.1	
Provisions for impairment			-	
TOTAL			**104.2**	

[1] Any loan that is 90-days past due is classified as being in default and is categorised in Stage 3.

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For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

Credit risk: Commercial lending

Commercial: analysis of risk concentration

Loans secured on commercial property are as follows:

	2019		2018	
	Loan Balance £m	Collateral Held £m	Loan Balance £m	Collateral Held £m
Commercial mortgage	23.3	38.3	35.7	73.8
Development finance	67.5	97.5	62.7	94.4
Investment loans	216.5	376.5	235.2	411.7
Renewable energy	19.4	-	20.7	-
	326.7	**512.3**	**354.3**	**579.9**
Less: Loan fee deferral	(2.0)	-	(2.3)	-
Provisions for impairment	(9.5)	-	(3.7)	-
	315.2	**512.3**	**348.3**	**579.9**

On inception, commercial property loans are fully secured against the value of the related properties. The increase in the provision for impairment is predominantly caused by an increase in Stage 3 provisioning relating to one development finance loan of £4.3m.

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

	2019		2018	
	£m	%	£m	%
Wales	70.6	21.6	81.3	23.0
London – England	123.5	37.8	123.8	34.8
South East & East of England	25.0	7.6	16.2	4.6
Midlands – England	21.2	6.5	31.0	8.8
South West of England	49.5	15.2	68.6	19.4
North West & North East of England	24.2	7.4	19.9	5.6
Scotland	12.7	3.9	13.5	3.8
	326.7	**100.0**	**354.3**	**100.0**

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

The average loan to value (LTV) in respect of commercial loans is estimated to be 56.1% (2018: 54.2%). 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.

£22.9m (2018: £13.2m) of exposures have an LTV of greater than 100%. Of these, £22.6m (2018: £12.8m) are already classified as impaired, leaving £0.3m (2018: £0.4m) of exposures considered to be satisfactory. In these instances, management is satisfied that the cash flows generated by the underlying assets will be sufficient to fully repay the debt over time.

The largest exposure to one counterparty is £17.9m (2018: £18.5m) or 5.5% (2018: 5.2%) 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):

	2019		2018	
	£m	%	£m	%
Stage 1	286.7	87.7	310.3	87.6
Stage 2 – significant increase in credit risk	14.3	4.4	17.1	4.8
Stage 3 – default	25.7	7.9	26.9	7.6
	326.7	100.0	354.3	100.0

As at 31 October 2019 there were £16.8m of commercial loans in arrears (2018: £16.9m).

Past due but not impaired

As at 31 October 2019 there were £nil (2018: £16.9m) of commercial loans that were past due but not impaired.

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

Exposure by credit rating

The gross exposure on commercial financial assets and its exposure to credit risk in line with internal risk grades and the corresponding external credit rating agency's credit risk rating at 31 October 2019 is disclosed below:

Risk grade	Description	Stage	S&P Rating	Gross Loan Balance £m	ECL provision £m
1	Negligible risk	Stage 1	A+	1.4	-
2.1	Minimal risk	Stage 1 or 2	B+	17.9	-
2.2	Low risk	Stage 1 or 2	B	10.9	-
3.1	Fair risk	Stage 1 or 2	B-	65.6	0.2
3.2	Moderate risk	Stage 1 or 2	BB+	174.9	1.4
4.1	Watch	Stage 1 or 2	BB	22.2	0.4
4.2	Enhanced watch	Stage 1 or 2	BB-	8.1	0.1
5	Substandard	Stage 2	BBB	-	-
6	Default	Stage 3	CCC+	22.2	4.9
7	Loss	Stage 3	CCC-	3.5	2.5
TOTAL				**326.7**	**9.5**

The gross exposure on commercial financial assets and its exposure to credit risk in line with internal risk grades and the corresponding external credit rating agency's credit risk rating at 31 October 2018 is disclosed below:

Risk grade	Description	Stage	S&P Rating	Gross Loan Balance £m	ECL provision £m
1	Negligible risk	Stage 1	A+	2.2	-
2.1	Minimal risk	Stage 1 or 2	B+	0.4	-
2.2	Low risk	Stage 1 or 2	B	24.2	-
3.1	Fair risk	Stage 1 or 2	B-	111.3	-
3.2	Moderate risk	Stage 1 or 2	BB+	130.8	-
4.1	Watch	Stage 1 or 2	BB	35	-
4.2	Enhanced watch	Stage 1 or 2	BB-	6.4	-
5	Substandard	Stage 2	BBB	17.1	0.2
6	Default	Stage 3	CCC+	23.4	1.1
7	Loss	Stage 3	CCC-	3.5	2.4
TOTAL				**354.3**	**3.7**

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

Forbearance

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

Credit risk: portfolio buy-to-let lending

The buy-to-let portfolio product was launched in June 2019 and as such, there is no prior year comparative.

Buy-to-let: analysis of Risk concentration

Loans secured on buy-to-let property are as follows:

	2019		2018	
	Loan Balance £m	Collateral Held £m	Loan Balance £m	Collateral Held £m
Portfolio buy-to-let lending	21.3	30.8	-	-
	21.3	**30.8**	**-**	**-**

On inception buy-to-let property loans are fully secured against the value of the related properties.

The Group's buy-to-let loan portfolio comprises the following:

	2019		2018	
	£m	%	£m	%
Loans secured on buy-to-let property	21.3	100.0	-	-
	21.3	**100.0**	**-**	**-**
Less: Loan fee deferral	(0.1)		-	
Provisions for impairment	(0.3)		-	
	20.9		**-**	

The Group provides loans secured on property across England, Scotland and Wales. An analysis of buy-to-let property loans by geographical location is provided below:

	2019		2018	
	£m	%	£m	%
London-England	19.7	92.5	-	-
South East & East of England	0.8	3.6	-	-
Midlands-England	0.8	3.9	-	-
	21.3	**100.0**	**-**	**-**

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

The average loan to value (LTV) in respect of buy-to-let loans is estimated to be 68.5%. 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. No exposures have an LTV of greater than 100%.

The largest exposure to one counterparty is £11.4m or 53.5% of gross balances.

Buy-to-let: 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 buy-to-let loan portfolio is classified as follows (figures do not include provisions for loan impairment or unamortised loan fees):

	2019		2018	
	£m	%	£m	%
Stage 1	21.3	100.0	-	-
Stage 2 – significant increase in credit risk	-	-	-	-
Stage 3 – default	-	-	-	-
	21.3	100.0	-	-

As at 31 October 2019 there were no buy-to-let loans in arrears.

Buy-to-let: lending provisions

Provisions are held against impaired loans as follows:

	2019 £m	2018 £m
Specific provisions	(0.3)	-
	(0.3)	-

Past due but not impaired

As at 31 October 2019 there were no buy-to-let loans that were past due but not impaired.

Exposure by credit rating

The gross exposure on buy-to-let financial assets and its exposure to credit risk in line with credit rating agencies credit risk ratings is disclosed below:

Risk grade	Description	Stage	S&P Rating	Gross Loan Balance £m	ECL provision £m
3.2	Moderate risk	Stage 1 or 2	BB+	21.3	(0.3)
TOTAL				21.3	(0.3)

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

Credit risk: treasury assets

Treasury risk comprises of 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:

	2019 £m	2018 £m
UK government and amounts held with central banks	321.9	153.2
Treasury bills	55.5	99.6
Debt securities	134.8	148.4
Loans and advances to credit institutions	87.3	111.9
	599.5	**513.1**
Provision for impairment	-	-
	599.5	**513.1**

None of these exposures are past due or impaired.

The following shows the exposures broken down by rating:

	2019 £m	2018 £m
AAA to AA-	559.7	458.7
A+ to A-	27.2	29.9
BBB+ to BBB-	12.6	20.9
BB+ to BB-	-	3.6
	599.5	**513.1**

Concentration of credit risk

The geographical exposure is as follows:

	2019 £m	2018 £m
UK	548.0	469.2
Other	51.5	43.9
	599.5	**513.1**

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

Notes to the Financial Statements

For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

b) Liquidity risk

Liquidity risk is the risk that the Group will encounter difficulty in realising assets or otherwise raising funds to meet commitments as they fall due. The Group 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 31 (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 Group 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.

The maturity analysis of financial assets and liabilities is disclosed in note 31(e) to the financial statements. For insurance contract liabilities, maturity profiles are determined based on estimated timing of net cash outflows from the recognised insurance liabilities.

Insurance contract liabilities	Not more than three months £m	More than three months but not more than six months £m	More than six months but not more than one year £m	More than one year but not more than five years £m	More than five years £m	Total £m
As at 31 October 2019	**7.0**	**7.0**	**13.8**	**102.7**	**368.2**	**498.7**
As at 31 October 2018	6.8	6.7	13.3	96.4	313.8	437.0

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For the year ended 31 October 2019

32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

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 Group manages its interest rate risk through its Assets and Liabilities Committee. The Group's policy is to maintain interest rate risk at a controlled level within limits set by the Board.

The table in note 31(d) shows an estimate of the interest rate sensitivity gap as at 31 October 2019. 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 Group are interest rate swap contracts of varying maturities and start dates.

The Group's interest rate risk management policy defines the type of derivative transactions that can be undertaken, which are all actioned by the Group'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.

d) 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 Group. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications or can lead to financial loss. The Group cannot expect to eliminate all operational risks but by initiating a rigorous control framework and by monitoring and responding to potential risks, the Group 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.

e) 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 Group's equity release and retirement mortgages and reversionary interests, such that the ultimate realisation of the property would not yield the expected return to the Group and could, in certain circumstances, result in a capital loss. The Group mitigates house price risk by monitoring maximum loan to value at inception of the loan and reversionary interests. The reversionary interests are a legacy product which is being run-off over the medium term.

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32. FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)

Geographical analysis of loans secured on equity release and retirement mortgages

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

	2019		2018	
	£m	%	£m	%
Wales	19.3	3.5	18.6	3.4
South East	144.3	26.4	149.9	27.5
South West	62.8	11.5	68.6	12.6
London	69.6	12.7	71.6	13.2
East Anglia	59.8	10.9	62.8	11.5
North West	45.7	8.3	43.6	8.0
West Midlands	31.1	5.7	30.5	5.6
North East	23.8	4.3	19.8	3.6
Yorkshire & Humberside	20.5	3.7	17.7	3.3
East Midlands	17.3	3.1	19.4	3.6
Scotland	37.0	6.7	24.1	4.4
Northern Ireland & Other	17.7	3.2	17.7	3.3
	548.9	100.0	544.3	100.0

f) Conduct risk

Conduct risk is the risk that the Group's behaviour results in poor outcomes for customers. The Group 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 Group holds a provision of £nil as at 31 October 2019 (2018: £0.1m).

g) Insurance risk

Life insurance risk includes the possibility of loss due to uncertainty of rates of death. The principal risk the Group faces under insurance contracts is that the actual claims and benefits payments exceed the amounts expected at the time of determining the insurance liabilities.

The Group principally writes the following type of life insurance contract:

- Annuity products where typically the policyholder is entitled to payments which cease upon death.

The nature of the Group's business involves the acceptance of insurance risks which primarily relate to longevity.

For annuity contracts, the most significant factor is continued improvement in medical science and social conditions that would increase longevity.

The risk exposure is mitigated by diversification across a large portfolio of insurance contracts and geographical areas. The Group does not use reinsurance contracts to mitigate insurance risk.

Notes to the Financial Statements

For the year ended 31 October 2019

33. ULTIMATE PARENT UNDERTAKING

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.

34. SHARES IN GROUP UNDERTAKINGS

Company	£m
At beginning of year	82.0
Additions	-
Issue of new shares	-
AT END OF YEAR	82.0

The undertakings in which the Group's and/or Company's interest at the year-end is more than 20% are as follows:

Subsidiary Undertaking	Country of incorporation	Principal Activity	Class and Percentage of shares held:	
			Group	Company
Hodge Life Assurance Company Limited	United Kingdom	Life Assurance	100%	100%
Julian Hodge Bank Limited	United Kingdom	Banking	100%	100%

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For the year ended 31 October 2019

35. RELATED PARTIES

The Company has relationships with its immediate parent Company, The Carlyle Trust Limited and fellow subsidiaries of The Carlyle Trust Limited. All transactions are carried out on an arm's length basis. The other Group related party transactions are disclosed below:

	Interest income / (expense): 2019 £'000	2018 £'000
Jane Hodge Foundation – shareholder of The Carlyle Trust Limited	-	(5.3)
The Carlyle Trust Limited – parent	9.9	(4.8)
	9.9	**(10.1)**

The following balances were owed to or from related parties at 31 October:

Group	2019 £m	2018 £m
Amounts owed from parent and fellow subsidiaries		
The Carlyle Trust Limited – parent	3.3	0.3
Reimbursement asset due from The Carlyle Trust Limited	2.9	2.4
Carlyle Property Development Company Limited – fellow subsidiary	-	0.4
Sterling House Limited – fellow subsidiary	-	0.1
Group relief	1.1	-
Deposits owed to parent and fellow subsidiaries		
Jane Hodge Foundation – shareholder of The Carlyle Trust Limited	(2.5)	(2.5)
The Carlyle Trust Limited – parent	(1.1)	(0.2)
Beaufort Park Limited	(0.3)	-
Sterling House Limited	(0.1)	-
Wingwest (Fountain Lane) Limited	(0.2)	-
Carlyle Property Development Limited	(0.4)	-
	2.7	**0.5**

Key management personnel comprise only the directors of the Group. There were no material transactions between the Group and its key management personnel other than those disclosed below.

Key management compensation is as follows:

	2019 £m	2018 £m
Short-term employee benefits:	1.0	0.8

Notes to the Financial Statements

For the year ended 31 October 2019

36. CAPITAL RISK MANAGEMENT

Banking segment

The banking segment conducts an Internal Capital Adequacy Assessment Process ('ICAAP'), at least annually, which is approved by the Board. This is used to assess the Group'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 Bank'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 Bank's Individual Capital Guidance (ICG).

The Bank's capital resources requirements are calculated based on the CRD IV and 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 Bank at each board meeting through the receipt of management information which sets out the Bank's current and forecast capital position, based on the methodology adopted within its ICAAP.

This means that the Bank 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.

	Unaudited 2019 £m	Unaudited 2018 £m
Common Equity Tier 1 capital	156.4	168.0
Total risk weighted assets	695.2	751.7
Common Equity Tier 1 capital ratio	**22.5%**	**22.3%**
Total own funds	156.4	168.0
Total risk weighted assets	695.2	751.7
TOTAL CAPITAL RATIO	**22.5%**	**22.3%**

Notes to the Financial Statements

For the year ended 31 October 2019

36. 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 operates only in the United Kingdom. The principal activities of the Bank are noted in the Strategic Report.
- Average number of employees: as disclosed in note 9 to the accounts.
- Annual turnover (Net Interest Income) and profit before tax: as disclosed in the Income Statement.
- Corporation Tax paid by Julian Hodge Bank Limited: 2019 £0.2m (2018: £0.3m).
- Public subsidies: there were none received in the year.

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

The banking segment's objectives when managing capital are:

- To have sufficient capital to safeguard the Bank'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's capital requirements set out by the PRA in the UK.

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

Life assurance segment

The insurance segment is required to maintain a minimum margin of solvency capital in excess of the value of its liabilities to comply with regulatory requirements.

The amount of regulatory and economic capital required also depends on the level of risk facing the insurance business, and as such correlates to economic market cycles. The insurer must assess its capital resources on both a Pillar 1 (regulatory capital) and a Pillar 2 (own risk and solvency assessment) basis. The Pillar 1 capital requirement is calculated by applying the Solvency II standard formula for solvency capital requirements whereas the Pillar 2 capital requirement is determined following an internal capital assessment by the insurer.

All minimum regulatory requirements were met during the year.

The objectives when managing capital are:

- To have sufficient capital to safeguard its 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 insurance capital requirements set out by the regulators of the insurance markets in which the insurer operates (the PRA in the UK);
- To provide an adequate return to the shareholder by pricing insurance contracts according to the level of risk associated with the business written.

The insurer's capital comprises solely equity, movements of which are set out in the Statement of Changes in Equity.

Notes to the Financial Statements

For the year ended 31 October 2019

36. CAPITAL RISK MANAGEMENT (continued)

Pillar 1 capital position

	Unaudited	
	2019 £m	2018 £m
Total capital resources	148.5	143.9
Solvency capital requirement	(90.1)	(78.4)
Excess available capital resources	58.4	65.5
Cover ratio	165%	183%

A reconciliation of the Company's total equity to distributable reserves is summarised below:

	Unaudited	
	2019 £m	2018 £m
Total equity	156.0	144.3
Less: share capital	(6.8)	(6.8)
Less: other non-distributable reserves	(90.8)	(72.0)
DISTRIBUTABLE RESERVES	**58.4**	**65.5**

Registered Office:

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Cardiff, CF10 1FS

HODGE

We make life better for our customers, colleagues and communities by providing specialist lending, savings and retirement solutions in a manner that is fair, friendly and personal.