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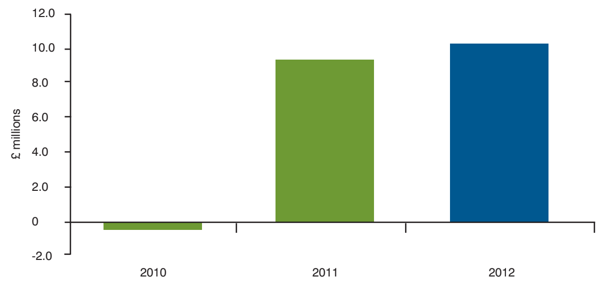
Annual Report and Accounts 2012

Celebrating 150 years
Local knowledge. Mutual understanding.

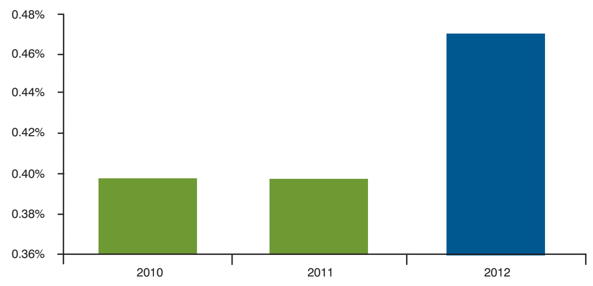
Newcastle Building Society

2012 key highlights

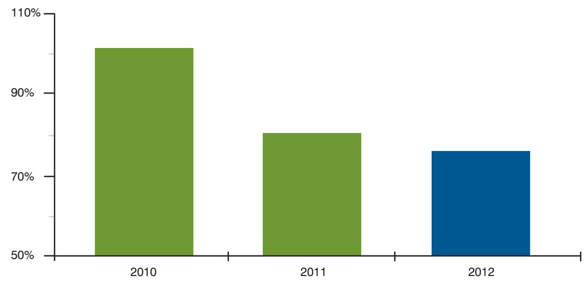
Operating Profit before Impairments, Provisions,
FSCS Levy and Exceptional Items



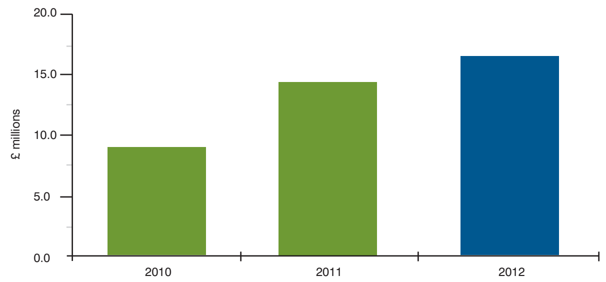
Interest Margin as a Percentage of Mean Total Assets



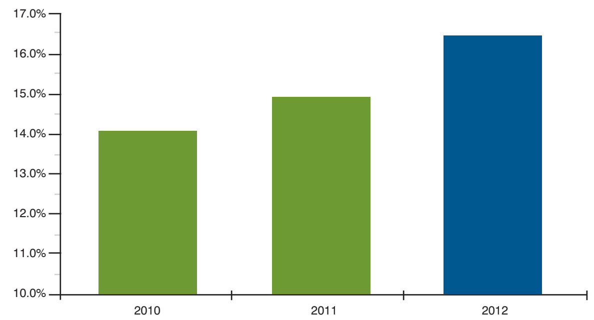
Cost Income Ratio



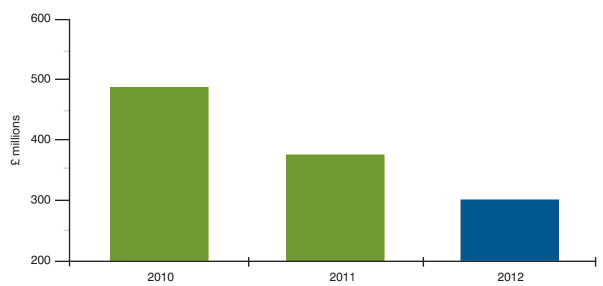
Solutions Business Annual Income
(excluding Pre Paid Card business)



Solvency Ratio



Commercial Investment Loan Exposure (net of provisions)



Contents

Our Vision

We aim to deliver excellent service to our members; long term, secure and rewarding employment to our staff; and recognisable support to local communities. We also aim to provide best in class service for our Solutions business customers.

Our members, customers, employees and the communities we serve all have an important part to play in the future of the Society. We believe we can best serve the interests of all stakeholders by remaining a strong, dynamic and independent mutual building society.

Our objectives for each are:

Our Members and Customers

- To provide a good range of savings, investment, mortgage and insurance products;
- To provide value for money;
- To be a friendly customer-focused organisation which understands its customers, listens to and acts on what they say;
- To offer expert and trusted advice across a range of services;
- To deliver exceptional service in a prompt, courteous, professional, respectful and efficient manner;
- To be straightforward in what we do while being efficient and effective;
- To take personal ownership and care about what we deliver;
- To treat customers fairly and in a way that is consistent with mutuality; and
- To provide a diversified income stream through our Solutions business by sharing our technology and processing capability, built on our core building society competencies, with business partners.

Our Employees

- To provide secure and rewarding long term employment;
- To provide further development of our staff;
- To provide our staff with a thorough understanding of our corporate strategy to enable them to pursue it with commitment and passion;
- To be open and honest and do what we say we will do;
- To respect our employees and operate within an environment of mutual trust and understanding; and
- To provide competitive and fair remuneration packages.

Our Communities

- To be seen to be a major contributor to the economic wellbeing of the areas in which we operate; and
- To support the communities in which we operate, by way of both personal and financial involvement.

Chairman's Statement

David Holborn - Chairman

I am pleased to report a further year of very satisfactory results and progress in all of the key areas on which we have been concentrating for the last three years.

Economic Backdrop and Our Society

Principally our progress surrounds operating profitability and development of the business, staff engagement, and our relationships with the local communities in which we operate. The Chief Executive's Review on pages 6 and 7, which covers all aspects of the business year, and the Corporate Social Responsibility (CSR) update on pages 12 and 13, has substantial comment on these elements.

The restrictive economic conditions in which we operate have now been evident for some five years and this is set to continue. It is therefore difficult to argue with the often heard view that "this is the new norm", at least for the near future. We continue to review the Society's business with rigour and implement well-considered management actions so we can operate successfully and efficiently in this environment. We prepare for the opportunities that occur, even in difficult times and for those that will become evident as economic circumstances gradually begin to improve.

Currently, we see significant adverse economic and related social issues in much of Europe, difficult political and economic issues in the USA, while at home, there is the need to restore financial good health. It is clear many of these problems are not likely to be resolved quickly and we are planning the Society's business on the basis of being prepared for a prolonged period of readjustment and the reality that it will be some years before the buoyant economic conditions, which prevailed up to 2007, are seen again.

Some of the economic measures introduced in our country have alleviated some of the worst aspects of previous recessionary periods. The low interest rate regime has helped the economy in several ways; unemployment figures are in a better position than many economic forecasters predicted, there has been job creation in the private sector and borrowers have also benefited from the reduced call on their resources as a result of lower rates.

In addition, we have seen some positive impact from the actions of the Bank of England (BoE) and from the Financial Services regulator. The combination of the BoE's Funding for Lending Scheme and the easing of requirements relating to capital and liquidity by the Regulator have been major factors behind the increase in lending by the banks and other financial institutions. This progress has been particularly evident in the mortgage market, where the latest figures from the Council of Mortgage Lenders highlight increased mortgage lending activity over the last three months.

We welcome these initiatives and have increased our mortgage lending significantly during 2012 and plan to do so again in 2013.

This low interest rate environment of course affects savers and impacts on their income. We have endeavoured to cushion that adverse effect, where we can, through our competitive savings accounts range, with some of our products regularly appearing in the 'Best Buy' tables. Our Chief Executive's Report comments further on this.

Our Board

At Board level, John Warden left the Society in June. John had worked with the Society as our Operations Director and was a valued member of the Board team. We wish him well in his future endeavours.

I have recently completed 10 years on the Board and will be stepping down as Chairman and Non Executive Director, after the Annual General Meeting. I have greatly appreciated the support of all my Board colleagues and staff throughout the Society and it has been a privilege to be a part of such a conscientiously run organisation. I have no doubt that my successor, Phil Moorhouse, will build further on the progress we've already made and I wish him every success as the new Chairman.

Moving Forward

The Board, Executive Management and all of our staff recognise the difficult conditions, which prevail in the financial services sector and indeed in the wider economy. We do, however, have a positive outlook and attitude, recognising over recent years, in particular, that our planning for the Society's business has been sound and management actions timely.

We continue to make distinct progress and our strategy of simplifying the business to better meet member needs continues to be seen to be correct. This was confirmed recently at the review by the Board of our Strategy and Business Opportunities where we undertook a thorough assessment of our position in the current market. We do, therefore, look forward with confidence.

Our management and staff give tremendous commitment to the Society and its members, both in their working time and in the part many play in supporting and helping local communities. I would like to pay tribute to that and thank them for all they do, it is really appreciated.

I wish you all well in 2013 and beyond.

David Holborn
Chairman
27 February 2013

Jim Willens - Chief Executive

As expected 2012 was a year where further challenges emerged and it is against this backdrop that I am pleased to report the Society continued to deliver against its strategy.

In 2010 we changed our strategic focus to returning the Society to a traditional building society model with a diversified income stream via our Solutions business; built on core building society competencies. At the heart of this strategy are our members, our staff and the communities within which we operate and ensuring we provide a good range of products and excellent service, underpinned by the Society's values.

The Society continues to show steady year on year positive trends in all its Corporate Key Performance Indicators, which are fully aligned with the Society's strategy. From a financial perspective, profitability, capital and liquidity ratios continue to strengthen further, and our key non-financial measures; the satisfaction of both our members and employees, increased. We exceeded our targets for business simplification and delivered on schedule on key regulatory projects. Overall we have had a very positive year of progress.

Members

Thanks to the launch of products, such as our hugely popular charity linked accounts – the Sir Bobby Robson Foundation ISA and Saver – we have enjoyed great support from both new and existing members. The Foundation was the perfect match for us as a mutual especially with both of us based in the North East of England. This helped us open 40,000 new savings accounts for members in 2012.

Additionally, we supported First Time Buyers (FTB) throughout the year, with the launch of a range of competitive 90-95% LTV products which were very well received. Our lending to FTBs increased by more than 210% in 2012 in comparison to 2011 and helped support a group that is key to the success of the wider housing market. Our total gross mortgage lending in 2012 was double that of 2011 and we expect it to be double again in 2013. Increased lending activity reflects the progress we have made in unwinding legacy mortgage portfolios which has released capital and liquidity that can be ploughed back into prime residential lending for members. This flows from our strategy of simplification and focussing on being a traditional building society.

The Society was admitted to the Funding for Lending Scheme (FLS) in October 2012, having met the eligibility criteria, and has arrangements in place to draw down under the scheme should the funding be required. Given the success of unwinding legacy portfolios, the Society has a strong liquidity position and does not currently need to access the FLS to fund additional mortgage lending; however we will continue to keep the position under review.

Following the devastating floods the North East of England experienced in July, our Alnwick branch was badly damaged. We took the opportunity to reassess the needs of the branch and its customers and have redeveloped it to become one of the beacons for our new style of branches within the network. We celebrated the reopening with a community launch event that was very warmly received by both local members and staff.

Our annual customer satisfaction survey results improved from overall satisfaction of 90% in 2011 to 92% in 2012. This has in part been due to an ongoing desire to develop not only our staff but also our proposition and processes ensuring that we take all feedback from customers, whether positive or negative, and use it constructively.

Staff Engagement

In 2010 we formed a staff representative group which has helped us define many of the positive staff-related changes that have taken place within our organisation including the launch of our values, regular business update sessions with senior management, as well as the launch of our staff recognition awards.

We carried out our third annual staff survey in December 2012 which has become an intrinsic part of our employee strategy. This assesses several key areas of our business including; culture, leadership, environment and learning and development. The results were again very positive and highlight those areas of continued focus going forward and the progress we have made to date.

We launched the Society's values to staff this year, which were also developed by our staff representative group. This was extremely important to us as we wanted something relevant for staff and that would add value to the Society. The process of agreeing values was comprehensive, with both challenge and support which in turn has helped develop a framework that supports our strategy going forward. This initiative was rolled out to every staff member through a range of group interactive sessions, team meetings and other activities, and is now embedded into our appraisal and development process.

We introduced our new staff recognition scheme in 2012; S.T.A.R. means Staff To Achieve Recognition and aims to celebrate work well done.

2012 was also the year we launched our graduate training scheme where we took on local graduates in a number of key business areas. This has proved very successful and we are committed to offering rewarding long-term career opportunities alongside nurturing leaders of the future. It is also the second year of our undergraduate student placement programme where a number of students work in the Society for a year to gain valuable work experience in a commercial environment.

Communities

I am very pleased we have continued to support our local communities in 2012 and further details are given on pages 12 and 13.

Business Simplification

Our strategy of returning to a traditional building society model, has necessitated a robust review of all business areas that do not form part of our key products of savings, mortgages, insurance, financial advice or the core services provided by the Solutions business. The main areas of focus in continuing our simplification strategy have been as follows:

- At the start of 2012 we agreed a wind down strategy for the Society's subsidiary, Kings Manor Properties Limited, which holds a portfolio of residential properties originally held for investment purposes. The business has continued to perform well operationally as demand for rental property has increased over recent years and mortgage lending activity has been subdued. However it does not form part of our core building society business and it has been adversely affected by falling property values. The valuation of the portfolio at 31st December 2012 reflects the wind down strategy and a charge of £1m has been recognised to write down the value of the portfolio;
- The Society sold its Prepaid Cards Business (PPC) to Wirecard AG in December 2011 and as part of the transitional arrangements following the sale, the Society continued to provide services and e-money licence capability to PPC. In November 2012, Wirecard AG obtained its own UK e-money licence and any residual activities operated by the Society were transferred fully to Wirecard AG; and
- In 2010 the Society adopted a more pro-active stance in winding down higher risk or lower margin legacy mortgage portfolios which did not fit the traditional building society model. In 2012 this approach continued to be successful with a reduction of £180m in legacy portfolios including £75m in commercial investment lending and £68m in loans to registered social landlords. Since the start of 2010 we have reduced legacy portfolios by £430m, with the largest element of this reduction relating to commercial investment loans, falling by £241m or 44%.

Financial Performance

Profit before tax improved from £0.1m to £1.5m reflecting increased mortgage lending activity, higher income from financial advice services and a strong performance from the Solutions business. Our financial performance at the operating profit level (before provisions and FSCS levy) improved by 13% from £9.2m to £10.4m. This was a pleasing performance as operating profit for 2011 included £1.4m in relation to the prepaid cards business and the 2012 figure is adversely affected by the £1m charge on the revaluation of the investment property portfolio. Adjusting for these factors gives a year-on-year improvement in operating profit of 46%.

Our cost to income ratio improved from 80% to 77% (excluding the investment property revaluation adjustment) although management expenses overall increased by 5%. This increase was due mainly to higher staff costs as a result of the growth in the Solutions business (where income has grown at a much greater rate), the annual pay review and the payment of a modest corporate bonus to all staff equal to 2.5% of salaries. There was also a £0.3m increase in costs relating to regulatory projects and fees and an increase of £0.3m in dealing with complaints.

As has been the case with many financial institutions the Society has seen a significant increase in complaints relating to mis-selling of Mortgage Payment Protection Insurance (MPPI) with over 2,300 complaints received in 2012. Over a third of these complaints related to claims where the customer did not have an MPPI policy with the Society. The Society has never sold single premium MPPI and we have not seen any issues of systemic mis-selling. Of the complaints received in 2012 only 3% were upheld with redress of less than £30k paid, solely in relation to administrative matters which did not relate to mis-selling. In addition the Society received 269 MPPI complaints via the Financial Ombudsman Service in 2012, with one upheld, which the Society is challenging. There is a cost to the business of dealing with these complaints and it is frustrating that we have had to divert our attention from other more positive activities which would add value to members and staff. It is pleasing that complaints excluding MPPI cases reduced by 24% in 2012.

We continue to incur a large ongoing cost in relation to the financial crisis over the last 5 years which impacts the Society in two ways. Firstly, the recessionary conditions combined with low business confidence have depressed commercial property values whilst at the same time there has been an increased incidence of tenant failure/difficulty; both of these factors increase the need for provisions within our commercial investment mortgage portfolio and we have therefore recognised an impairment provision of £10.9m in 2012 (relating mainly to commercial), including an increase in the commercial collective provision of £4.3m. Secondly the cost of failed banks is borne by financial institutions via a levy from the Financial Services Compensation Scheme (FSCS). The FSCS levy has increased by 50% from £1.4m to £2.1m reflecting that in addition to paying the interest cost of loans to failed institutions, the Society will also need to take a share of any expected capital shortfall on repayment of the loans. Further details of this increase are given in Note 26 on page 52.

The Society's capital ratios continued to improve with the Solvency Ratio improving from 15% to 16.4% and Core Tier 1 ratio, the key measure of focus under new capital regulations, improving from 10% to 10.7%. Liquidity was also strong at 30.2% although this high level was in part due to the retention of funds from the wind down of legacy mortgage portfolios in 2012 which will fund increased prime residential mortgage lending activity in 2013.

NBS Solutions

Our Solutions business continues to go from strength to strength with growth in savings balances under management of 22% including the launch of a new savings management contract in May 2012. Solutions operating profit (before provisions and gain from the disposal of PPC) increased from £6.2m to £6.7m an increase of 8%, with the underlying increase being much higher at 40%, after adjusting for the impact of the sale of PPC. This improvement was driven by the expansion in balances but also an increase in efficiency of 7% due to greater economies of scale. We have also continued to invest in technology with a wide area network replacement, server upgrades, new fraud detection and anti-money laundering software as well as enhancing internet load capability. Delivery of our IT roadmap will ensure the service we provide to Solutions customers continues to be best in class for outsourced savings management services with the next key area of focus being delivery via mobile devices.

We currently have projects underway on two new contracts and a strong pipeline of other potential new clients. We expect Solutions business volumes may be relatively flat in 2013 due to clients utilising the cheaper financing provided by the FLS rather than more expensive retail funding, however in 2014 we expect to see growth rates resume.

Regulation

In 2012 the regulatory agenda continued unabated with the Society delivering on several major regulatory projects as follows:

- Retail Distribution Review (RDR) – In December 2012 the Society completed an 18 month project to transition its financial advice subsidiary, Newcastle Financial Services Limited, to a new fees based advice model in preparation for new RDR regulations coming into effect in January 2013. This included signing a new 5 year contract with Openwork under the appointed representative model. It is particularly pleasing that we have been able to deliver this project as we see a potential gap in the marketplace with several big banks withdrawing from the provision of advice for all but their most wealthy customers;
- Mortgage Market Review (MMR) – In October 2012 the FSA issued the long awaited policy statement on reform of the mortgage lending market which had been preceded by various consultation and discussion papers since the start of 2009. The final policy statement will have minimal impact on the Society's mortgage business as the Society already complied with the majority of the requirements and over the last 18 months has taken steps to comply with new requirements as papers have been published e.g. the introduction of an affordability calculator; and
- Recovery & Resolution Plan (RRP) – the lessons learned since the onset of the credit crisis have made it critical for financial institutions and the FSA to understand the recovery options that can be pursued when a financial institution encounters a crisis and also the steps that may need to be taken in the event those recovery options fail, this is what is set out within an RRP. The Society has invested considerable resource in developing its RRP, including use of external advisors, and we believe we are well positioned to comply with the final FSA policy rules when they are published.

At the same time the advent of twin peaks regulation has meant the Society has been dealing with two FSA supervisory teams; the Prudential Regulatory Authority with prudential oversight of banks and insurers; and the Financial Conduct Authority which oversees market conduct and prudential regulation for smaller firms. The Society has reviewed its governance committees, processes and management information to ensure they are fully aligned with the new regulatory regime which legally becomes effective on 1 April 2013.

Summary

The Society continued to make excellent progress in 2012 towards achieving our long term objectives. While there is some evidence that the UK economy is moving towards recovery it may take years to achieve the long term growth rates we have seen in the past. We therefore continue to take a cautious view in our three year plan and we have assumed there will be no upside from current market conditions. However we see the next three years as an opportunity to show that building societies can continue to thrive, with an increased focus on mortgage lending and good long term value savings products, a commitment to our financial advice service and our pursuit of excellent customer service.

In 2013 we celebrate the Society's 150th anniversary, that's 150 years of providing mortgages and savings products, supported by a range of services, to our members. It goes without saying that we would not be here without our members so thank you to you all - we look forward to another 150 years.

I would also like to take this opportunity to thank the staff and Executive team, who have shown exceptional commitment and enthusiasm both this year and over the last three years.

Finally, on behalf of the Board I wish to place on record our sincere thanks to our Chairman, David Holborn, who has served the Society with distinction for the past 10 years, the last two as Chairman. We will miss his wise counsel and guidance. Following careful and timely planning the Society has secured an equally impressive replacement in Phil Moorhouse under whose guidance we look forward to building further on successes achieved to date. This new appointment will commence after our AGM on 24th April.

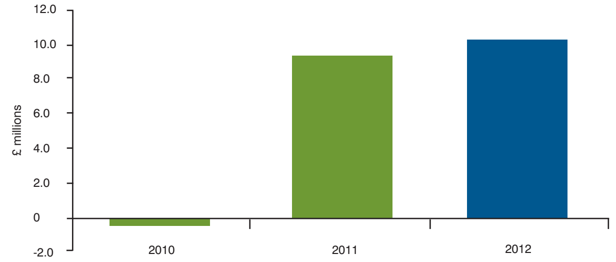
Jim Willens
Chief Executive
27 February 2013

Overview

Despite quarterly fluctuations, the UK economy was relatively flat across 2012. The uncertain road to recovery in the UK has seen a double-dip recession in 2012 and short bursts of growth stimulated by the Jubilee and Olympic Games. The year has ended as it started with negative growth and the possibility of a third recession since 2008. Although signs of recovery, like a modest fall in unemployment, is good news for the Society's residential mortgage portfolio, gloomy metrics such as reduced output from the service and construction sectors, failure of high street retailers and global trading uncertainties, present challenges for the Society's commercial borrowers. The concerted political effort in Europe to deal with its economic difficulties has resulted in some stabilisation in UK markets but commentators agree there is still a difficult, and protracted, period of subdued economic activity ahead.

In the face of these ongoing challenges the Society has maintained its strategy of building on core strengths under a simpler building society model, leading to continued and steady progress in 2012 and pre-tax profits increasing to £1.5m from £0.1m in 2011. Operating profit before provisions, exceptional items and the FSCS levy maintained an improving trend by increasing 13% to £10.4m from £9.2m in 2011. This is particularly strong when considering 2011 accounts included income of £1.4m from the Pre Paid Cards business and the 2012 equivalent includes a £1m charge for revaluation of the Group's investment properties. Adjusting for these items gives a year-on-year growth for operating profit before provisions, exceptional items and the FSCS levy of 46%. This progress is supported by the diversified income stream via Solutions business; coupled with a more efficient cost base, the Society is able to balance delivering value to both its mortgage and savings customers while maintaining profit sufficiency and an improving capital position.

Operating profit before impairments, provisions, FSCS levy and exceptional items



The Group balance sheet remains strong with high levels of premium, low risk liquid assets, overall well-performing quality residential mortgage assets, funding predominantly from retail savers, and an improving capital position. The improvement in the capital base has increased the Core Tier I ratio to 10.7% from 10.0% in 2011. Since 2007 the Group's solvency ratio, a key measure of protection afforded to members, improved by 46% to stand at 16.4% at the end of 2012.

The Society continued to de-risk its balance sheet by winding down legacy portfolios, including the commercial investment portfolio, buy-to-let mortgages to portfolio investors and also low margin loans, which include loans to housing associations. Legacy portfolios in wind-down reduced by £180m in 2012. In recognition of the underlying difficult conditions being experienced by some commercial borrowers, the Society has provided a further £10.6m against commercial loans in arrears or possession, with LPA receivers or where a trigger event has identified there may be a problem in the future servicing of the loan.

Income Statement Review

GROUP INCOME STATEMENT	2012 £m	2011 £m	2010 £m
Net interest income	19.9	17.5	17.8
Other income	28.6	27.3	18.8
Loss on revaluation of investment properties	(1.0)	(0.1)	-
Total income	**47.5**	**44.7**	**36.6**
Administrative expenses	(34.5)	(32.6)	(33.7)
Depreciation	(2.6)	(2.9)	(3.2)
Operating profit/(loss) before impairments, provisions, FSCS levy & exceptional items	**10.4**	**9.2**	**(0.3)**
Gain on disposal	0.8	3.9	-
Impairment losses - loans	(8.3)	(12.3)	(1.8)
Impairment losses - banks and debt securities	0.7	0.7	2.4
FSCS levy	(2.1)	(1.4)	-
Repositioning Programme	-	-	(4.0)
Provisions for liabilities and charges	-	-	(1.0)
Profit/(loss) for the year before taxation	**1.5**	**0.1**	**(4.7)**

Net interest margin has increased from 0.40% in 2011 to 0.47% in 2012 due mainly to increased mortgage lending and improved returns on liquid assets. Margin remains under pressure from relatively high retail funding costs, although latterly this has seen some signs of abating as the market reacts to the Funding for Lending Scheme.

Other Income and Charges

Other income across the Group rose by £0.4m in 2012 to £27.6m from £27.2m in 2011. Although appearing a modest improvement the figure in 2011 includes income of £1.4m from the Prepaid Cards business sold in December 2011 and in 2012 a £1m charge for investment property fair value write down. Adjusting for these items gives an underlying growth in other income of 11%. Income from the Solutions business remained strong at £16.2m due to 22% growth in balances under management including the launch of a new savings contract in May 2012.

Investment Property Revaluation

The subsidiary company, Kings Manor Property Limited (KMPL), holds the Group's residential investment property portfolio. The Group follows the fair value model of asset valuation for investment properties as laid out in IAS 40 including assets held by KMPL. As such the portfolio is revalued at the balance sheet date using active market price comparisons. In 2012 the fair value revaluations have seen the Group write down the portfolio by a total of £1m, further details are given in Note 18 to the Annual Accounts. The KMPL investment property business does not fall into the Group's simplified core model and the decision to dispose of the portfolio of assets on a piecemeal basis in the 12 months from the 2012 balance sheet date has resulted in the assets being classified as Held for Sale in accordance with IFRS 5.

Administrative Expenses and Depreciation

Administrative expenses grew by £1.9m in the year to £34.5m (2011: £32.6m) driven in the main by the increased staffing requirement to support activity and income growth in the Group and particularly the Solutions business and also increased regulatory costs. The Society also incurred additional staff costs as a result of the annual pay review and paid a corporate bonus equivalent to 2.5% of salaries at the end of 2012.

Regulatory fees and costs associated with regulatory projects, together with the cost of administering the ongoing stream of MPPI claims, added £0.6m to administrative expenses in 2012.

The increase in administrative expenses, mitigated by a £0.3m fall in depreciation charge contributed 4 basis points (bp) to the total 8bp increase in the ratio of management expenses to mean total assets; 0.88% in 2012 compared to 0.80% in 2011. A fall in balance sheet size across 2012, with the resulting fall in mean total assets of £190m, contributed 4bp to the ratio's increase.

In contrast the ratio of management expenses to income decreased by 3% to 77% (excluding the fair value adjustment for investment properties) from 80% in 2011. This efficiency ratio better reflects the Society's investment in the business to improve income streams as the Solutions business has minimal assets to support it.

Building on the success of the repositioning programme in 2010, the Society continues to review its cost base with a number of initiatives identified which will reduce cost going forward.

Gain on Disposal of Prepaid Cards Division

The Society legally completed on the sale of its Prepaid Cards Division to Wirecard AG on 21st December 2011. Cash received on completion amounted to £7.5m and a further £2.5m may be payable as deferred consideration which is based on trading performance in 2012 and 2013. The Society recognised £0.5m of the earn-out in 2011 with a further £0.8m in 2012, any remaining income will be recognised in 2013 when receipt is more certain. Further details are given in Note 10 on page 42 of the Annual Accounts.

Impairment Losses

Loans and Advances to Customers

The impairment charge for loans and advances to customers has fallen to £8.3m in 2012 from £12.3m in 2011, excluding provision charges for suspended interest, however it is still high compared to historic levels prior to the credit crunch. The continued high level of provisioning reflects the difficult economic backdrop which has had a greater impact on commercial investment loans as property values have fallen, there has been greater incidence of tenant failure (particularly on the high street) and when a tenant fails it takes much longer to find and replace tenants. A summary of loan impairment charges, which demonstrates the significance of commercial provisions to the overall charge, is given opposite with full details of provisions included in Note 14 on page 44 of the Annual Accounts.

IMPAIRMENT CHARGES BY AREA	2012 £m	2011 £m
Commercial	8.5	12.2
Residential (1)/ other	(0.2)	0.1
Charge for the year	**8.3**	**12.3**
Interest added to provisions (2)	2.6	2.9
Total charge recognised	**10.9**	**15.2**

(1) Residential includes provisions in relation to owner occupier and BTL properties
(2) Interest provisions flow through net interest margin and relate primarily to commercial loans

Commercial

The total commercial impairment charge for the year including interest added to provisions amounted to £10.6m for 2012 (2011: £15m). The Society has been successful in winding down and de-risking the commercial portfolio, with a 44% reduction over the last three years, but as trading difficulties persist in the commercial property sector and valuations fall on the back of low demand, so the requirement to provide for impairments that are considered 'incurred' continues. Impairment calculations are carried out by considering future discounted cashflows as per rules laid out in international accounting standard, IAS39. In considering future cashflows the Society estimates the future valuation of the security less anticipated disposal costs, any interest rate hedging unwinding required as well as interest rates, operational expenses and charges. The Society considers several factors when deciding if a commercial exposure is impaired including any missed payments, tenant failure, tenant voids and likelihood of re-letting and any other potential loan servicing issues arising from assessments or professional advice particularly where this provides evidence that a loan is or is unlikely to be fully serviced. In addition a full review has been carried out of loans where forbearance has been granted during 2012 including; capitalising arrears, extending the loan term, or where there has been a restructuring of the original loan terms and conditions. The Society has a provisioning committee, chaired by the Society's Group Risk Executive, with terms of reference for ensuring full and consistent application of the Society's impairment methodology to commercial loans, with the best internal and external information available.

Residential

A charge of £0.9m relates to residential lending; the majority being against historic lending to BTL portfolio investors which is another loan portfolio in wind down (although the Society hopes to return to the BTL market for individuals requiring smaller loan balances in 2013). Despite the squeeze on household budgets, credit losses on the Society's residential lending assets continue to be insignificant compared to the size of the portfolio. This is a reflection of the excellent quality of 87% of the Group's mortgage assets which continue to perform below the industry average. Impairment of the residential book is considered collectively for loans with 3 months or more arrears based on an estimation of loss given default and probability of default based on individual loan circumstances. All properties entering possession are provided specifically based on loan to value and anticipated disposal costs. A small collective provision arises from the Society's roll-rate to possession modelling for loans with low arrears; previous arrears or where forbearance has previously been granted.

Other

The Society's book of other loans is secured on endowment policies and its associated risk has significantly decreased again in 2012, a £0.1m credit has been taken through impairment charges to reflect this. A provision release of £0.7m from other impairment provisions in relation to PPC debtors has been credited to the provisions charge.

Loans and Advances to Banks and Debt Securities

In 2008 the Society made impairment provisions totalling £32.6m against exposures to Icelandic banks. In respect of Kaupthing Singer and Friedlander and Heritable investments the Society is provided with information from administrators about the level of recoveries the creditors could expect to recover from the Icelandic banks. For Landsbanki and Glitnir investments the Society uses market data for recoveries, provided by specialist Icelandic debt traders.

To date the Society has received £18.3m on its total Icelandic investments of £44.0m and expects to recover a further £5.4m. The provision release during the year of £0.7m reflects an improving position on recoveries.

FSCS Levy

The Society's provision for its contributions to the Financial Services Compensation Scheme (FSCS) has been increased to £2.1m in 2012 (2011: £1.4m) The provision covers estimated liabilities under the rules of the scheme in compliance with applicable International Financial Reporting Standards and guidance, IAS37 and IFRIC6. The 50% increase in the charge reflects both an agreement between the FSCS and HM Treasury to increase the interest rate on the original loan to the scheme, and also the requirement for participants to contribute to the capital shortfalls on the outstanding debts. Further details of the provision are given in Note 26 on page 52.

Segment Reporting

Segmental information is prepared under IFRS 8 with activities split into 'Member' and 'Solutions' businesses. Details are given in Note 9 to the Annual Accounts. The Member business provides mortgage, savings, investment and insurance products to members and customers. The Solutions business provides business-to-business services through people, processes and technology. The Board assesses performance based on profit before tax after the allocation of all central costs. The presentation in Note 9 highlights the pronounced impact commercial provisions and FSCS Levy have on the overall loss before tax of the Member business. The Solutions business operating profit before provisions, impairments and exceptional items in 2011 includes £1.4m gained from the period the Prepaid Cards Division remained under the Society's control. Adjusting for this, Solutions operating profit before provisions, impairments and exceptional items increased by £1.9m or 40%. Details of the exceptional item relating to the sale and earn out of the Prepaid Cards business is given in Note 10 to the Annual Accounts.

Taxation

The Group shows an effective corporation tax rate of 100% in 2012. The tax charge relates to the reduction in the deferred tax asset carried on the balance sheet. This reduction arises as taxable losses from previous years are used to extinguish the current year corporation tax charge and, in addition, the deferred tax asset has to be written down where there is a reduction in the enacted corporation tax rate, reflecting that taxable losses have a lower recovery value in the future. The Society and Group have not paid any corporation tax since 2007 due to the taxable losses available.

Balance Sheet Review

Liquid Assets

The Society has continued to maintain a high level of quality liquid assets throughout 2012, a higher liquidity percentage of 30.2% is reported at 31 December 2012 (2011: 29.2%), partly driven by the cash generated by the run off of legacy mortgage portfolios. This liquidity will fund increased lending activity in 2013. The Society pursues a prudent and careful approach to its liquid asset investments with robust and thorough credit risk assessment. Over 76% of the liquid assets held are with AAA-rated counterparties, an increase on the 2011 level of 70%:

RATING	2012 %	2011 %
Aaa	76.3	70.1
Aa1 - Aa3	9.0	15.5
A1 - A3	12.7	10.8
Baa1 or below	1.4	2.3
Unrated	0.6	1.3
Total	**100%**	**100%**

Exposures with a rating of A3 or below are all deposits with other building societies and with 2013 maturity dates.

The Society has no liquid instruments with counterparties based in Greece, Portugal, Italy, France, Belgium or Spain.

COUNTRY EXPOSURE	2012 %	2011 %
Australia	2.1	4.1
Finland	-	1.5
Iceland	0.6	0.7
Netherlands	2.5	2.4
Spain	-	0.3
Sweden	0.3	-
Switzerland	-	0.5
UK	88.6	72.1
Supranational	5.9	16.0
QMMF*	-	2.4
	100%	**100%**

*Qualifying Money Market Funds (QMMF) exposures are AAA-rated, of overnight duration, and are domiciled in the Republic of Ireland. The Society only invests in QMMF that are members of the Institutional Money Market Funds Association, the trade association for AAA-rated European Money Market Funds.

The table below shows the profile of the Society's liquid assets by asset class at fair value.

	2012 %	2011 %
Cash in hand and balances with the Bank of England	32.7	13.8
Deposits with banks and building societies	15.7	21.5
Gilts	-	17.1
Certificates of deposit	-	4.7
Fixed rate bonds	8.7	12.1
Floating rate notes	3.6	11.0
Residential mortgage backed securities	24.5	16.0
Covered bonds	14.8	3.8
	100%	100%

All of the Society's liquid assets are denominated in UK sterling; the Society does not invest in instruments denominated in other currencies.

Loans and Advances to Customers

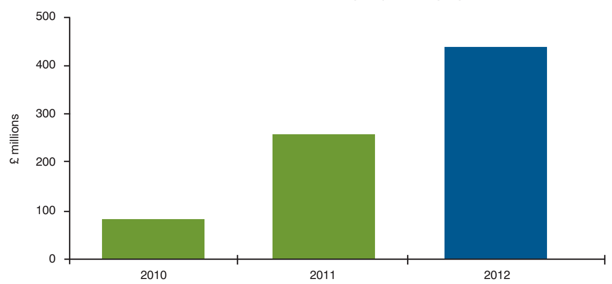
Loans and advances to customers fell by £240m in 2012 as shown in the table below, with two thirds attributable to unwind of portfolios where the Society had ceased new lending and exited the market, this includes £68m of housing association loans, £75m of commercial investment loans and £28m of non-standard residential lending including BTL lending to portfolio investors.

	2012 £m	2012 LTV%	2011 £m	2011 LTV%
Residential	1,628	55.3	1,715	55.8
Housing Associations	781	72.2	849	74.8
Commercial Investment	317	97.5	392	93.9
Other	30	68.3	38	66.7
	2,756		2,994	
Provisions	(28)		(17)	
	2,728	65.1	2,977	66.3

The Group's lending is all secured with a first legal charge registered against the collateral property. Residential loans are shown at indexed loan to value using the quarterly regional Halifax House Price Index, the remaining loans are shown without indexing although over 90% of the commercial loans have been revalued in 2011/12 which is reflected in the high LTV of this portfolio. Further information on security loan to value is provided in Note 33 on page 65.

Since the Society decided to reduce its exposure to legacy portfolios from the beginning of 2010, over £430m has redeemed off the balance sheet, the majority being commercial investment where £241m of balances have redeemed.

Cumulative Unwind of Legacy Mortgage Books



The wind down of the legacy portfolios and the resulting increased liquidity has allowed the Society to return to higher volumes of residential lending to owner occupiers, with 2012 completions double those seen in 2011. The Society was pleased to be able to utilise freed-up capital to support first time buyers (FTB) in its lending for the year with 210% higher FTB completions compared to the previous 12 months. The Society will continue to grow its residential lending volumes as legacy portfolios unwind but only where the balance between credit risk and net return are within risk appetite.

The remaining reduction in the residential book was due to capital repayments as the Society's gross lending exceeded redemptions.

Overall Arrears

The Society measures mortgage arrears of 3 months or more by both number of loans and balance as a percentage of total number of loans and total balance, respectively. The levels of arrears experienced continue to be below Council of Mortgage Lenders reported averages and more than satisfactory given the prevailing economic conditions.

While the table below shows the overall number of loans in 3 months or more arrears has remained relatively static at 0.76% there is a 22bp increase in 3 month+ arrears by balance reflecting the adverse impact that problem commercial loans can have on the Society's overall reported arrears performance.

ARREARS PERFORMANCE 3 months or more arrears	By number of loans 2012 %	By number of loans 2011 %	By balance 2012 %	By balance 2011 %
Residential	0.75	0.73	0.82	0.78
Commercial Investment	1.37	0.61	3.26	1.37
Housing Association	-	-	-	-
Other	0.80	1.12	0.26	0.86
Total	0.76	0.75	0.86	0.64

Residential Arrears, Forbearance and Possessions

Residential arrears have risen by 2bp by number and 4bp by balance due mainly to the reduction in the residential portfolio; both the number of loans in arrears and the balances in arrears have fallen from the previous year. The year end reported arrears figure by balance was affected by one mortgage balance of £1.7m where the arrears were paid off in full in January 2013 and the 3 month+ arrears figure by balance fell back to 0.74% from 0.82%, which is lower than at the end of 2011.

The Society's policy on forbearance measures is fully compliant with the detailed requirements of the FSA's Mortgage Code of Business Sourcebook (MCOB). The term forbearance is defined as the granting of a concession which alters the contractual terms of a loan. The Society will work closely with any homeowner experiencing difficulties, offering help and advice on all aspects of the situation. In an approach which seeks to treat its customers fairly the Society tailors its forbearance measures to reflect the borrower's individual circumstances, the Society can offer measures including changing the term of the loan, a temporary change to interest only, a reduced subscription, a payment holiday or deferring interest payments. The Society will also consider whether the borrower qualifies for Government initiatives covering Homeowner Mortgage Support Scheme (HMSS) and Homeowner Mortgage Rescue Scheme (HMRS). The Society enters into forbearance agreements on the understanding that concessions are granted in the best interests of the borrower in order to return the loan to performing status over time.

FORBEARANCE CASES	2012	2011
Interest Only Payments	2	5
Payment Holiday	13	17
Extension of Term	3	5
Reduced Payments	40	27
Scheme Transfer	1	3
Forbearance Declined	15	20
Total number of cases	74	77

The forbearance information above is presented in line with the definition used by the FSA in the data gathering exercise for the Financial Policy Committee carried out in the autumn of 2011. Forbearance data is monitored closely on a monthly basis by the Society's Residential Credit Committee with the levels of concessions granted not considered to be material for the size of the overall book.

The Society continued to experience a low level of possessions on residential loans in 2012 with only five possession properties at the end of 2012 in relation to owner occupied loans, representing a reduction of three from the end of 2011. The Society took in only nine properties on owner occupied loans in 2012 with the majority of these relating to the borrower surrendering the property or due to action by second charge lenders. Further details are given in the table opposite:

Residential possessions - owner occupier	31-Dec-11	Taken in	Sold	31-Dec-12
Equity release managed sale	2	1	2	1
Court action by the Society	4	3	5	2
2nd charge mortgagor action	1	2	1	2
Abandoned/surrendered	1	3	4	-
Total owner occupier possessions	8	9	12	5
BTL possessions	20	2	5	17
Total residential possessions	**28**	**11**	**17**	**22**

Possessions on BTL properties also reduced from 20 to 17 although this was due more to the Society's preferred route now being to adopt a Law of Property Act 1925 (LPA) receiver to the property in order to take action on a more timely basis. The number of BTL loans subject to LPA receiver appointment increased by five from two at the end of 2011 to seven at the end of 2012. The Society takes a more proactive stance on arrears on BTL properties reflecting that the borrower does not occupy the property, has taken out the loan to enable property investment, and should be able to repay the Society's mortgage via sale if arrears problems arise.

Commercial Investment Arrears, Forbearance and Possessions

At 31 December 2012 the Society had three commercial investment loans in arrears of 3 months or more with balances of £10.1m, this compared to two at the end of 2011 with balances of £5.4m. The increase in the year related to one exposure where the loan could not be serviced due to a tenant void period. Total specific provisions against these three loans amounted to £2.4m (2011: £1.8m). The Society had no loans in possession at the end of 2012 (2011: one loan with a balance of £0.4m and provision of £0.2m).

At the end of 2012 the Society had 4 exposures subject to LPA receivership with total balances of £22.4m (2011: 2 exposures with balances of £3.1m). Specific provisions against these exposures at 31 December 2012 amounted to £8.6m (2011: £1.3m). The Society generally goes down the route of LPA appointment where the relationship has broken down with the borrower and the Society needs to ensure the security property is properly managed in order to secure the best outcome for the Society in terms of eventual repayment of the loan.

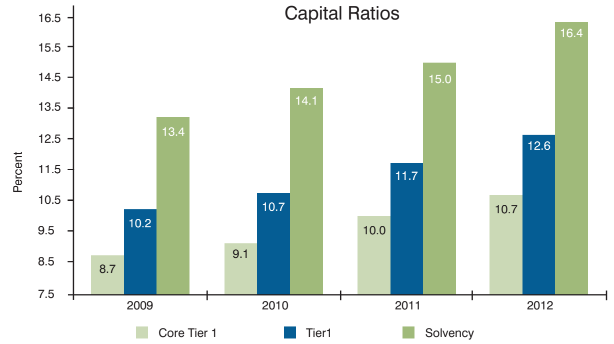
The Society grants forbearance to commercial borrowers in the form of extending the loan term on maturity, capitalising arrears as part of a wider exercise to get a borrower back on track with a revised debt repayment plan, and adjusting the interest rate to aid serviceability particularly where a fixed rate has expired. Generally the Society expects commercial investment loans to be repaid on maturity given the stated strategy of winding down the portfolio but will grant forbearance when this is also in the best interests of the Society e.g. this provides the borrower with a little more time to sell the security property following a tenant renewal. In Note 33 on page 66 of the Annual Accounts details are given of forbearance granted to commercial borrowers in 2012; in summary the Society granted loan extensions on nine loans (on original commercial terms or better), two of which are considered impaired, and capitalised arrears on two loans, both of which are considered impaired.

Funding

Retail savings balances reduced by 8% or £316.0m in 2012 as the Society's balance sheet reduced due to the unwind of legacy portfolios. Wholesale exposures also decreased across the year, by £34.8m or 12%. This relevant movement in funding mix resulted in the percentage of wholesale balances to total share and deposit liabilities falling from 6.95% in 2011 to 6.66% in 2012. The Society's mortgage portfolio remains fully funded by retail savings.

Capital

All capital ratios show improvement in 2012 and follow a trend of a strengthening capital base, as shown in the bar chart opposite with the total solvency ratio improving to 16.4% (2011:15.0%) and Core Tier I improving to 10.7% from 10.0%.



The table below shows the composition of the Group's capital and capital ratios at the end of the year.

CAPITAL	2012 £m	2011 £m
Tier 1 Capital		
General Reserve	165.6	170.8
Permanent interest bearing shares	29.7	29.6
	195.3	200.4
Tier 2 Capital		
Subordinated Debt	53.0	56.0
Collective impairment allowance	6.2	1.6
	59.2	57.6
Total Capital	254.5	258.0
Risk Weighted Assets		
Liquid Assets	141.2	127.4
Loans and Advances to customers	1,271.4	1,420.4
Other Assets	58.9	64.9
Off Balance Sheet	16.5	40.1
Operational Risk	66.5	62.5
	1,554.5	1,715.3
Capital Ratios	%	%
Core Tier 1 ratio	10.7	10.0
Tier 1 ratio	12.6	11.7
Solvency ratio	16.4	15.0

The Group complied with Individual Capital Guidance as notified by the FSA throughout 2012.

Basel III

The Basel Committee on Banking Supervision issued its revised Basel III text in December 2010 reforming the quantity and quality of regulatory capital in order to improve the resilience of the banking sector to shocks arising from financial and/or economic stress. The Basel III text will be implemented in Europe via the Capital Resources Requirement and Capital Requirements Directive. The latter will then be implemented in the UK by the FSA via the issue of policy statements for inclusion in the FSA Handbook.

The impact of Basel III on the Society is that subordinated debt will be phased out from regulatory capital in the longer term and that PIBS will eventually move from tier 1 to tier 2 capital. As the Society's subordinated debt is all due for repayment by 2019 the impact in the short term may be to accelerate the unwind of the subordinated debt from the Society's capital resources, but in the long term there is no impact. The impact of Basel III on capital will be phased in accordance with transitional arrangements and changes are reflected in the Society's medium and long term capital planning. The current improving capital ratios mean that the Society is well positioned to maintain its overall capital strength.

Outlook

There is a distinct possibility the UK will enter a third recession in 2013 given the negative growth figures issued by the ONS for Quarter 4 2012. The road to recovery is likely to be bumpy and long, economic data continues to vary and signals for growth are mixed. Political leaders are likely to continue to work towards a sustained recovery across the globe, central banks trying to stimulate state economies wherever possible. A new Governor of the Bank of England in 2013 could see a policy shift away from concentration on inflation control and more towards growth and stimulus objectives. The Board expects the low interest rate environment to continue throughout 2013 and beyond. While this will maintain pressure on margins, household budgets should continue to benefit from a lower mortgage interest payment burden. Signs that the UK retail savings market is becoming less competitive are likely to see rates falling for a time in 2013 as financial institutions draw down from the Funding for Lending Scheme rather than fund via retail savings.

The Society will maintain its cautious approach to lending in terms of risk and return, but with the expectation that gross residential lending will again double in 2013. The commercial wind-down strategy and improving the overall risk profile of the Society's mortgage portfolio will continue to be pursued. The Board is confident that given the progress already made that an improving financial performance should be achieved over 2013 and into the future.

Angela Russell
Finance Director
27 February 2013

At the Newcastle, we have a distinct regional focus, which makes Corporate Social Responsibility (CSR) even more important to us. In fact, it's an integral part of our strategy.

In reality it means we take a responsible approach to our business practices. So, when we engage with our stakeholders and the wider environment we aim, wherever possible, to maintain a positive impact.

Community – Supporting, Celebrating and Rewarding

In 2012, we launched a branch-led initiative called Cornerstone in the Community. The aims were simple; to 'breakout' from our branches, demonstrate our mutual values and grow support to our local communities. There were five key elements to the initiative; an education programme for schools, a Charity-of-the-Year for each branch to raise money for local charities, to develop a free in-branch community area for organisations to use free of charge, a branch volunteer programme and an awards scheme to reward charity stars in the local area.

Back to the Classroom

The 'Boardroom Challenge' was part of a six-week long curriculum based learning package that taught core numeracy and literacy skills to around 500 nine-ten year old pupils.

After the initial learning, pupils had to come up with a business idea, which focused on benefiting their local community while also making a profit. Finalists then presented their plans to a panel of senior NBS managers, headed by the Society's Chief Executive, in the boardroom of our Principal Office in Newcastle.

Roseberry Primary's 'Penny Palz' with Chief Executive, Jim Willens

Awarding our Local Champions

At our Cornerstone awards ceremonies, winners were celebrated and received a star trophy with a monetary prize. The focus here was to attract nominations from members of the community for people they thought should be acknowledged for their work in one of four categories: Branch Award, Young Person's Award, Team Award and People's Choice.

Winners at our Northumberland and North Tyneside Cornerstone ceremony with Chairman, David Holborn

Our 'hero' award scheme rewarded approximately 50 people in 2012 including 90-year old Eileen Gardner. On the day we awarded her the People's Choice award she had retired, after 30 years of helping her community.

Eileen Gardner winner of the Teesside People's Choice Award

Quotes from two winners say a lot about the impact our awards had on the local community…

"I came home from a holiday, to open a letter from the Newcastle Building Society, to say I had been nominated (for an award). I could not express the feeling I had when I read about this. I have to take this opportunity to say the Newcastle Building Society put on a very good reception – we were all treated like lords. Many, many thanks to all of those who have helped me to attain this great achievement." Joe Grant, South Shields Branch Award winner.

"I'm overwhelmed to win this award. This charity was set up to do something my son intended to do, who we lost. I'm grateful to those that voted for me and the winnings will go towards helping a child and their family who are living with cancer. The trophy I was presented with is very apt too – a star, just like my son." Andrea Thompson, founder of the TOMA Fund, West Denton Branch Award winner.

Local Charities receive Local Branch Support

In addition to the above, some of our branches chose a local charity to support throughout the year. This helped to raise thousands of pounds for local good causes.

The South Shields branch hosted a hugely successful football raffle for a local good cause

Our Middlesbrough and Hartlepool branches also took part in a cycle challenge. Middlesbrough branch raised cash for Zoe's Place while Hartlepool raised cash for Hartlepool and District Hospice.

Pedal Power - Hartlepool Branch take part in a Cycle Challenge

Many branches also hosted a 'toy amnesty' and the aim was to benefit local children's hospital wards and hospices. Although a particular focus of our Alnwick branch, which reopened in December after the North East summer floods devastated it, was to thank the local community for its support during this time by hosting a collection for a local children's centre at Christmas to help struggling families give a toy or two to their children.

Alnwick branch's toy collection for a local SureStart group

Our Darlington branch collected more then 50 toys as part of its amnesty, with a delighted Deputy Head of Service for Child Health accepting them on behalf of a local hospital.

Local branch staff visit Darlington Memorial Hospital's Children's Ward to deliver bags of toys after a successful toy collection

Supporting Sir Bobby Robson's Charity

As mentioned in the Chief Executive's Review on page 6, the Newcastle launched two charity-linked accounts in 2012 and in doing so has so far raised more than £100,000 for the Sir Bobby Robson Foundation.

Lady Elsie, Sir Bobby's widow, said: **"I'm extremely grateful to the Newcastle Building Society and its members for their wonderful support".**

"We share the Newcastle's hopes that this will be a long-standing partnership and one which can help the Foundation continue its important work for a long time to come".

Lady Elsie and Chief Executive, Jim Willens, at the launch of the Sir Bobby Robson Foundation ISA

Celebrating through Photography

Images taken by talented photographers of their home towns were snapped up by the Society for use in a range of 2013 calendars that raised money for local good causes. Each branch that hosted this photography competition had a calendar created especially for it of local images, taken by local people, and they sold it for their Charity of the Year. Dozens of photos were received by our branches with the best taking pride of place in the calendars.

Charity of the Year

The Society also supports one major Charity of the Year, which all staff can get involved with. For 2012-13, this is Help for Heroes. We have dressed up, dressed down, taken on cycling challenges, ran half marathons and hosted family fun days – so far we have raised almost £20k. In 2011/12 we raised over £35k for our Charity of the Year Macmillan Cancer Support.

The annual Family Fun Day had a superhero theme dedicated to our Charity of the Year, Help for Heroes

Our CSR Volunteers, also visited Phoenix House, the Help for Heroes Recovery Centre at Catterick Garrison, to get a better understanding of what the charity does and who it helps. It was an emotional yet hugely informative visit that really illustrated how important our fundraising was to the charity. We also plan to start to help injured veterans get back into the workplace through a series of 'interview preparation' workshops held at one of our head offices. This is due to start in 2013.

Community Foundation

Through the Community Foundation, the Society donates every year to worthy local charity groups and community organisations. To date the Society has donated more than £800,000 to over 800 good causes via the Community Foundation.

In 2012, we have donated to around 20 small local charities including North East Special Needs Network, Hearing Dogs for Deaf People, Darlington Memorial Hospital - Paediatric Trust Fund, Toby Henderson Trust and Newcastle Society for Blind People.

Environment

We are striving to become a greener Society and are committed to helping the environment and reducing our carbon footprint. Our activities include: A recycling initiative, print reduction scheme, carbon reduction campaign, encouraging the use of email where possible including AGM voting, encouraging use of sustainable methods of transport and when redevelopment opportunities arise, we make our offices and branches energy efficient.

NBS has piloted an electric car as part of a launch campaign

Our Directors

Richard Mayland
Non Executive Director

Richard is an experienced accountant who was a partner at Pricewaterhouse Coopers LLP (PwC) for 17 years before his retirement in 2003. During his time with PwC, he specialised in audit and business advisory services. His time as a partner was spent in the North East before being asked to head the financial services audit practice for the North of England. He has significant expertise in regulatory and accounting matters. He is currently Chief Executive of Norprime Ltd, a post he has held for five years. He brings more than 31 years' experience of the accountancy world to the Society's Board, which he has been a member of for more than seven years. He is a member of the Audit, Nomination and Remuneration Committees.

John Morris
Non Executive Director

John is a Fellow of the Institute of Chartered Accountants and brings to the Society a significant amount of experience of both the banking and building society sectors. He worked for several years as Director of Finance for the Retail Banking Division at HBOS. Prior to that, he held senior posts at Halifax (Halifax Building Society and then Halifax PLC) as General Manager and Leeds Permanent Building Society where he held the post of General Manager Finance. He also worked at KPMG where he started his accountancy career. He is a member of the Society's Audit Committee.

Gillian Tiplady
Business Services Director

Gillian has more than 20 years' experience of the legal profession, which includes 11 years working in the building society sector. She worked at Universal Building Society for five years before the merger with the Society where she was a Director and Group Secretary. In January 2011, she became a Board member of the Society when she was appointed as Business Services Director. She is a solicitor and spent 13 years at Watson Burton where she specialised in Banking and Insolvency law.

Ron McCormick
Deputy Chairman

Ron has established a successful career in the building society sector as an experienced accountant. He is both a Fellow of the Institute of Chartered Accountants and a Fellow of the Chartered Institute of Internal Auditors. He has previously worked as Group Finance Director then Group Commercial Director at Skipton Building Society, posts which he held for a total of 14 years. In addition, he has more than seven years experience with Guardian Royal Exchange, as well as seven with KPMG, both in the UK and abroad. Following three years on the Newcastle's Board, in January 2011 he was appointed Deputy Chairman and Senior Independent Director. He is a member of the Society's Audit and Group Risk Committees. He also works as a senior adviser to businesses within a range of sectors.

David Holborn
Chairman

David has spent his entire career as a finance professional. He worked for Lloyds Banking Group for 39 years in a number of Executive roles. He was Director of the Northern Region for 10 years and was responsible for service to customers in business, commercial and personal sectors through 225 branches and 3000 staff. He was also a member of the Lloyds TSB National Retail Board. He was elected to Fellowship of the Chartered Institute Of Financial Services in 1998 for his services to Banking and is a former President of the Bournemouth and Newcastle Centres. Prior to his appointment as Chairman of the Society's Board in January 2011, he built up significant experience of the Society; he was a Non Executive Director for eight years and held the post of Senior Independent Director. David is also the Vice Chairman of Rothley Trust, a post he has held for four years, having previously been a Trustee for four years.

Jim Willens
Chief Executive

Jim's expertise in, and commitment to, the building society sector spans more than 30 years. During this time, he has held significant senior posts including Retail Operations Director and Group Services Director at Nationwide. His roles over the years have included strategic responsibility for Branches, Telephony, Internet Services, Technology, Product Development and Central Support Services, which have involved leading teams in excess of 9,000 people. His career started out in the 'field' as a branch manager and he also held a range of retail and sales management positions. Jim has a strong track record of delivery and a passion for developing the people he works with to provide excellent customer service through the mutual business model both of which are key elements to the Society's strategy.

Angela Russell
Finance Director

Angela is a highly experienced Chartered Accountant and Certified Public Accountant with 25 years' experience in finance in the UK and abroad. She has worked in a variety of positions covering finance, risk, audit, project and corporate planning roles. In particular, she has several years' experience in finance roles within the building society sector including her current role as Finance Director for the Newcastle, which she has held since 2010. She also held the post of Finance Director at the Universal Building Society. Prior to joining the building society sector Angela spent 12 years at PricewaterhouseCoopers LLP. She is also a Non Executive Director of a North East based care charity.

Phil Moorhouse
Non Executive Director

Phil is a highly experienced accountant and is a Fellow of the Chartered Association of Certified Accountants. He has held a number of senior Board positions including that of Managing Director (UK) of Northgate PLC, which he held for more than seven years. This followed six years as Finance Director. He is a Director of Molins PLC where he is Chair of Audit and a Senior Independent Director. Additionally, he sits on the Board of Cumbria NHS Partnership Trust. Phil brings his 35 years' industry expertise to the Newcastle's Board and also the Society's Group Risk Committee, of which he is a member.

Catherine Vine-Lott
Non Executive Director

Catherine has a total of 35 years' experience in the financial services sector having spent her entire working life in the industry. This includes 18 years at Barclays where her positions included Chief Executive of Barclays Stock Brokers, as well as Barclays Personal Investment Management. In addition, she has significant experience with Legal and General both at group Board level and in running the wealth management division. This brings an abundance of expertise to Newcastle's Board, which she joined in January 2010. She is also an experienced Non Executive Director and is Chairman of Openwork Holdings Limited, and Rathbone Brothers PLC. For the Society, she is Chairman of the Remuneration Committee and Audit Committee.

David Buffham
Non Executive Director

David has spent most of his career at the Bank of England. He held a wide variety of banking and other roles, most recently the post of Bank of England Agent for the North East. There he was responsible for reporting to the Bank's Monetary Policy Committee on the region's economy and explaining policy to key stakeholders in the North East. He brings this knowledge and experience to the fore as Chairman of the Group Risk Committee and also as a member of the Nomination and Remuneration Committees. He is an experienced Non Executive Director and, additionally, is a Director of Zytronic PLC, William Leech (Investment) Limited and William Leech Foundation.

The Directors present their Annual Report and Accounts and Annual Business Statement for the year ended 31 December 2012.

Objectives and Activities

The principal objective of Newcastle Building Society is to attract funds, through a competitive range of personal savings and investment products, in order to make available advances secured on land and property, primarily for use of our members. This core activity is supported by offering a range of related financial products and services which are provided by the Society and its subsidiary companies. The Society also provides IT and savings administration services to other businesses; these services provide a diversified income stream and are based on the competencies of the core building society business The principal subsidiary companies which affect the net profits and net assets of the Group are listed in Note 16 on page 45.

It is the intention of the Directors that the Society will continue to remain an independent building society. We believe this status enables us to deliver consistent and fair value and to provide enhanced benefits to all our members and customers through our attractive, innovative products and our increasing network of business partnerships.

Business Review

The Chief Executive's Review and Business Review on pages 6 to 11 report on the business activities and business performance for the year as well as likely future developments.

The Directors have reviewed the Group's capital, liquidity and profit forecasts and considered the risks faced by the Group, including under stressed scenarios. The Directors are satisfied there are no material uncertainties that cast significant doubt about the Group's ability to continue as a Going Concern and have, therefore, continued to adopt the Going Concern basis in preparing the Annual Accounts. (See Note 1 on page 34.)

Risk Management Objectives and Policies

The Board seeks to manage the key risks faced by the Group in order to minimise any potential adverse impact on performance. The key financial risks faced by the Group include credit risk, liquidity risk, operational risk and market risk which are managed through the Group's documented risk management framework. Further details can be found below and in the Risk Management Report on pages 25 to 27.

Principal Risks and Uncertainties

The principal risks and uncertainties faced by the Group are summarised below.

Credit Risk - Commercial

The Society's commercial lending exposure is made up of larger, more concentrated loans secured on land and non-residential property at a loan to value (LTV) ratio which is higher than more traditional residential lending due mainly to falling commercial property values. The Society ceased commercial lending in 2008 and is actively winding the portfolio down however the potential for credit losses continues to be a material risk, despite a reduction in the portfolio of some 19% over 2012 and 43% since the beginning of 2010. Commercial property values continue to fall outside of London. With a backdrop of prevailing economic turbulence an additional £10.6m of capital and interest provisions have been made in the 2012 Annual Report and Accounts. The 3 month arrears rate on the Society's commercial lending portfolio based on balances, was 3.26% at 31 December 2012 (2011: 1.37%) representing three loans with a value of £8.0m after provisions. This represented 1.37% based on number of loans (2011: 0.61%). Further details are given on page 11 in the Business Review.

The Society does not expect any improvement in the outlook for commercial property values or commercial market conditions, over the foreseeable future.

Credit Risk – Residential

The Group's residential lending portfolio comprises mostly well seasoned, performing, low LTV owner-occupied lending. Throughout the year the Society continued to see low levels of arrears and possessions on this part of its mortgage portfolio. In 2012 the Society continued to experience high levels of customers adding to their mortgage payments or making lump sum payments in the challenging economic climate. Average UK prices have fallen modestly in 2012, remaining approximately 15% below their peak in 2007, but this includes regional variations where rises and falls are compensating in the overall average price. Unemployment in the UK is still above the long term average but with falls experienced in the latter half of 2012. Although no major effect on the Society's arrears has been discernable over the period of higher unemployment, it remains a key factor in the credit risk associated with this type of lending.

The Society stopped buy to let (BTL) lending in 2008 and in previous years has experienced difficulties with several larger portfolio investors. The rental market in 2012 remained buoyant and the Society works closely with borrowers experiencing cashflow difficulties, although we have seen the incidence of these problems reduce. The credit risk inherent in the BTL portfolio has reduced but is still concentrated on a small group of borrowers, factors influencing the Society's provisioning strategy and methodologies. The Society will continue to run down the portfolio investor element of the BTL portfolio to aid de-risking of the balance sheet.

Overall the number of 3 month residential arrears cases rose from 0.73% to 0.75% in 2012 with the value of 3 month arrears rising from 0.78% to 0.82%. The number of residential properties in possession reduced from 28 to 22 of which 5 related to home owners. The number of residential loans subject to LPA receiver increased from 2 to 7, all relating to BTL portfolio investors. This slight increase was due to a reduction in the residential portfolio rather than an increase in arrears. Further details are given in the Business Review.

The Society expects risk within the residential mortgage portfolio to remain relatively benign.

Liquidity Risk

The Society monitors on a daily basis the risk it will have insufficient cash to meet its liabilities as they fall due. The Society has throughout the year mitigated this risk by maintaining high quality liquid assets and has further reduced its reliance on treasury markets, with the wholesale funding ratio maintained below 10% throughout the year. The Society undertakes lending only where funding is in place and operates a range of retail savings products to attract and retain customers. The success of winding down legacy portfolios combined with the popularity of a range of savings products, particularly the Sir Bobby Robson range of charity accounts, saw the Society increase its liquidity holdings and this is reflected in an increased liquidity ratio of 30.2% (2011: 29.2%). This liquidity will fund increased lending activity in 2013.

Operational Risk

Further details on operational risk are given in the Risk Management Report.

Market Risk

The Society's market risk relates only to interest rate risk in the banking book and the way interest margin is impacted by a changing rate environment. This includes basis risk as well as understanding the impact of upward and downward movements in interest rates. Sensitivity to, and effect of, interest rate changes is monitored by the Asset and Liability Committee. The Society actively measures the effect of rate movements in accordance with best practice, and manages the interest rate risk to which it is exposed using interest rate hedges or natural offsetting of asset and liability rate-characteristics. Further details are given in the Risk Management Report.

Group Results for the Year

The Business Review on pages 8 to 11 provides a detailed overview of the Group's results and performance during the year and should be read in conjunction with the following summary, which the Directors consider to be the key performance indicators used to manage the business.

Key Performance Indicators (KPI's)

	2012	2011
PROFITABILITY		
Group operating profit before impairments, provisions and exceptional items	£10.4m	£9.2m
Profit before tax	£1.5m	£0.1m
Interest margin	0.47%	0.40%
Solutions income	£16.2m	£15.6m
Cost to income ratio	77%	80%
CAPITAL		
Solvency ratio	16.4%	15.0%
Tier 1	12.6%	11.7%
Core Tier 1 ratio	10.7%	10.0%
CREDIT QUALITY		
Properties in possession	22	29
Properties in LPA receivership	11	4
3 months or more arrears for mortgage portfolio, by number	0.76%	0.75%
3 months or more arrears for mortgage portfolio, by balance	0.86%	0.64%
Wind-down of legacy portfolios	£180m	£185m
Impairment losses on loans and advances to customers*	£8.3m	£12.3m
LIQUIDITY		
Liquidity as a percentage of shares, deposits and liabilities	30.2%	29.2%
NON FINANCIAL KPIs		
Customer satisfaction	92%	90%
Employee satisfaction	85%	84%

*excluding suspended interest

The Society operated above both Individual Capital Guidance and Individual Liquidity Guidance issued by the FSA throughout 2012.

The Society also uses a number of other non-financial KPI's to monitor its performance against target such as customer service levels, staff turnover and number of new members.

Staff

The Society operates an Equal Opportunities Policy. It is the intention of the Society that no applicant or employee receives less favourable treatment on the grounds of disability, sex, transgender status, sexual orientation, marital status, civil partnership status, race, ethnic origin, colour, age, nationality, national origins, political beliefs or trade union membership, or is disadvantaged by conditions or requirements that cannot be shown to be justifiable.

Staff remuneration reviews are carried out on an annual basis and a variety of performance related bonus schemes are operated in some key business areas to enable individual and branch team efforts to be recognised and rewarded. The Society has withdrawn incentive schemes for its branch and contact centre sales staff in January 2013 with all of these staff now part of the corporate bonus scheme only.

At the end of 2012 a Group-wide corporate bonus was paid to all staff which was equivalent to 2.5% of salary and was linked to the Society's 2012 performance.

The Society takes its responsibilities for staff development very seriously and has held the Investors in People accreditation for more than 17 years. We are committed to effective communication at all levels and the Society was able to build on its Staff Engagement Programme in 2012 taking steps to ensure that employee consultation is ample and ongoing. Unite has negotiating rights on behalf of all staff up to and including senior management level.

The Society has an active staff engagement programme that aims to make consistent improvements to our working environment and practices to ensure our organisation is a great place to work. Part of this is an annual staff survey that aims to identify staff perceptions, the results of which go on to shape aspects of people strategy going forward.

As a result of one of our staff surveys, our Staff Engagement team worked hard to develop a set of internal Values, which defined both how we work with each other as well as how we operate as a business.

Everyone in the business, including our Board, have embraced these and following a roll-out programme to integrate and embed them in the business, staff have adopted them on a day-to-day basis.

We introduced a new staff recognition scheme in 2012. S.T.A.R. means 'Staff To Achieve Recognition' and aims to celebrate work well done. Since its launch only four months ago, 12 of our staff have received the award.

Charitable Donations and Political Contributions

The Society made donations to charities amounting to £43,442 in 2012 (2011: £57,773). This excludes contributions to charity accounts. The Society is very supportive of local and national charities, continuing to offer "in kind" donations through a programme of fundraising events.

There were no political contributions during the year.

Creditor Payment Policy

The Society's policy concerning the payment of suppliers is to negotiate and agree terms and conditions with all suppliers and to pay in accordance with its contractual and other legal obligations. At 31 December 2012 the creditor days figure was 24 days (2011: 23 days).

Directors

As at 31 December 2012, the members of the Board, who had served throughout the year and continue to act as Directors were as follows:

David Buffham, David Holborn, Richard Mayland, Ron McCormick, Phil Moorhouse, John Morris, Angela Russell*, Gillian Tiplady*, Catherine Vine-Lott, and Jim Willens*

During the year the only change to Directors was the resignation of John Warden from the Board on 30 June 2012.

At the Annual General Meeting (AGM) to be held on 24 April 2013, all Directors will offer themselves up for annual re-election with the exception of David Holborn, who retires as a Director and Chairman at the end of this year's AGM.

Directors and Officers insurance has been put in place by the Society.

*Executive Directors

Independent Auditors

A resolution to re-appoint PricewaterhouseCoopers LLP will be proposed at the Annual General Meeting.

Statement of Disclosure to Auditors

So far as each Director is aware, there is no relevant audit information of which the Society's auditors are unaware; and

Each of the Directors, whose names and functions are listed in the Our Directors section on pages 14 and 15 has taken all steps that he or she ought to have taken as a Director in order to make himself/herself aware of any relevant audit information and to establish that the Society's auditors are aware of that information.

Statement of Directors' Responsibilities

The following statement, which should be read in conjunction with the statement of auditors' responsibilities on page 28, is made by the Directors to explain their responsibilities in relation to the preparation of the Annual Report and Accounts, Annual Business Statement and Directors' Report.

The Directors are responsible for preparing the Annual Report and Accounts, Annual Business Statement and Directors Report in accordance with the appropriate law and regulations. The Building Societies Act 1986 (the Act) requires the Directors to prepare Group and Society Annual Accounts for each financial year. Under the Act they are required to prepare the Group and Society Annual Accounts in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU), and applicable law.

The Group and Society Annual Accounts are required by law and IFRS, as adopted by the EU, to give a true and fair view of the state of affairs of the Group and Society as at the end of the financial year and of the income and expenditure of the Group and Society for the financial year, and which provide details of Directors' emoluments in accordance with part VIII of the Act and the regulations made under it.

In preparing the Group and Society Annual Accounts, the Directors are required to:

- Select appropriate accounting policies and apply them consistently;
- Make judgements and accounting estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed subject to any material departures disclosed and explained in the Annual Accounts; and
- Prepare the Annual Accounts on the going concern basis unless it is inappropriate to presume the Group will continue in business.

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

The Directors are responsible for ensuring that the Group:

- Keep adequate accounting records that are sufficient to show and explain the Group's transactions and disclose with reasonable accuracy at any time the financial position of the Group and Society in accordance with the Act; and
- Takes reasonable care to establish, maintain, document and review such systems and controls as are appropriate to its businesses in accordance with the rules made by the Financial Services Authority and Markets Act 2000.

They are also responsible for safeguarding the assets of the Society and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the financial information included on the Group's website. Legislation in the UK governing the preparation and dissemination of Annual Accounts may differ from legislation in other jurisdictions.

On behalf of the Board
David Holborn
Chairman
27 February 2013

Report of the Directors on Corporate Governance

Introduction

In discharging its responsibilities to be accountable to the Society's members for the operation of the Society, the Board regards good corporate governance as extremely important. The UK Corporate Governance Code (the Code), issued by the Financial Reporting Council in June 2010 is addressed to publicly quoted companies, however, the Society's Board considers it to be best practice to have regard to the Code when establishing and reviewing corporate governance arrangements.

A working party operates to ensure the corporate governance procedures and processes within the Society are consistent with the Code on an ongoing basis including when updates or revised guidance are published. In September 2012 a revised Code was issued, which applies to accounting periods beginning on or after 1st October 2012, and the Society will incorporate this into the 2013 Annual Report and Accounts.

This report outlines the approach taken by the Society and how the Board considers it has demonstrated application of the principles of the Code.

The Board

The Society recognises that it must be headed by an effective Board which is responsible for the long- term success of the Society. The composition of the Board is detailed on pages 14 and 15. The Board's Terms of Reference are reviewed on a regular basis and were last agreed by the Board in November 2012. Key responsibilities, included within the Terms of Reference are set out below.

- The Board is responsible for agreeing the overall strategy for the Society, with the responsibility for implementing it being delegated to the Executive team. The Board is responsible for monitoring operational and financial performance in pursuit of the strategy;
- At a dedicated Board "Strategy Day" the Board agrees the strategic plan for the Society ensuring that the necessary financial and operational resources are in place so that the Society can meet its objectives and also that appropriate targets are set against which to review management performance;
- The Board is responsible for risk management, for governance, and for ensuring adequate internal controls. The Board delegates oversight of risk management to the Group Risk Committee, and oversight of internal controls to the Audit Committee;
- The Board completes a formal review of the effectiveness of risk management and internal controls on an annual basis with the latest review completed in January 2013;
- The Board is responsible for overseeing and approving the Society's Recovery and Resolution Plan and monitoring any recovery plan should it need to be invoked;
- The Board is responsible for approving; budgets and forecasts, capital and liquidity plans, and major capital expenditure. In addition, the Board is responsible for final approval of the interim and Annual Accounts on a going concern basis;
- In order to oversee the business, the Board receives and reviews various reports and management information from Board Committees and the Executive team;
- The Board formally reviews its effectiveness, on an annual basis, and by 31st October each year. The Board, at its meeting held on 22 October 2012, carried out this task, and followed up action points at the subsequent meeting held on 26th November 2012. From time to time the Board will consider whether it would be beneficial to use outside consultants to assist in this review process. The Board also has responsibility for overseeing the evaluation process for all Committees of the Board;
- The Executive team have been delegated the task of ensuring that the business operates in a compliant way, with regard to all legislative requirements and guidance, and is focussed on delivery of the Strategic Plan and Budget, Internal Capital Adequacy Assessment Process (ICAAP), Individual Liquidity Adequacy Assessment (ILAA), and also progressing action points deriving from the Board meetings, as appropriate.

There is a clear division of responsibilities between the running of the Board, and the Executive responsibility for the running of the Society's business. No one individual has unfettered powers of decision and the roles of Chairman and Chief Executive are exercised by different people within the Society. There is a need for all Non Executive Directors to be deemed to be independent, a task which is carried out by the Nominations Committee (NomCo) as set out on page 20.

An effective Board should not necessarily be a comfortable place, with challenge, as well as teamwork, being an essential feature. Challenge by Non Executive Directors is something which is encouraged by the Chairman and, where appropriate, training is provided to support the challenge process. A culture of openness exists within the Society and Non Executive Directors are encouraged to meet with members of the Executive team.

David Holborn was appointed Chairman of the Society on 1st January 2011 having first become a Director on 1st January 2003, and at the time of appointment was considered to be independent by the Board. The Board appointed Ron McCormick as Deputy Chairman and Senior Independent Director on 1st January 2011; he provides a sounding board for the Chairman and serves as an intermediary for the other Directors where necessary.

Board balance and independence is important and the Board should include an appropriate combination of Executive and Non Executive Directors (and in particular independent Non Executive Directors) such that no individual or small group of individuals can dominate the Board's decision making. The composition of the Board, through NomCo, reflects an appropriate balance of skills and at the end of 2012 the Board comprised of seven Non Executive Directors and three Executive Directors.

Details of the various Board Committees in existence are set out later in this report.

Board Changes and Elections/Re-elections

It is recognised that changes need to be made to the Board from time to time, and changes during 2012 are set out in the Directors' Report on page 17.

Copies of the Terms of Engagement for all of the Society's Directors are available on request, and at the Annual General Meeting (AGM).

One aspect of the Code provides that all directors of FTSE 350 companies should be subject to annual election by shareholders, and the Building Societies Association considers that this requirement would apply to the twelve largest building societies. Therefore, in line with good corporate governance, all Directors will continue to offer themselves up for annual election/re-election at the Society's AGM, with the exception of David Holborn, who retires as a Director and Chairman at the end of this year's AGM. The biographies of all of the Directors are detailed on pages 14 and 15.

Management Information

The Chairman is responsible for ensuring that the Directors receive accurate, timely and clear information. Members of the Board receive monthly Board and Management Information packs except in August when there is no Board meeting but a Management Information pack is still issued. A rolling Board agenda is tabled at each meeting to ensure all key areas are covered appropriately during the year. Sufficient time is set aside to ensure that constructive discussion and challenge can take place. Once a year, the Board considers whether the regular Management Information which Directors receive is adequate, and this was deemed to be so at the meeting held on 25th April 2012. All Directors have access to independent professional advice, if required, and also access to the services of the Group Secretary.

Board Committees

The Board has a number of Committees, all of which have their own Terms of Reference which are reviewed on an annual basis, further details of which are set out below. The Chairman of each Committee reports to the subsequent Board meeting on the matters discussed at each Committee meeting.

Similar to the Board, each Committee has carried out a review of its own effectiveness, and where improved opportunities have been identified, the individual Committees are responsible for tracking action points. These reviews are carried out on an annual basis and the effectiveness review for each Committee is summarised and presented to the Board for review.

Information concerning attendances at the meetings is detailed on page 22.

Audit Committee

Members of Audit Committee are:

Catherine Vine-Lott (Committee Chairman), Richard Mayland, Ron McCormick and John Morris. Three members of the Audit Committee are qualified accountants who adhere to continuing professional education requirements.

The main responsibilities of the Committee as delegated by the Board are as follows:-

- Financial reporting: to review the accounting policies, to monitor the integrity of the financial statements of the Group including the interim and annual reports, and any other formal announcements relating to the Group's financial performance, and reviewing significant financial reporting judgements contained therein. This includes ensuring the reports present a balanced and clear assessment of the Society's financial position and outlook;
- Internal control and risk management: to review the scope and effectiveness of the Group's internal controls and risk management systems including those for ensuring compliance with the regulatory environment in which the Group operates. The Committee fulfils its responsibilities by reviewing reports prepared by the Business, Group Risk, Internal Audit and External Audit, on a regular basis;
- To review the Society's procedures for detecting fraud and irregularities and to ensure that arrangements are in place by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters, and to ensure that arrangements are in place for independent investigation and appropriate follow up action;
- Internal audit: to monitor the effectiveness of the Group's internal audit function, its independence and objectivity. On a regular basis, the Head of Internal Audit has meetings with members of the Audit Committee only;
- External audit: to oversee the Group's relations with the external auditors, including appointment, removal, independence, objectivity, effectiveness and remuneration. On an annual basis the Audit Committee meets with the External Auditors without management present; and
- The Society has established a policy on the use of the External Auditors for non-audit work which is considered and approved annually by the Audit Committee. The principal purpose of this policy is to ensure the continued independence and objectivity of the External Auditors.

A full copy of the Terms of Reference for the Audit Committee can be viewed on the Society's website (www.newcastle.co.uk) under the Governance section.

Group Risk Committee

The Society has a separate Group Risk Committee, and further details of the Committee's responsibilities are set out in the Risk Management Report on page 25.

Members of Group Risk Committee are:

David Buffham (Committee Chairman), Ron McCormick, Phil Moorhouse, Jim Willens and Angela Russell.

A full copy of the Terms of Reference for the Group Risk Committee can be viewed on the Society's website (www.newcastle.co.uk) under the Governance section.

Remuneration Committee

The Society has a separate Remuneration Committee comprising only of Non Executive Directors, and further details of the Committee's membership and responsibilities are set out on page 23 within the Remuneration Committee Report.

A full copy of the Terms of Reference for the Remuneration Committee can be viewed on the Society's website (www.newcastle.co.uk) under the Governance section.

Nominations Committee (NomCo)

The Society has a separate NomCo comprising only of Non Executive Directors, and which operates within the Terms of Reference agreed by the Board. The Terms of Reference and the effectiveness of NomCo are reviewed on an annual basis with the last review completed on 26th November 2012.

Members of NomCo are:

David Holborn (Committee Chairman), David Buffham and Richard Mayland.

The main objectives of NomCo are summarised as follows:

- To oversee the structure of the Board and Board Committees;
- To identify suitable candidates to fill Board vacancies;
- To ensure that the Board has the appropriate balance of skills, experience, independence and knowledge; and
- To oversee the Board's succession plan.

A full copy of the Terms of Reference for NomCo can be viewed on the Society's website (www.newcastle.co.uk) under the Governance section.

All key decisions of NomCo, for example, Board appointments, must also be ratified by the full Board.

NomCo operates to a rolling agenda in order to ensure it discharges its full responsibilities. It normally meets twice a year however; in 2012 it met on three occasions.

NomCo is supported by the Chief Executive and Human Resources Executive who attend meetings in an advisory capacity only.

Appointments to the Board

NomCo follows a stringent recruitment process when making appointments to the Board. This process is tailored to meet the requirements of each particular vacancy and the method of attracting candidates is adapted depending on the nature of the skills required for the vacancy. External consultants and advisors are normally utilised to ensure there is a robust list of suitable candidates with which to fill a vacancy. All Board appointments are made on merit against objective criteria with the need for diversity always considered however the key driver is to appoint the best person to do the job.

Whenever new Directors are appointed the Financial Services Authority has the right to carry out formal "Significant Influence Function" (SIF) interviews in order that they become "Approved Persons".

All Directors have been issued with Role Descriptions and Terms of Engagement for Non Executive Directors to ensure that all Directors fully understand and comply with their role and the responsibilities of being a Director of the Society.

No appointments were made to the Board during 2012. During 2012 a rigorous process was followed to identify the successor Chairman of the Society, reflecting the key skills and attributes required to fill such a senior role with the Society.

Re-election to the Board

It has been agreed previously by the Board that all Directors should be required to seek annual re-election, which will take place at the forthcoming Annual General Meeting, to be held on 24th April 2013 with the exception of Mr FD Holborn who is standing down as a Director and Chairman at the end of this year's AGM.

Non Executive Directors are usually expected to serve two full three year terms, subject to satisfactory performance evaluations and re-election by members. They may also be proposed for a further third term but only in exceptional circumstances will Non Executive Directors be able to seek re-election when they have served nine years on the Board. During 2011, NomCo has in place a risk based succession plan which is reviewed at each meeting as part of the standing agenda.

Independence of Directors

The Terms of Engagement for Non Executive Directors require that they declare to the Society any other external interests.

NomCo carries out an annual review of the independence of Non Executive Directors, and the last review was carried out on 21st January 2013. In the opinion of NomCo, and subsequently agreed by the Board, each of its Non Executive Directors is independent in both character and judgement. One of the Non Executive Directors, Catherine Vine-Lott, is Chairman of Openwork Holdings Limited, which pays commission to Newcastle Financial Services Limited, a wholly owned subsidiary of the Society. The Board has determined that she is independent, notwithstanding the existence of this relationship, and under the Conflicts of Interest Policy, she has undertaken to advise the Board if any conflict arises.

The Society recognises it is good corporate governance to have a Senior Independent Director. This role has been held by the Society's Deputy Chairman, Ron McCormick since 1st January 2011 and it is intended that, subject to re-election, he continues in this role.

During 2012 the Chairman met separately with the Non Executive Directors on two occasions, without the Executive Directors present, in addition to regular telephone contacts with the Non Executive Directors throughout the year.

Assessment of Directors

All Directors are subject to a formal appraisal of their performance on an annual basis.

The Chairman conducts the appraisals of the Chief Executive and Non Executive Directors, the Chief Executive conducts the appraisals of the Executive Directors, and the Deputy Chairman/Senior Independent Director leads the appraisal of the Chairman.

An assessment of the Directors was last undertaken during February 2013.

Skills and Continuous Development

All Directors are required, as part of their terms of engagement, to follow a process of continuous development to ensure that their skills and experience meet the needs of the Society and the regulatory environment in which it operates. The training and development plans of Non Executive Directors are reviewed at least annually during their performance appraisal.

The Committee oversees the on-going training and development of Non Executive Directors including a formal induction programme for newly appointed Directors. The Chief Executive oversees the programmes for Executive Directors.

In order to ensure that the Committee discharges its duties in this area effectively, a new skills matrix and training menu for Non Executive Directors has been put in place.

Newcastle Strategic Solutions Limited (Solutions)

Members of Solutions are:

Ron McCormick (Solutions Chairman), Phil Moorhouse, Gillian Tiplady, Nigel Wright (Non Executive Director only of Solutions) and Phil Grand (Customer Services Executive).

The main responsibilities of Solutions as delegated by the Board:

- To oversee the strategic direction of Solutions ensuring this is consistent with the Society's agreed strategy;
- To evaluate and monitor the financial and operational performance of Solutions against pre-determined objectives, which includes assessing performance in terms of sales, profitability, efficiencies, risk and compliance;
- Approval of new contracts where required under the Society's risk appetite and delegation of authorities;
- To ensure that Solutions complies with all relevant legislation and the appropriate regulations relating to its activities;
- To review Solutions' risk appetite statement on a regular basis, including the stressed scenarios for the Solutions business and the requirement for any additional capital;
- To overview and monitor the activities of Newton Facilities Management Limited (NFML) including assessing sales performance, profitability, efficiencies, risk and compliance;
- To ensure that an annual review of service resilience is conducted;
- To approve the Solutions statutory accounts; and
- To consider and act upon the findings of internal and external audit reviews.

Board and Board Committee Membership Attendance Record

The table below sets out the number of meetings attended by Directors during 2012 with the number in brackets representing the maximum number of meetings the Director was eligible to attend.

Director	Board	Audit Committee	Group Risk Committee	Remuneration Committee	Nominations Committee	Solutions
David Holborn	12 (12)	-	-	-	3 (3)	-
Ron McCormick	11 (12)	4 (6)	5 (6)	-	-	8 (8)
Jim Willens	12 (12)	-	5 (6)	-	-	-
David Buffham	12 (12)	-	6 (6)	3 (3)	3 (3)	-
Richard Mayland	10 (12)	6 (6)	-	3 (3)	3 (3)	-
Phil Moorhouse	12 (12)	1 (1)	3 (4)	-	-	6 (6)
John Morris	12 (12)	5 (5)	2 (2)	-	-	-
Angela Russell	12 (12)	-	6 (6)	-	-	-
Gillian Tiplady	11 (12)	-	-	-	-	2 (3)
Catherine Vine-Lott	12 (12)	6 (6)	-	3 (3)	-	-
John Warden	6 (7)	-	-	-	-	4 (5)

Relations with Members

Member engagement is at the heart of our strategy and the Society develops relationships with members on a number of different levels. The first and most obvious is through the AGM voting process where we encourage members, as owners of the business, to use their vote and we try to make this process as easy as possible.

Understanding what members think about our products and service is also extremely important. Members are encouraged to join our customer panel and we regularly consult with this group on a range of topics. We also use customer satisfaction surveys extensively and obtain feedback from different types of product holders and from customers who choose to deal with us through our main channels i.e. our branches, over the telephone, by post and via the internet. The information which is collected is used to develop and improve our offering.

Special members' seminars are held on a regular basis and are designed to provide our customers with useful information to help them understand and make sense of what is becoming an increasingly uncertain financial world. These seminars provide an excellent opportunity not only to speak to our members but also to interact and listen to their views.

Through our Corporate Social Responsibility (CSR) activities we are able to engage with both our members and the communities we serve. Whether it is helping to raise money for local, worthy causes, or helping to develop financial education in local schools, we try hard to make a difference and improve the well being of people who live within our heartland. Further details are included on pages 12 and 13 of the Annual Accounts.

Annual General Meeting

The Annual General Meeting provides an opportunity for members to question the Chairman, Chief Executive, Committee Chairmen and fellow Directors on the resolutions to be proposed at the meeting, the Annual Report and Accounts, and on any other aspect of the Society's business.

All members who are eligible to vote at the Annual General Meeting are encouraged to participate, either in person or by using their proxy voting form. The use of the online voting system is encouraged and for each vote placed online, the Society will be donating 20p to its charity of the year. All votes are counted by independent scrutineers. As soon as practicable after the AGM, full details of the results of the voting are placed on the Society's website.

On behalf of the Board
David Holborn
Chairman
27 February 2013

The Remuneration Committee (RemCo) operates within the Terms of Reference (TOR) agreed by the Board. The TOR are reviewed annually and were last reviewed on 26th November 2012. The effectiveness of the committee is also reviewed on an annual basis and was last reviewed on 26th November 2012.

The main objectives of the committee are summarised as follows:

- To ensure compliance with the applicable principles of the FSA's Remuneration Code (the Code);
- To consider and make recommendations to the Board on executive remuneration and conditions of employment;
- Consideration of proposals from the Chief Executive for changes to the level of fees for Non Executive Directors including approving the fees for the Chairman;
- Approval of the Society's Remuneration Policy Statement including ensuring it is aligned with the Society's strategy and objectives;
- Approval of the Pillar 3 remuneration disclosures; and
- To consider and make recommendations to the Board on the general framework of staff bonus schemes ensuring these include risk management assessments.

Composition of the Committee

The committee consists solely of Non Executive Directors.

Members of RemCo are:

Catherine Vine-Lott (Chairman of the committee), David Buffham and Richard Mayland.

The attendance record of the committee is shown on page 22. The committee operates to a rolling agenda in order to ensure that it fully discharges its responsibilities. It normally meets at least three times each year. The committee is supported by the Chief Executive and Human Resources Executive who attend meetings in an advisory capacity only. The Chief Executive does not attend any part of the meeting where his own remuneration is being discussed.

FSA Remuneration Code

The Society has been governed by the Code since 1st January 2011. The FSA issued general guidance on proportionality which resulted in a re-classification of the Society from a 'Tier 2' to a 'Tier 3' firm. This re-classification gives the Society the ability to disapply several Remuneration Code Principles in relation to; retained shares or other instruments; deferral; and performance adjustment. The Remuneration Committee agreed to disapply these principles subject to annual review.

The remaining key requirements of the Code affecting the Society are summarised below:

- To establish a Remuneration Committee;
- To maintain a Remuneration Policy Statement; and
- To maintain a list of employees whose professional activities have a material impact on its risk profile – such staff are known as 'FSA Code Staff'.

The Remuneration Committee have reviewed and monitored all remuneration policies and processes during 2012 and consider that the Society fully complies with the requirements of the Code.

FSA Code Staff

The Committee considers that at 31 December 2012 there are 14 employees that should be categorised as Code Staff and these include:

- All Executive Directors (3)
- Executives and senior managers responsible for key control functions (5) – Group Risk Executive, Head of Business Assurance, Head of Compliance, Money Laundering Reporting Officer and Senior Underwriting Manager; and
- All other Executives (6)

A summary of the remuneration of Code Staff and the business areas in which they operate is shown on page 24. One code staff member left the Society in the year (the Operations Director) and details are given on page 24.

Remuneration Strategy

The Society's remuneration strategy is summarised opposite.

Basic Salaries

Remuneration packages are normally set at a level to attract, motivate and retain Executives, Officers and staff of the Society of the calibre necessary to oversee the operations of the Society. Basic salaries are normally set by taking into account salary levels within similar sized financial services organisations and the market as a whole, so as to attract and retain the skill levels that are appropriate. A £500 across the board pay increase was awarded to all staff, except Executive Directors, in April 2012.

Performance Related Bonuses

In recognition of the continued progress and achievement of the Society's corporate key performance indicators (KPIs), the Remuneration Committee approved a modest payment of 2.5% under the Society's Corporate Bonus Scheme. The payment was made to all staff, with the exception of the Chief Executive and Finance Director who declined the offer of payment. The KPI's underpinning the Corporate Bonus Scheme are based on the following:

- Financial Performance covering profitability, capital and liquidity;
- Focus on Members including achievement of service levels, customer satisfaction and increasing numbers of members;
- Achievement of staff engagement strategies and improved employee satisfaction;
- Success of the Solutions Business; and
- Achievement of key objectives to deliver projects and de-risking.

The corporate KPI's are reviewed annually and are fully aligned with the latest strategic plan approved by the Board.

There are no separate bonus schemes for Executive Directors.

Sales related incentive and bonus schemes continued to be operated for most sales staff in 2012. Bonus payments were set in such a way as to ensure that they promoted the financial strength of the Society, put members' interests first, did not reward failure and did not encourage the taking of risks outwith the Society's agreed risk appetite, this included the risk appetite for conduct risk. The Society has withdrawn incentive schemes for the majority of staff in January 2013 with staff now covered by the Corporate Bonus Scheme only.

The Committee has monitored the operation of bonus schemes throughout 2012 to ensure compliance with the Code and the Society's Remuneration Policy Statement.

The performance of all staff, including Code Staff, is reviewed at least annually via a formal appraisal process.

Exceptional Items

The Committee is required to report any exceptional items such as 'sign-on' or severance payments made to Code Staff. It is confirmed that there was one such payment made in respect of the role of Operations Director becoming redundant as shown on page 24.

Pensions

All staff (including Executive Directors and Executives) are eligible for membership of the Newcastle Building Society Group Personal Pension Scheme, which is a defined contribution scheme. The Newcastle Building Society Pension and Assurance Scheme (a 'defined benefit' scheme) has been closed to active membership since November 2010 and has been closed to new entrants since 2000. None of the current directors participated in this scheme.

Other Benefits

All Executive Directors and Executives are eligible for a range of taxable benefits, which include a motor vehicle or cash equivalent, private health care and the ability to participate in a concessionary mortgage scheme. Cover for a lump sum on death in service is also provided. None of the Executive Directors or Executives participated in the concessionary mortgage scheme during the year.

Service Contracts

It is the Society's policy to provide six months notice of termination for all Executive Directors and all of the current Executive Directors have such notice periods. Four of the longer serving Executives have service agreements, which provide for 12 months notice of termination from the Society. The remaining Executives all have notice periods of six months. It is the policy of the Society to employ all newly appointed Executives with notice periods of six months. There are no contracts of employment for Non Executive Directors and no compensatory terms for loss of office.

Remuneration Committee Report (cont)

Policy on Remuneration of Non Executive Directors

Non Executive Directors fees are set at a level appropriate to reflect the skills and time required to oversee the Society's operations and progress. Non Executive Directors receive a base fee and additional fees depending upon the Board Committees on which they sit or chair.

Fees are normally reviewed annually in light of those paid to directors of other similar financial services organisations. The Non Executive Directors do not determine their own fees.

The CEO recommends the fees for Non Executive Directors. The Remuneration Committee then agree any such recommendations before they are ratified by the full Board i.e. by Non Executive Directors and Executive Directors. Fees were subject to a general across the board increase of £500 in April 2012. Non Executive Directors do not participate in any bonus or pension scheme.

Directors' Emoluments (Audited)

Emoluments of the Society's Directors from the Society and its subsidiary undertakings are detailed below:

	Salary or fees	Annual bonus	Pension contributions to defined contribution scheme (Note 1)	Other benefits	Total 2012 contractual benefits	2011 total
	£000	£000	£000	£000	£000	£000
Executive Directors						
JH Willens - notes 1 and 3	260	-	-	37	297	309
AM Russell - notes 2 and 3	145	-	13	10	168	168
G Tiplady	120	3	8	11	142	139
JH Warden (resigned 30th June 2012) note 4	70	-	6	6	82	164
	595	3	27	64	689	780
Non Executive Directors						
DJ Buffham	40	-	-	-	40	38
FD Holborn	62	-	-	-	62	62
RD Mayland	40	-	-	-	40	43
RJ McCormick	50	-	-	2	52	52
J Morris (appointed 31 October 2011)	35	-	-	-	35	6
PJ Moorhouse (appointed 31 October 2011)	38	-	-	-	38	6
CRR Vine-Lott	41	-	-	2	43	41
AM Cairns (resigned 30 June 2011)	-	-	-	-	-	16
NA Westwood (retired 28 November 2011)	-	-	-	-	-	30
Total for Non Executive Directors	306	-	-	4	310	294
Total for all Directors	901	3	27	68	999	1,074

Notes:
1. Mr JH Willens has elected to take his pension contribution amounting to £23,400 as a cash payment. He is liable for his own Tax and National Insurance Contributions on this payment.
2. Mrs AM Russell's salary was increased to £150,000 on 1 April 2011 however, Mrs Russell has elected not to accept the increase yet.
3. Mr JH Willens and Mrs AM Russell declined their bonus entitlement of 2.5% of basic salary due under the Society's 2012 Corporate Bonus Scheme.
4. Mr J H Warden received compensation for loss of office amounting to £82,600

Summary of the Remuneration of FSA Code Staff

A summary of the remuneration of Code Staff during 2012 and the business areas in which they operate is shown below.

Category	Typical Functions	Number in Category	*Fixed Remuneration £000	Variable Remuneration £000	Total Remuneration 2012 £000	Total Remuneration 2011 £000
Executive Directors	CEO, Finance Director, Business Services Director, Operations Director	4	686	3	689	780
Sales & Marketing Executives	Sales & Marketing	2	210	4	214	212
Control Functions	Business Assurance, Risk Management, Compliance, Underwriting	5	333	7	340	343
Other Executives	Treasury, Information Technology, Operations, Human Resources	4	366	9	375	379
Total		15	1,595	23	1,618	1,714

*Includes benefits and pension contributions.
There was no deferred remuneration in 2012 or in 2011.

Catherine Vine-Lott
Chair - Remuneration Committee
27 February 2013

Risk Management Report

Overview

The Society's Group Risk Committee oversees the management of risk across the Group and is supported by the Group Risk department and various sub-committees. The Society and Group risk management framework operates under the "three lines of defence" principle.

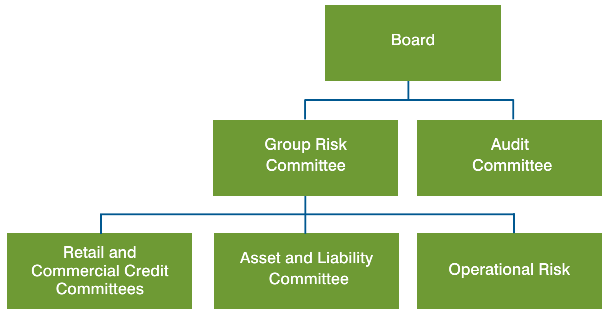
The first line of defence is within departments, business units and subsidiaries where Executives, Managers and staff have responsibility for risk management and ensuring adequate controls are in place to mitigate risk.

The second line of defence is provided by the Group Risk Committee and supporting sub-committees together with oversight by the Group Risk department.

The third line of defence is provided by Business Assurance and the Audit Committee, which are responsible for reviewing the effectiveness of the first and second lines of defence.

Risk Governance

Risk Governance Structure



The Group Risk Committee is a Board Committee that has responsibility, under its detailed terms of reference, for considering and co-ordinating the approach to risk management across the Group in the following key areas:

- Oversight of overall risk appetite, risk management strategy and framework, including oversight of both prudential and conduct risk appetites;
- Oversight of compliance with risk policy statements and approval of changes to those policies on an annual basis, or more frequently where market conditions require;
- Oversight of the Retail and Commercial Credit Committees, and of the Asset and Liability Committee;
- Oversight of Operational Risk and the governance of Operational Risk by the Executive;
- Review and assessment of the adequacy of risk management information to monitor and control risks;
- Approval of new initiatives and projects, including the risks those initiatives and projects expose the Group to and the amount of capital required to cover those risks;
- Consideration and approval of the top risks for the Society and Group including low likelihood, high impact risks;
- Approval and recommendation to the Board of both the Internal Capital Adequacy Assessment Process (ICAAP) and the Individual Liquidity Adequacy Assessment (ILAA) ; and
- Consideration and approval of stress testing scenarios including reverse stress tests.

The Group Risk Committee normally meets six times a year and is supported by four Executive committees that meet on a monthly basis, as follows:

The Retail Credit Committee is responsible for credit risk across the Group arising from the retail mortgage portfolio as follows:

- Review of lending policy statements and compliance therewith;
- Review of risk metrics and management information for the retail mortgage portfolio;
- Review and approval of arrears and possessions policy (including breach policies) and compliance therewith;
- Sanction of larger loans in accordance with the lending policy statement;
- Review and approval of new types of mortgage products including ensuring return on capital employed meets internal benchmarks and that risks have been effectively considered and mitigated;
- Performance review of underwriters, panel managers and brokers;
- Review of credit risk profile of existing retail mortgage book including trends on arrears (both historical and against the market), losses and capital requirements;
- Review of key economic data impacting credit risk including trends on unemployment, house prices, arrears rates, affordability, inflation and confidence indices;
- Review of credit control activity levels including customer contact volumes, forbearance measures granted, disturbed payment patterns and changes in behavioural scoring. This includes reviewing the effectiveness of forbearance measures granted to customers;
- Review and approval of stress testing assumptions and outputs including monitoring of trends;
- Review of arrears and possessions reports including causal factors and lessons learned; and
- Review of Mortgage Indemnity Guarantee (MIG) policy arrangements.

The Commercial Credit Committee is responsible for credit risk across the Group's non-retail mortgage portfolio as follows:

- Review of non-retail policies and compliance therewith;
- Review of risk metrics and management information for the non-retail mortgage portfolio;
- Monitor compliance with controls and limits set out in the policies;
- Review of credit risk profile of existing mortgage book including trends on arrears, losses and capital requirements;
- Review of key performance indicators in relation to the delivery of the commercial strategy;
- Review of risk indicators and risk factors. This includes review of tenant and borrower watch-lists and sector specific reports;
- Approval of annual reviews, breach reports, loan renegotiations and restructures, in accordance with the delegation of authorities;
- Review and approval of stress testing assumptions and outputs including monitoring of trends;
- Review of key trends in commercial property markets including values, yields and levels of activity; and
- Approval of changes to the Risk Grade Scorecard and monitoring the effectiveness thereof.

Operational Risk is overseen by the Executive Committee (see below) and its remit includes:

- Review of operational risk policy and other related risk and compliance policy statements;
- Monitoring compliance with policies;
- Review of risk indicators in risk dashboards including risk event trends across the business, actions being taken on significant risk events, and status of project risks;
- Review of conduct risk indicators, via monthly dashboards, including in relation to Compliance monitoring, Mortgage Conduct of Business (MCOB), Giving Customers a Fair Deal (formerly Treating Customers Fairly), Complaints, Information Security and Fraud monitoring;
- Approval of corporate insurance policy statement, status of claims and effectiveness of policies at mitigating operational risk; and

- Review of business continuity policy, disaster scenarios and results of annual disaster recovery test.

The Executive Committee includes the Executive Directors and other officers listed on page 69.

The Asset and Liability Committee (ALCO) is responsible for all aspects of treasury risk management including liquidity risk, interest rate risk, treasury counterparty credit risk and balance sheet management. The ALCO terms of reference cover the following areas:

- Review of Treasury Policy Statement and compliance therewith;
- Review of treasury dealing strategy and compliance with risk appetite statement;
- Management of balance sheet assets and liabilities;
- Review of risk dashboards covering all aspects of treasury, liquidity, funding and interest rate risk, including basis risk;
- Setting of interest rate view;
- Review of wider treasury markets and economic backdrop to assess the impact on the Society's funding and liquidity requirements;
- Detailed review and agreement of cashflow requirements across the business on a rolling 24 month basis;
- Monitoring of interest rate risk and hedging activity, including profit performance;
- Review of treasury counterparty limits and country limits including assessing the impact of ratings changes;
- Review of funding including sources, mix and compliance with limits;
- Review of contingency funding plans;
- Review of liquidity requirements and compliance with limits;
- Review and approval of results of liquidity stress testing scenarios; and
- Review and approval of product pricing including rate changes, mix of new business and maturity defence strategy.

The Group has detailed risk management policies setting out how risk is managed across the Group, including specific risk appetite statements. The risk appetite statement outlines for each risk area the basis on which risks are accepted or declined. This forms the basis for various limits and key criteria, set out in the policies that must be followed in order to mitigate risk exposures.

These limits are embedded into daily, weekly and monthly management and Board reporting in order to monitor compliance with the Society's risk profile.

Other governance structures exist as outlined in the Report of the Directors on Corporate Governance on pages 19 to 22.

Risk Appetite

The Board approved risk appetite statements consider profit and loss in a moderate stress scenario; capital adequacy in a severe stress; and the existence of "tail risks" – low likelihood high impact risks. They also consider measures relating to the fair treatment of customers and conduct risk. They set out limits and escalation triggers in relation to liquidity, Solutions business, credit risk, operational risk, compliance monitoring, and complaints. Policies, including credit risk policies, treasury policies, operational risk policies, and the Retail Conduct Risk Appetite Statements, set limits to ensure that the Society complies with its Board approved risk appetite statements. The risk appetite statements are subject to annual review and approval by the Board and performance against the risk appetites is monitored on a quarterly basis by the Board.

Credit Risk

Credit risk is the risk that a treasury counterparty, debtor or borrower will not be able to meet their obligations as they fall due. Credit risk arises primarily on retail and commercial loans, and on treasury assets held for liquidity purposes. The Group has comprehensive policies in place covering credit risk management that set out criteria that must be followed before funds are advanced and in corporate limits for concentration risk arising from, inter alia, large exposures, geographical areas and lending types. Return on Capital Employed benchmarks are set to ensure that reward is commensurate with the risk taken; once the risk is considered acceptable to the Society.

For retail lending the Group operates manual underwriting procedures to prudent policy criteria, including restrictions on loan to value, income multiples/rental cover, and affordability criteria.

The Group does not undertake sub-prime or self-certification lending. The level of Buy to Let (BTL) lending has been capped via the application of portfolio limits that reflect the risk appetite for this type of lending.

The Commercial Risk division continues to monitor the performance of the commercial and residential investment portfolios through annual reviews and key risk management information, including tenant and borrower watchlists, arrears trends, breach reports and general market and sector specific information. The Society has a range of Committees established to oversee risk within the Commercial portfolio including Commercial Credit Committee, Risk and Recovery Committee, Watch Committee and the Provisioning Committee.

A collections team operates, which has a more targeted approach to collections and recovery for commercial and BTL portfolio borrowers, featuring a rapid response where difficulties are identified such as late payments, tenant failure, ratings downgrades and general negative market news. The Society has a credit risk management information department that monitors and reports credit risk within the mortgage portfolio, including stress testing.

Credit risk on liquid assets is controlled via the operation of counterparty, sector, instrument, and country limits for treasury assets. Counterparty limits are set with regard to external ratings agency assessments with the Society investing only in highly rated financial institutions or other building societies. The Society supplements ratings agency information with more extensive credit assessment procedures for counterparty limits including market information and movement on credit default swap (CDS) spreads for countries and individual counterparties. Treasury counterparty risk is monitored within Treasury Middle Office in accordance with the Treasury Policy Statement. All treasury counterparty ratings, CDS spreads and market information are monitored in real time and prompt action is taken where volatile market conditions require a tightening of criteria.

Liquidity Risk

Liquidity risk is the risk of loss or failure caused by the Group being unable to meet its liabilities or commitments as they fall due, or to be able to do so only at excessive cost. The nature of the business of a building society is to lend longer-term (typically up to 25 years) and fund with short term savings accounts. This leads to a maturity mismatch between assets and liabilities.

The Group's liquidity policy is to maintain sufficient liquid resources to cover cash flow imbalances and fluctuations in funding and enable the Group to meet its financial obligations when they fall due. This is achieved by maintaining a prudent level of liquid assets and ensuring that funding and lending plans are balanced.

The Society has continued to invest in liquidity of the highest quality and further details are provided within the Business Review on pages 9 and 10.

Conduct Risk

Conduct risk is the risk of poor consumer outcomes, resulting from poorly designed or targeted products, mis-selling of products, inadequate controls relating to fraud prevention and detection or to prevent money laundering.

The Group has established a conduct risk framework including a Retail Conduct Risk Appetite statement supported by detailed policies relating to Compliance, Giving Customers a Fair Deal (formerly Treating Customers Fairly), Fraud, and Anti-Money Laundering. Compliance with the Retail Conduct Risk Appetite statement is monitored by the Executive on a monthly basis and by the Group Risk Committee on a quarterly basis.

The Group has a Product Approval Committee which approves all products. Included in the terms of reference for the Product Approval Committee is consideration of risks to consumer outcomes arising from products or services.

Operational Risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, people and systems, or from external events. For the Group this definition includes legal risk, strategic risk and reputational risk.

The Group has a well established operational risk framework with a detailed Operational Risk Policy that sets out the framework for operational risk, including the measurement and management of risk, operational risk appetite, tracking of risk events and operational losses, timescales for implementation of action plans and escalation procedures for more serious risk events that require immediate action to mitigate loss.

A key feature of the Group's operational risk framework is that key risks and controls are identified for all areas of the business ranging from the high level risks, discussed at Board level, down to the risks within individual departments. Risk assessments remain the responsibility of the relevant departmental managers and Executives, and are updated regularly for new risks, the results of risk events and following internal audit reviews.

As the Society's business model includes diversification via the Solutions Business, this increases exposure to operational risk particularly in relation to IT systems capability and human error.

Risks are scored in terms of the impact and probability of the risk arising and are scored before and after considering the impact of controls. The operational risk system is also utilised by Business Assurance with the audit inspection plan based on high scoring risk areas or where there is significant reliance on key controls to mitigate the impact of otherwise significant risks. Group Corporate Insurance policies are also negotiated with full regard to the key risks within the Group requiring greater mitigation.

Pension Obligation Risk

The Group has funding obligations for a defined benefit scheme which is closed to new entrants. It was closed to future benefit accrual with effect from 30 November 2010. Pension risk is the risk that the value of the Scheme's assets, together with any agreed employer contributions, will be insufficient to cover the projected obligations of the Scheme over time. The return on assets, which includes equities and bonds, will vary with movements in equity prices and interest rates.

The projection of the Scheme's obligations includes estimates of mortality and inflation, the actual out-turn of which may differ from estimates. The Scheme is also exposed to changes in pension legislation. To mitigate these risks the Trustees of the Scheme, in consultation with management, regularly review reports prepared by the Scheme's independent actuary and take appropriate actions including adjusting the investment strategy.

The Group also performs stress testing on the pension scheme liabilities and assets as part of capital planning as set out in the ICAAP.

Market Risk

The principal market risk to which the Group is exposed is interest rate risk. The Group has no exposure to foreign currency and only a very moderate direct net exposure to equities through a small shareholding in Standard Life arising from the demutualisation of the insurance company in 2006. The Group has an indirect exposure to the performance of equities through its defined benefit pension scheme.

Interest rate risk arises on mortgages, savings and treasury instruments due to timing differences on re-pricing of assets and liabilities and the imperfect matching of interest rates between different asset and liability types. This risk is managed using financial instruments including derivatives. Natural hedging strategies are also utilised e.g. matching two year fixed rate mortgages with two-year fixed rate bonds.

The Group's risk appetite for interest rate risk is documented in the Treasury Policy Statement and includes limits for the maximum adverse impact on net interest margin, maximum value at risk, basis risk, as well as limits to minimise gaps in specific time buckets.

The table below describes the activities undertaken by the Group and the derivatives used to manage the associated risks.

ACTIVITY	RISK	TYPE OF HEDGE
Fixed rate savings products and funding instruments	Sensitivity to fall in interest rates	Fair value interest rate swap
Fixed rate mortgage products and funding investment instruments	Sensitivity to rise in interest rates	Fair value interest rate swap
Index-linked savings products	Sensitivity to changes in underlying indices	Fair value hedges with index-linked swaps
General balance sheet management	Sensitivity to different types of interest rates moving in different ways e.g. LIBOR and Base Rate	Basis risk swaps

Derivatives are only used by the Group in accordance with the Building Societies Act 1986. These instruments are not used for trading or speculative purposes and their sole purpose is to mitigate risks arising from movement in interest rates or indices.

Note 33 gives details of the derivative financial instruments held at 31 December 2012.

Capital Management

Capital adequacy is monitored on a monthly basis by the Board and the 3 year capital plan has been updated on a regular basis between ICAAP reviews against the background of changing economic circumstances. The Group maintains its capital at a level in excess of Individual Capital Guidance notified by the FSA.

Under Basel II Pillar III (disclosure) the Group is required to publish further information about risk exposures. The Group's Pillar III disclosures will be published on the Society's website (www.newcastle.co.uk) shortly after the publication of these accounts.

David Buffham
Chair - Group Risk Committee
27 February 2013

Independent Auditors' Report to the Members of Newcastle Building Society

We have audited the Group and Society Annual Report and Accounts of Newcastle Building Society for the year ended 31st December 2012 which comprise Group and Society Income Statements, Group and Society Statements of Comprehensive Income, Group and Society Balance Sheets, Group and Society Statements of Movements in Member's Interests, Group and Society Cash Flow Statements, and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union.

Respective Responsibilities of Directors and Auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 18, the directors are responsible for the preparation of the Annual Report and Accounts which give a true and fair view. Our responsibility is to audit and express an opinion on the Annual Report and Accounts in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

This report, including the opinions, has been prepared for, and only for, the Society's Members as a body in accordance with Section 78 of the Building Societies Act 1986 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements Annual Report and Accounts

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

Opinion on Annual Report and Accounts

In our opinion the Annual Report and Accounts:

- Give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's and the Society's affairs as at 31st December 2012 and of the Group's and the Society's income and expenditure and cash flows for the year then ended; and
- Have been prepared in accordance with the requirements of the Building Societies Act 1986 and, as regards the group Annual Report and Accounts, Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Building Societies Act 1986

In our opinion:

- The Annual Business Statement and the Directors' Report have been prepared in accordance with the requirements of the Building Societies Act 1986;
- The information given in the Directors' Report for the financial year for which the Annual Report and Accounts are prepared is consistent with the accounting records and the financial statements Annual Report and Accounts; and
- The information given in the Annual Business Statement (other than the information upon which we are not required to report) gives a true representation of the matters in respect of which it is given.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Building Societies Act 1986 requires us to report to you if, in our opinion:

- Proper accounting records have not been kept by the Society; or
- The Group and Society Annual Report and Accounts are not in agreement with the accounting records; or
- We have not received all the information and explanations and access to documents we require for our audit.

Karyn Lamont (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Newcastle upon Tyne
27 February 2013

Income Statements for the year ended 31 December 2012

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Interest receivable and similar income	2	**110.3**	103.2	**110.8**	103.7
Interest payable and similar charges	3	**(90.4)**	(85.7)	**(90.4)**	(85.7)
Net interest income		**19.9**	17.5	**20.4**	18.0
Other income	4	**28.8**	27.3	**24.7**	20.6
Other charges	4	**(0.9)**	(0.6)	**(0.9)**	(0.6)
Gains less losses on financial instruments and hedge accounting		**0.7**	0.6	**0.7**	0.6
Loss recognised on revaluation of investment properties held for sale	18	**(1.0)**	(0.1)	**-**	-
Dividend income	5	**-**	-	**-**	3.0
Total operating income		**47.5**	44.7	**44.9**	41.6
Administrative expenses	6	**(34.5)**	(32.6)	**(30.6)**	(30.1)
Depreciation	17	**(2.6)**	(2.9)	**(2.4)**	(2.7)
Operating profit before impairments, provisions, FSCS levy and exceptional items		**10.4**	9.2	**11.9**	8.8
Impairment credit / (charge) on loans and advances to banks	11	**0.7**	(0.2)	**0.7**	(0.2)
Impairment credit on debt securities	12	**-**	0.9	**-**	0.9
Impairment charges on loans and advances to customers	14	**(8.3)**	(12.3)	**(8.3)**	(12.3)
FSCS levy	26	**(2.1)**	(1.4)	**(2.1)**	(1.4)
Gain on disposal of Prepaid Cards Business	10	**0.8**	3.9	**0.8**	3.9
Profit / (loss) for the year before taxation		**1.5**	0.1	**3.0**	(0.3)
Taxation expense	8	**(1.5)**	(0.8)	**(3.0)**	-
Result after taxation for the financial year		**-**	(0.7)	**-**	(0.3)

Statements of Comprehensive Income for the year ended 31 December 2012

		2012 £m	2011 £m	2012 £m	2011 £m
Result for the financial year		**-**	(0.7)	**-**	(0.3)
Other comprehensive income / (expense)					
Movement on available for sale reserve		**6.8**	(0.5)	**6.8**	(0.5)
Actuarial loss on retirement benefit obligations	31	**(6.7)**	(3.9)	**(6.7)**	(3.9)
Income tax relating to components of other comprehensive income	19	**(0.1)**	1.1	**(0.1)**	1.1
Other comprehensive expense for the financial year, net of tax		**-**	(3.3)	**-**	(3.3)
Total comprehensive expense for the financial year		**-**	(4.0)	**-**	(3.6)

The notes on pages 34 to 67 form part of these Accounts.

Balance Sheets at 31 December 2012

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
ASSETS					
Cash and balances with the Bank of England		364.4	162.3	364.4	162.3
Loans and advances to banks	11	175.4	254.1	175.3	254.0
Debt securities	12	574.3	764.5	574.3	764.5
Derivative financial instruments	33	38.1	44.3	38.1	44.3
Loans and advances to customers	14	2,727.6	2,976.6	2,707.2	2,951.0
Fair value adjustments for hedged risk	15	40.0	57.9	40.0	57.9
Assets pledged as collateral	13	54.0	85.1	54.0	85.1
Investment in subsidiaries	16	-	-	41.7	47.5
Property, plant and equipment	17	23.0	23.9	14.6	15.3
Investment properties held for sale	18	14.0	15.9	-	-
Deferred tax assets	19	11.6	13.6	11.0	13.5
Other assets	20	17.7	20.3	31.3	30.8
TOTAL ASSETS		4,040.1	4,418.5	4,051.9	4,426.2

The notes on pages 34 to 67 form part of these Accounts.

Balance Sheets at 31 December 2012

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
LIABILITIES					
Due to members	21	3,445.4	3,761.4	3,445.4	3,761.4
Fair value adjustments for hedged risk	15	17.5	28.7	17.5	28.7
Due to other customers	22	160.8	157.2	163.9	160.3
Deposits from banks	23	77.2	107.6	77.2	107.6
Debt securities in issue	24	8.0	16.0	8.0	16.0
Derivative financial instruments	33	40.0	57.4	40.0	57.4
Current tax liabilities		0.2	0.5	-	0.3
Other liabilities	25	19.0	19.0	27.3	23.3
Provisions for liabilities and charges	26	5.0	8.4	5.0	8.4
Retirement benefit obligations	31	5.7	1.2	5.7	1.2
Deferred tax liabilities	19	0.6	0.7	-	-
Subordinated liabilities	27	58.9	58.7	58.9	58.7
Subscribed capital	28	29.7	29.6	29.7	29.6
Reserves		172.1	172.1	173.3	173.3
TOTAL LIABILITIES		4,040.1	4,418.5	4,051.9	4,426.2

These Accounts were approved by the Board of Directors on 27 February 2013 and signed on its behalf by:

David Holborn, Chairman
Catherine Vine-Lott, Chairman of Audit Committee
Jim Willens, Chief Executive

The notes on pages 34 to 67 form part of these Accounts.

Statements of Movement in Members' Interests for the year ended 31 December 2012

GROUP	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2012	171.0	1.1	172.1
Movement in the year	(5.2)	5.2	-
At 31 December 2012	**165.8**	**6.3**	**172.1**

	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2011	174.6	1.5	176.1
Movement in the year	(3.6)	(0.4)	(4.0)
At 31 December 2011	**171.0**	**1.1**	**172.1**

SOCIETY	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2012	172.2	1.1	173.3
Movement in the year	(5.2)	5.2	-
At 31 December 2012	**167.0**	**6.3**	**173.3**

	General reserve £m	Available for sale reserve £m	Total £m
At 1 January 2011	175.4	1.5	176.9
Movement in the year	(3.2)	(0.4)	(3.6)
At 31 December 2011	**172.2**	**1.1**	**173.3**

Movement in the year reflects changes disclosed in the Statements of Comprehensive Income, net of tax.

The notes on pages 34 to 67 form part of these Accounts.

Cash Flow Statements for the year ended 31 December 2012

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Cash (outflows) / inflows from operating activities	29	**(71.3)**	314.7	**(76.2)**	318.4
Payment into defined benefit pension scheme		**(2.1)**	(2.4)	**(2.1)**	(2.4)
Net cash (outflows) / inflows from operating activities		**(73.4)**	312.3	**(78.3)**	316.0
Cash (outflows) / inflows from investing activities					
Purchase of property, plant and equipment		**(1.7)**	(1.0)	**(1.8)**	(1.0)
Sale / (purchase) of investment properties		**0.9**	(1.7)	**-**	-
Sale of property, plant and equipment		**-**	0.4	**0.1**	0.2
Decrease in loans to subsidiary undertakings		**-**	-	**5.8**	9.0
Purchase of investment securities		**(1,005.7)**	(939.6)	**(1,005.7)**	(939.6)
Sale and maturity of investment securities		**1,236.3**	645.2	**1,236.3**	645.2
Proceeds on disposal of Prepaid Card Business		**-**	7.5	**-**	7.5
Dividend received		**-**	-	**-**	3.0
Net cash inflows / (outflows) from investing activities		**229.8**	(289.2)	**234.7**	(275.7)
Net cash outflows from financing activities					
Interest paid on subordinated liabilities		**(2.6)**	(2.2)	**(2.6)**	(2.2)
Interest paid on subscribed capital		**(3.6)**	(3.6)	**(3.6)**	(3.6)
Repayments under finance lease agreements		**(0.2)**	(0.2)	**(0.2)**	(0.1)
Net cash outflows from financing activities		**(6.4)**	(6.0)	**(6.4)**	(5.9)
Net increase in cash		**150.0**	17.1	**150.0**	34.4
Cash and cash equivalents at start of year		**378.0**	360.9	**377.9**	343.5
Cash and cash equivalents at end of year	29	**528.0**	378.0	**527.9**	377.9

The notes on pages 34 to 67 form part of these Accounts.

1 Significant Accounting Policies

Basis of Preparation
The Annual Accounts have been prepared in accordance with International Financial Reporting Standards (IFRS) and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC); as adopted for use in the EU; and with those parts of the Building Societies (Accounts and Related Provisions) 1998 applicable to building societies reporting under IFRS.

The Board has reviewed medium and long term plans with particular emphasis on examining forecast liquidity, capital and profitability of the Group and the risks to those forecasts through a variety of stress testing scenarios. The outcome of this review is that the Directors are satisfied that the Society and the Group have adequate resources to continue in business for the foreseeable future. Accordingly, the financial statements of the Society and the Group have been prepared on a going concern basis.

The Annual Accounts have been prepared under the historical cost convention except for those financial assets and hedging instruments which are required by IAS 39 to be carried at fair value. A summary of the Group's principal accounting policies is set out below:

Basis of Consolidation
The Group Accounts include the results of the Society and its subsidiary undertakings, all of which have accounting periods ending 31 December. Subsidiaries are entities over which the Society has the power to control the financial and operating policies so as to obtain benefits from its activities. Subsidiaries are consolidated from the date on which control is transferred to the Group and are deconsolidated from the date that control ceases. Upon consolidation, inter-company transactions, balances and unrealised gains on transactions are eliminated. The accounting policies of subsidiaries are consistent with Group accounting policies.

Income Recognition
Interest Income and Expense
Interest receivable and interest payable for all interest-bearing financial instruments are recognised within 'Interest receivable and similar income' and 'Interest payable and similar charges' in the consolidated income statements, using the effective interest rate method (EIRM).

EIRM is used to calculate the amortised cost of financial instruments and to recognise interest receivable or payable over the relevant period. The effective interest rate is the rate that exactly discounts estimated cash flows (excluding credit losses) to zero, through the expected life of the instrument. In calculating the effective interest rate all contractual terms of the financial instrument (for example, early redemption charges) are taken into account.

Fees and Commissions
Fees and commissions relating to creating loans and advances to customers are deferred and spread as 'interest receivable', using the EIRM. Other fees and commissions are recognised as 'Other income' on the accruals basis as services are provided.

Dividend Income
Dividends receivable are recognised in the Income statements in 'Dividend income' when the right to receive payment is established.

Financial Assets
In accordance with IAS 39, Financial Instruments: Recognition and Measurement, the Group classifies its financial assets into the following categories:

Loans and Receivables
The Group's mortgage assets and similar loans are classified as loans and receivables and measured at amortised cost using EIRM. In accordance with EIRM, incremental up-front costs and fees receivable which are directly related to the loans (including administration and completion fees, arrangement fees, procuration fees and commissions paid to agents) are deferred and released to income over the effective life of the mortgage assets. Historical and forecast mortgage redemption data and management judgement are used to estimate the expected lives of mortgage assets.

At Fair Value through Profit and Loss
The Group enters into derivative financial instruments to hedge its exposures relating to interest rates, index risk relating to savings products (equities, house prices and inflation) and longevity risk on equity release mortgages. At the balance sheet date the Group has only entered into contracts which lead to derivatives designated as fair value hedges. In accordance with the Treasury Policy Statement and the Building Societies Act 1986 the Group does not hold or issue derivative financial instruments for trading purposes.

In accordance with IAS 39, all derivative financial instruments (both assets and liabilities) are initially and on an ongoing basis, assessed to determine whether they are highly effective in offsetting the changes in fair value of hedged items. Derivatives are recognised at fair value on the date the derivative contract is entered into, and subsequently re-measured at their fair value with changes going through the Income Statements along with changes in fair value attributable to the hedged risk of the hedged items. The carrying value of the hedged item is included on the balance sheet under the heading "Fair value adjustments for hedged risk". Any gain or loss arising from an ineffective portion is recognised immediately in the Income Statements under the heading "Gains less losses on financial instruments and hedge accounting".

When a hedging instrument expires, is sold, or no longer meets the criteria for hedge accounting, then hedge accounting is discontinued and any cumulative gain or loss is recognised in the Income Statements.

Certain derivatives are embedded within other non-derivative host financial instruments to create a hybrid instrument. Where the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risk of the host instrument and where the hybrid instrument is not measured at fair value, the embedded derivative is separated from the host instrument with changes in the fair value of the embedded derivative recognised in the Income Statements.

Fair values are obtained in line with the three tier hierarchy described in IFRS7 from quoted market prices in active markets, valuation techniques using specialist tools and confirmations from counterparties.

Significant Accounting Policies Continued

Available for Sale
These assets are non-derivative financial instruments where the intention is to hold for an indefinite period of time. They are initially measured at fair value, with subsequent fair value movements recognised directly in Members' Interests, until the asset is derecognised or impaired, at which point the cumulative gain or loss previously recognised in Members' Interests is recognised in the Income Statements. Interest received on the asset is recognised immediately in the Income Statements.

Held to Maturity
These are non-derivative financial assets with fixed maturities that the Group has a positive intention and ability to hold until maturity. Held to maturity investments are initially recognised at fair value and are subsequently measured at amortised cost using the effective interest rate method. Interest on held to maturity investments is included in the Income Statements and reported as interest receivable and similar income.

Cash and Cash Equivalents
For the purpose of the Cash Flow Statements, 'Cash and cash equivalents' comprises cash in hand, balances with the Bank of England, loans and advances to banks available on demand or with original maturities of three months or less and investment securities with a maturity period of three months or less i.e. highly liquid assets readily convertible into cash.

Impairment of Financial Assets
Individual assessments are made against all those known loans and advances in arrears, in possession, where an event of default has occurred, where fraud has been identified or where any other potential loan servicing issues arising from assessments or professional advice are known. The value of those loans and advances that are considered to be impaired is reduced on an individual basis. Impairment calculations are carried out by considering future discounted cashflows as per rules laid out in international accounting standard, IAS39. In considering future cashflows the Society estimates the future valuation of the security less anticipated disposal costs, any irrecoverable hedging costs, and other payments and charges, which are then discounted using the original effective interest rate based on the Groups approved strategy for the loan at the balance sheet date. Collective impairment allowances are also made to reduce the value of those loans and advances where there has been an event which may give rise to impairment but of which the Society is not yet aware at the balance sheet date, with the result that the amount advanced may not be recovered in full. For the purposes of the collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics. Any impairment loss or allowance is recognised in the Income Statements.

Loans are classed as renegotiated when their terms have changed during the year. The Group applies a policy of capitalising arrears on residential loans with the customer's agreement, once the customer has made six contractual monthly mortgage repayments following the instance of non-payments. Capitalisation is only applied where there is no realistic alternative and this is expected to be of long-term benefit to the borrower.

Financial Liabilities
All financial liabilities including shares, deposits, debt securities, subordinated liabilities and Permanent Interest Bearing Shares are recognised initially at fair value, being the issue proceeds, net of premia, discounts and transaction costs incurred. Financial liabilities are subsequently measured at amortised cost, using the EIR method.

Investment Properties
Property that is held for long-term rental yields or for capital appreciation or both, and that is not occupied by the companies included in the consolidated Group, is classed as investment property. This comprises mainly residential properties. Investment property is measured initially at cost, including related transaction costs.

After initial recognition, investment property is carried at fair value. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specified asset. Fair values are determined by the Society's Portfolio Manager with input on methodologies from a RICS qualified valuer and external valuation companies as appropriate.

Subsequent expenditure is included in the carrying amount of the property when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred. Similarly income is recognised in the financial period in which it arises. Gains or losses arising from changes in the fair value of the Group's investment properties are included in the Income Statements in the period in which they arise.

At the balance sheet date the investment properties in the Groups' Kings Manor Properties Limited subsidiary have been classified as Held for Sale, having met the conditions laid out in IFRS5.

Property, Plant, Equipment and Depreciation
On transition to IFRS, the Group elected to adopt the exemption in IFRS 1 which permits an entity to use, on transition to IFRS, a value, which is not depreciated cost, as the 'deemed cost' of the asset. Property, plant and equipment is stated at cost (or 'deemed cost') less accumulated depreciation and any provisions for impairment. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use. Depreciation on assets commences when they are ready for their intended use and is provided at rates calculated to write down the assets to their estimated residual values over the course of their anticipated useful lives, on the following bases:

Freehold buildings and leasehold buildings:

With a residual lease term of greater than fifty years	- 2% per annum straight line
Other leasehold buildings	- over the term of the lease

Equipment, fixtures, fittings and motor vehicles:

Refurbishment expenditure	- 6.67% to 10% per annum, straight line
Equipment, fixtures and fittings	- 10% per annum, straight line
Computer equipment	- 20% per annum, straight line
Motor vehicles	- over the term of the lease

Gains and losses on disposals are determined by comparing the net disposal proceeds with the carrying amount of the asset and are included in the income statement in the period in which they arise.

Significant Accounting Policies Continued

Lease Purchase and Leasing
The Group enters into lease purchase contracts and finance and operating leases. Assets held under lease purchase contracts and finance leases are capitalised in property, plant and equipment at the fair value of the asset at the inception of the lease, with an equivalent liability categorised under other liabilities. Assets are depreciated in accordance with the relevant Group policy, over the lower of the useful life of the asset and the term of the lease. Finance charges are allocated to accounting periods over the life of each lease on a straight line basis or using the sum of digits method, depending on the cash flows attached to the agreement. Rentals under operating leases are charged on a straight line basis over the lease term. Both finance charges and rentals are recognised in administrative expenses in the Income Statements.

Taxation
Corporation tax is charged on profits adjusted for tax purposes.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements of the individual entities. Deferred tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled. Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Pension Scheme Costs
The Society operates a defined contribution scheme on behalf of directors and staff. For the defined contribution scheme, contributions are charged to the Income Statements, as they become payable, in accordance with the rules of the Scheme.

The Society previously operated a defined benefit scheme; this was closed to future accrual from 30 November 2010, and was funded by contributions partly from employees and partly from the Society at rates determined by an independent actuary. These contributions are invested separately from the Group's assets. Under IAS 19, the Scheme assets are measured at bid value at each Balance Sheet date and the obligations are measured by an independent actuary using the projected unit valuation method, discounted using a high quality corporate bond rate. The resulting pension scheme surplus or deficit is recognised immediately on the Balance Sheet and any resulting actuarial gains and losses are recognised immediately in the Statements of Comprehensive Income.

Provisions
A provision is recognised when there is a present obligation as a result of a past event, it is probable that the obligation will be settled and it can be reliably estimated. Contingent liabilities have not been recognised.

Segment Information
The operating segments disclosed (Member business and Solutions business) are those used in the Group's management and internal reporting structures (for the Chief Operating Decision Maker) in accordance with IFRS 8. No segment information is presented on geographical lines, because substantially all of the Group's activities are in the United Kingdom.

Accounting Estimates and Judgements in applying Accounting Policies
The Group has to make judgements in applying its accounting policies which affect the amounts recognised in the Annual Accounts. These judgements are based on management's best knowledge but the eventual outcome may differ from them. In addition, estimates and assumptions are made that could affect the reported amounts of assets and liabilities within the following year. The most significant areas where judgements and assumptions are made are as follows:

Pensions
Significant judgements are required in relation to the assumptions for the valuation of the pension scheme surplus or deficit including discount, interest and mortality rates, inflation and future salary increases. The Board receives independent external advice from actuarial consultants in arriving at the assumptions that are outlined in Note 31 to the Annual Accounts.

The impact of a 0.1% increase in the inflation assumption would be to increase the carrying value of the defined benefit obligation by approximately £0.8m (and vice versa). The impact of a 0.1% increase in the assumed discount rate would be to decrease the carrying value of the defined benefit obligation by approximately £1.5m (and vice-versa).

Effective Interest Rate (EIR)
To calculate the appropriate EIR, certain assumptions are made in respect of the expected lives of specific asset portfolios which take into account such factors as the terms of the particular product, historic repayment data and prevailing economic conditions. These estimates are reviewed on a regular basis to ensure they reflect the portfolio's actual performance.

Impairment of Financial Assets
On loans fully secured on residential property the key assumptions in assessing the underlying value of the assets held as security for the loans is based on historic data and prudent expectations around future conditions. An estimate of forced sale adjustments (covering house price falls and disposal costs) has an impact on the level of provisioning for possession and arrears exposures. A forced sale adjustment that was higher by 5% would increase residential provisions by £0.5m.

Loans secured on commercial property or land are more individually significant. Provision is made against loans in arrears, possession or Law of Property Act 1925 (LPA) receivership, or where a trigger event raises the likelihood of future problems servicing the loan. The key assumptions used in the discounted future value calculations used to determine the level of impairment required in respect of individual financial assets include:

- Predictions of the future value of underlying assets held as security for loans advanced, based on historic data, professional advice and expectations around future conditions including tenancy levels;
- Any sale adjustments, disposal costs, fees or other cash flows applicable;
- Any applicable adjustments arising on hedging instruments relating to the loan as employed by the Society; and
- Timing of cash flows.

Significant Accounting Policies Continued

Impairment of Treasury Assets
Treasury investments are regularly reviewed for objective evidence of impairment. In determining whether objective evidence exists, the Group considers, amongst other factors, financial difficulties of the counterparty, missed payments in breach of contractual arrangements, appointment of an administrator and current market conditions. Provision is made against treasury assets with reference to information provided by administrators on recoverability and also against traded market values. A 1% increase in the average recovery and market value assumption would decrease the current provision by £0.4m (and vice-versa).

Fair Value of Derivatives and Financial Assets
Fair values are determined by the three tier valuation hierarchy as defined within IFRS 7, Financial Instruments: Disclosures.

- Level 1 - quoted market prices in an actively traded market;
- Level 2 - valuations are estimated from observable data where no active market exists; and
- Level 3 - valuation techniques for which one or more significant input is not based on observable market data.

Further details are given in Note 33 to the Accounts.

Financial Services Compensation Scheme Provision
As explained in Note 26, the Society is committed to paying a levy to the Financial Services Compensation Scheme (FSCS). The provision for these costs in this year's accounts relate to payments to be made in future periods. The actual payments to be made are subject to change because they are dependant on the realisation of the assets of the institutions which have triggered the claims against the FSCS and future interest rates. The Society has estimated its obligations to the Scheme with reference to currently available external information on both interest due on the loans and the amount of capital shortfall on the loans made to failed financial institutions.

Taxation
The Group is subject to tax in three jurisdictions and, consequently, estimates are required in determining the provision for corporation tax. As shown in Note 19 to the Annual Accounts the Group has deferred tax assets which are considered recoverable given the Society and Group plans over the planning horizon.

Accounting Developments
At the date of approval of these financial statements there are no new International Financial Reporting Standards or International Financial Reporting Interpretations Committee pronouncements that are mandatory for the first time for the financial year beginning 1 January 2012.

There are 2 amendments to standards effective for the 2012 accounting period, neither materially impact the Group:

- IAS 12 Deferred Tax: Recovery of Underlying Assets – provides a practical approach to an entity measurement of the deferred tax relating to an asset depending on whether the entity expects to recover the carrying amount of the asset through use or sale; and
- IFRS 7 Financial Instruments: Disclosures - introduces additional disclosures, designed to allow users of financial statements to improve their understanding of transfer transactions of financial assets (for example, securitisations).

Developments not effective at 31 December 2012
There are a number of new or amended standards which become effective in 2013, and beyond, which allow for early adoption but the Society is not taking up any of those standards before their mandatory date.

- IAS 1 Presentation of Items of Other Comprehensive Income - retains the 'one or two statement' approach, requiring separate subtotals for those elements which may be 'recycled', and those elements that will not;
- IFRS 7 Disclosures - Offsetting Financial Assets and Financial Liabilities - requires an entity to disclose information about rights of set-off and related arrangements for all recognised financial instruments that are set off in accordance with IAS 32 or an enforceable master netting arrangement or similar;
- IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial Statements - creates a new, and broader, definition of control than under current IAS 27 based on an understanding of an investee's purpose and design, and the investor's rights and exposures to variable returns, as well as rights and returns held by other investors;
- IFRS 11 Joint Arrangements, IFRS 12 Disclosures of Interests in Other Entities, IAS 28 Investments in Associates and Joint Ventures – includes the disclosure requirements for all forms of non-consolidated interests and joint arrangements with other entities;
- IFRS 13 Fair Value Measurement - describes how to measure fair value where fair value is required or permitted by IFRS; and
- IAS 19 Employee Benefits (Revised) - amendments which represent a significant further step in reporting gains and losses outside of profit and loss, with no subsequent recycling. Actuarial gains and losses will be excluded permanently from earnings.

Although these developments are being considered it is not expected that there will be any material impact on the Group.

Other standards being considered
IAS 32 Offsetting Financial Assets and Financial Liabilities - these amendments clarify the meaning of "currently has a legally enforceable right to set-off". The amendments also clarify the application of the IAS 32 offsetting criteria to settlement systems (such as central clearing house systems) which apply gross settlement mechanisms that are not simultaneous. The amendments clarify that rights of set-off must not only be legally enforceable in the normal course of business, but must also be enforceable in the event of default and the event of bankruptcy or insolvency.

IFRS 9 Financial Instruments will supersede IAS 39 with a mandatory effective date 1 January 2015. The three phase approach to IFRS 9 includes:

- Classification and measurement - for assets, IFRS 9 divides all financial assets that are currently in the scope of IAS 39 into two classifications, those measured at amortised cost and those measured at fair value. The available-for-sale and held-to-maturity categories currently in IAS 39 are not included in IFRS 9. For the Society the IFRS 9 rules would most likely see mortgages classified as amortised cost and all other financial assets at fair value through profit and loss.
- Impairment - currently there is no facility to look at potential losses before impairment evidence is available and the high level approach of IFRS 9 is to move from incurred to an expected loss model, with the timing of recognition of a provision becoming immediate or spread over the life of the asset. The Society will need to develop models to quantify impairment under an expected loss approach.
- Hedge accounting – simplification of current rules under IAS 39, long considered overly complex, under two main groupings. General hedging rules to cover basic, one-to-one hedging relationships and portfolio/macro hedging rules covering dynamic and macro fair value interest rate hedging. It is expected that the impact of this phase of IFRS 9 on the Society will come from the changes made under the general hedging model, but this assessment work has not yet begun.

2 Interest receivable and similar income

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
On loans and advances to customers	**116.3**	127.8	**116.8**	128.2
On debt securities				
- interest and other income	**18.8**	15.9	**18.8**	15.9
- profits net of losses on realisation	**9.1**	4.7	**9.1**	4.7
On other liquid assets				
- interest and other income	**2.9**	2.6	**2.9**	2.7
Net expense on derivatives hedging assets	**(36.8)**	(47.8)	**(36.8)**	(47.8)
	110.3	103.2	**110.8**	103.7

3 Interest payable and similar charges

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
On shares held by individuals	**97.1**	94.6	**97.1**	94.6
On subscribed capital	**3.6**	3.6	**3.6**	3.6
On deposits and other borrowings				
- subordinated liabilities	**2.6**	2.2	**2.6**	2.2
- to other depositors and borrowers	**3.1**	4.5	**3.1**	4.5
Net income on derivatives hedging liabilities	**(16.0)**	(19.3)	**(16.0)**	(19.3)
Covered bond costs	**-**	0.1	**-**	0.1
	90.4	85.7	**90.4**	85.7

4 Other income and charges

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Other income				
Fee and commission income	**11.5**	10.4	**8.0**	4.5
Other operating income	**17.3**	16.9	**16.7**	16.1
	28.8	27.3	**24.7**	20.6

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Other charges				
Fee and commission expense	**0.9**	0.6	**0.9**	0.6

Notes to the Accounts for the year ended 31 December 2012

5 Dividend income

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Received from subsidiary undertakings	**-**	-	**-**	3.0

6 Administrative expenses

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Staff costs	7	**23.2**	21.7	**20.2**	19.6
Rentals under operating leases for land and buildings					
- payable to third parties		**1.6**	1.4	**1.6**	1.4
- payable to subsidiary undertaking		**-**	-	**0.1**	0.1
Other administrative expenses		**9.7**	9.5	**8.7**	9.0
		34.5	32.6	**30.6**	30.1

During the year the Group and Society obtained the following services from the Group's auditors and these are included in other administrative expenses.

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Fees payable to the Society's auditor for audit of Society and consolidated financial statements	**0.2**	0.1	**0.2**	0.1
Fees payable to the Society's auditor for other services	**0.1**	0.1	**0.1**	0.1
	0.3	0.2	**0.3**	0.2

Fees payable to the Society's auditor for the audit of consolidated financial statements includes **£24k** (2011: £24k) attributable to subsidiary companies. Fees payable to the Society's auditor for other services includes **£14k** (2011: £12k) for tax services.

7 Staff costs

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Wages and salaries		**19.9**	19.0	**17.2**	17.2
Social security costs		**1.8**	1.8	**1.6**	1.6
Pension costs for defined benefit contribution plans		**1.5**	0.9	**1.4**	0.8
	6	**23.2**	21.7	**20.2**	19.6

Directors' emoluments are disclosed in the Remuneration Committee report on page 24.

The monthly average number of persons employed, including Executive Directors, during the year was:

	GROUP 2012	GROUP 2011	SOCIETY 2012	SOCIETY 2011
Full time	**699**	699	**663**	663
Part time	**205**	193	**204**	192
	904	892	**867**	855
Principal Office	**678**	675	**670**	666
Branches	**226**	217	**197**	189
	904	892	**867**	855

8 Taxation expense

	Note	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Current tax					
UK corporation tax on profit at 24.5% (2011: 26.5%) for the year		-	-	-	-
Group relief for the year		-	-	-	(1.0)
(Over) / under provision in respect of previous years		(0.3)	-	0.6	0.2
Total current tax		(0.3)	-	0.6	(0.8)
Deferred tax					
Current year	19	1.5	0.8	1.8	0.9
Adjustments in respect of prior periods		0.3	-	0.6	(0.1)
Total deferred tax		1.8	0.8	2.4	0.8
Total taxation expense in the Income Statements		1.5	0.8	3.0	-

Analysis of taxation expense / (credit) for the year

The tax on the Group and Society profit / (loss) before tax differs from the theoretical amount that would arise using the weighted average tax rate applicable to profits as follows:

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Profit / (loss) before taxation	1.5	0.1	3.0	(0.3)
Profit / (loss) before taxation at the standard rate of corporation tax in the UK of 24.5% (2011: 26.5%)	0.4	-	0.7	(0.1)
Expense / (income) not taxable / deductible for tax purposes:				
Expenses / (income)	0.1	(0.1)	0.1	(0.2)
Non-taxable dividend income received	-	-	-	(0.9)
Rate change	1.0	0.9	1.0	1.0
Under provision in respect of previous years	-	-	1.2	0.2
Total taxation expense	1.5	0.8	3.0	-

Factors affecting future tax charges

The Society has unrelieved trading losses which are expected to affect future taxable profits.

In addition to the changes in rates of Corporation tax disclosed above a further reduction of 1% to the main rate was announced in the March 2012 UK Budget Statement to 23% for the financial year 2013-2014. This further change has been substantively enacted at the balance sheet date and, therefore, is included in these financial statements.

A further reduction of 1% to 22% by the Financial year 2014-2015 is to be enacted. If this is applied to the deferred tax balance at the balance sheet date, it would further reduce the deferred tax asset by £0.5m.

9 Segment information

The chief operating decision maker has been identified as the Board of Directors. The Board reviews the Group's internal reporting in order to assess performance and allocate resources. Management has determined the operating segments based on these reports.

Following the management approach of IFRS 8, operating segments are reported in accordance with the internal reporting provided to the Board of Directors. The operating segments used by the Group meet the definition of a reportable segment under IFRS 8.

The 'Member business' segment provides mortgage, savings, investment and insurance products to members and customers. The 'Solutions business' segment provides business to business services through people, processes and technology. The Board assesses performance based on profit before tax after the allocation of all central costs. Operating profit before impairments, provisions, FSCS levy and exceptional items is also assessed as this provides information on underlying business performance excluding legacy portfolio impairment charges, levies outside of managements direct control and non-recurring items.

No segment information is presented on geographical lines, because substantially all of the Group's activities are in the United Kingdom.

Income and directly attributable costs are allocated to each segment and support costs are apportioned, based on direct salary costs and detailed allocations by budget holders.

Year to 31 December 2012	Member Business £m	Solutions Business £m	Total £m
Net interest receivable	19.9	-	19.9
Other income and charges	11.7	16.2	27.9
Losses recognised on revaluation of investment properties	(1.0)	-	(1.0)
Gains less losses from financial instruments and hedge ineffectiveness	0.7	-	0.7
Administrative expenses	(25.6)	(8.9)	(34.5)
Depreciation	(2.0)	(0.6)	(2.6)
Operating profit before impairments, provisions, FSCS levy and exceptional items	3.7	6.7	10.4
Impairment credit on loans and advances to banks	0.7	-	0.7
Impairment charges and provisions for liabilities and charges	(9.1)	0.8	(8.3)
FSCS levy	(2.1)	-	(2.1)
Gain on disposal of Prepaid Cards business	-	0.8	0.8
(Loss) / profit for the year before taxation	(6.8)	8.3	1.5
Taxation expense			(1.5)
Result after taxation for the financial year			-
Total assets	4,035.7	4.4	4,040.1

Year to 31 December 2011	Member Business £m	Solutions Business £m	Total £m
Net interest receivable	17.5	-	17.5
Other income and charges	11.1	15.6	26.7
Losses recognised on revaluation of investment properties	(0.1)	-	(0.1)
Gains less losses from financial instruments and hedge ineffectiveness	0.6	-	0.6
Administrative expenses	(24.0)	(8.6)	(32.6)
Depreciation	(2.1)	(0.8)	(2.9)
Operating profit before impairments, provisions, FSCS levy and exceptional items	3.0	6.2	9.2
Impairment credit on loans and advances to banks and debt securities	0.7	-	0.7
Impairment charges and provisions for liabilities and charges	(12.3)	0.0	(12.3)
FSCS levy	(1.4)	-	(1.4)
Gain on disposal of Prepaid Cards business	-	3.9	3.9
(Loss) / profit for the year before taxation	(10.0)	10.1	0.1
Taxation expense			(0.8)
Loss after taxation for the financial year			(0.7)
Total assets	4,412.5	6.0	4,418.5

10 Gain on Disposal of Prepaid Cards Division

On 21st December 2011 the Society sold its Prepaid Cards Business (PPC) to Wirecard AG ("the Buyer").

The total purchase price was £10m payable as £7.5m in cash on the date of legal completion and £2.5m payable as deferred consideration based on the financial performance of PPC in 2012 and 2013. As the deferred consideration is based solely on financial performance measures this meets the definition of a derivative under IAS39 and is therefore recognised at fair value. The valuation of the derivative is based on a prudent and probability based assessment of expected future performance with the cash receivable discounted back to present value at the year-end.

The Gain on disposal comprises the following elements:-

	2012 £m	2011 £m
Cash consideration	-	7.5
Deferred consideration	0.8	0.5
	0.8	8.0
Legal and Professional Fees	-	(0.7)
Assets written off	-	(0.3)
Pre-completion liabilities retained	-	(3.1)
Net Gain on disposal	**0.8**	**3.9**

The financial performance of PPC for 2011, up to the date of sale, was as follows:

	£m
Net income	2.4
Operating costs	(1.0)
Operating profit	**1.4**

11 Loans and advances to banks

Repayable from the date of the Balance Sheets in the ordinary course of business as follows:

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Accrued interest	0.3	0.4	0.3	0.4
On demand	1.1	0.8	1.0	0.7
In not more than three months	182.2	235.3	182.2	235.3
In more than three months but not more than one year	11.5	38.0	11.5	38.0
Gross loans and advances to banks	195.1	274.5	195.0	274.4
Less: allowance for losses on loans and advances to banks	(19.7)	(20.4)	(19.7)	(20.4)
	175.4	254.1	175.3	254.0

Allowance for losses on loans and advances to banks

	GROUP and SOCIETY 2012 £m	2011 £m
Balance at 1 January	20.4	20.2
New provisions during the year	-	0.2
Amounts released for the year	(0.7)	-
At 31 December	19.7	20.4

At 31 December 2012 the Society had loans and advances to Icelandic banks totalling **£25.4m** (2011: £27.6m), against which allowance for losses of **£19.7m** (2011: £20.4m) has been made.

12 Debt securities

Transferable debt securities	GROUP and SOCIETY 2012 £m	2011 £m
Issued by public bodies - listed	-	202.7
Issued by other borrowers - unlisted	574.3	561.8
	574.3	764.5

These have remaining maturities as follows:	2012 £m	2011 £m
Accrued interest	6.0	6.9
In not more than one year	17.5	204.1
In more than one year but not more than five years	477.2	354.0
In more than five years	73.6	199.5
	574.3	764.5

Allowance for losses on debt securities

	GROUP and SOCIETY 2012 £m	2011 £m
Balance at 1 January	-	0.9
Amounts released for the year	-	(0.9)
At 31 December	-	-

The Directors consider that the primary purpose of holding securities is to comply with prudential requirements. All transferable debt securities are held with the intention of use on a continuing basis in the Group's activities. They are designated by management on initial recognition as being available for sale and are recognised, both initially and subsequently, at fair value with changes recognised directly in other comprehensive income.

Unlisted debt securities are primarily AAA related holdings of RMBS and covered bonds.

Under IAS 39 as amended, certain financial instruments were reclassified with effect from 1 July 2008. The table below sets out the financial instruments reclassified and their carrying and fair values:

	31 December 2012 Carrying value £m	31 December 2012 Fair value £m	31 December 2011 Carrying value £m	31 December 2011 Fair value £m
Fair value through profit or loss financial instruments reclassified to held to maturity financial instruments	4.7	3.4	14.8	12.9

13 Assets pledged as collateral

Assets are pledged as collateral under repurchase agreements with banks. Securities pledged with banks are debt securities with a market value of **£54.0m** (2011: £85.1m). All collateral agreements mature within 1 year.

The nature and carrying amounts of the assets pledged as collateral are as follows:

	Group and Society Asset 2012 £m	Group and Society Asset 2011 £m	Group and Society Related liability 2012 £m	Group and Society Related liability 2011 £m
Debt securities pledged	54.0	85.1	55.2	85.1

14 Loans and advances to customers

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Loans fully secured on residential property	**2,408.7**	2,563.6	**2,388.3**	2,538.0
Loans fully secured on land	**316.7**	392.0	**316.7**	392.0
Other loans	**29.7**	38.0	**29.7**	38.0
Gross loans and advances	**2,755.1**	2,993.6	**2,734.7**	2,968.0
Less: allowance for losses on loans and advances	**(27.5)**	(17.0)	**(27.5)**	(17.0)
	2,727.6	2,976.6	**2,707.2**	2,951.0

Loans and advances to customers have remaining contractual maturities as follows:

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
On demand	**13.4**	17.1	**13.4**	17.1
In not more than three months	**127.7**	60.6	**127.6**	60.5
In more than three months but not more than one year	**121.2**	185.6	**121.0**	185.3
In more than one year but not more than five years	**337.1**	358.8	**336.0**	357.4
In more than five years	**2,155.7**	2,371.5	**2,136.7**	2,347.7
Gross loans and advances	**2,755.1**	2,993.6	**2,734.7**	2,968.0
Less: allowance for losses on loans and advances	**(27.5)**	(17.0)	**(27.5)**	(17.0)
	2,727.6	2,976.6	**2,707.2**	2,951.0

Where a loan is repayable by instalment, each such instalment has been treated as a separate repayment in the maturity analysis set out above. The Group's experience is that in many cases mortgages are redeemed before their scheduled maturity date. As a consequence, the maturity analysis illustrated above may not reflect actual experience.

Allowance for losses on loans and advances

GROUP and SOCIETY

	Loans fully secured on residential property		Loans fully secured on land		Other loans		Total		
	Individual £m	Collective £m	Individual £m	Collective £m	Individual £m	Collective £m	Individual £m	Collective £m	Total £m
Balance at 1 January 2012	1.9	0.3	13.0	1.3	0.4	0.1	15.3	1.7	17.0
Charge / (write-back) for the year	0.6	0.3	4.5	3.0	(0.1)	-	5.0	3.3	8.3
(Written off) / written back during the year	(0.4)	-	(0.7)	0.7	-	-	(1.1)	0.7	(0.4)
Interest suspended	0.2	-	1.9	0.5	-	-	2.1	0.5	2.6
At 31 December 2012	**2.3**	**0.6**	**18.7**	**5.5**	**0.3**	**0.1**	**21.3**	**6.2**	**27.5**

GROUP and SOCIETY

	Loans fully secured on residential property		Loans fully secured on land		Other loans		Total		
	Individual £m	Collective £m	Individual £m	Collective £m	Individual £m	Collective £m	Individual £m	Collective £m	Total £m
Balance at 1 January 2011	4.4	0.4	11.0	5.6	0.5	0.4	15.9	6.4	22.3
Charge / (write-back) for the year	0.6	(0.1)	17.0	(4.8)	(0.1)	(0.3)	17.5	(5.2)	12.3
Written off during the year	(3.2)	-	(17.3)	-	-	-	(20.5)	-	(20.5)
Interest suspended	0.1	-	2.3	0.5	-	-	2.4	0.5	2.9
At 31 December 2011	**1.9**	**0.3**	**13.0**	**1.3**	**0.4**	**0.1**	**15.3**	**1.7**	**17.0**

15 Fair value adjustment for hedged risk

As disclosed in the statement of accounting policies, when specific criteria are met, the Group applies fair value hedge accounting and the adjustments to assets and liabilities are included on the balance sheet under the heading 'Fair value adjustment for hedged risk'. The fair value adjustment for hedged risk for assets for the Group and Society was **£40.0m**, (2011: £57.9m). The fair value adjustment for hedged risk for liabilities for the Group and Society was **£17.5m**, (2011: £28.7m).

16 Investments in subsidiary undertakings

SOCIETY

Investments in subsidiary undertakings	Shares £m	Loans £m	Total £m
Cost			
At 1 January 2012	6.0	42.1	48.1
Additions	-	2.0	2.0
Repayments received	-	(7.8)	(7.8)
At 31 December 2012	**6.0**	**36.3**	**42.3**
Provisions			
At 1 January 2012	0.6	-	0.6
Write Offs	-	-	-
At 31 December 2012	**0.6**	**-**	**0.6**
Net book amount at 31 December 2012	**5.4**	**36.3**	**41.7**

Investments in subsidiary undertakings	Shares £m	Loans £m	Total £m
Cost			
At 1 January 2011	7.8	52.5	60.3
Additions	-	4.1	4.1
Repayments received	(1.8)	(14.5)	(16.3)
At 31 December 2011	**6.0**	**42.1**	**48.1**
Provisions			
	0.6	**-**	**0.6**
Net book amount at 31 December 2011	**5.4**	**42.1**	**47.5**

The Society directly holds 100% of the issued ordinary share capital of all its subsidiary undertakings.

The Directors believe that the carrying value of the investments in subsidiary undertakings is supported by their underlying net assets.

Name of principal subsidiary undertakings	**Principal activity**
Kings Manor Properties Limited	Residential property rental
Newcastle Financial Services Limited	Provision of financial services
Newcastle Mortgage Loans (Jersey) Limited	Mortgage lending
Newcastle Portland House Limited	Commercial property rental
Newcastle Strategic Solutions Limited	Provision of specialised products and services
Newton Facilities Management Limited	Provision of managed IT services
Newcastle Card Solutions Limited	Provides prepaid card solutions (dormant)

All the above subsidiary undertakings, except for Newcastle Mortgage Loans (Jersey) Limited, which is incorporated and operates in Jersey, are incorporated in England and Wales and operate in the United Kingdom.

17 Property, plant and equipment

GROUP

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Total £m
Cost				
At 1 January 2012	6.7	12.2	27.0	45.9
Additions	-	-	1.7	1.7
Disposals	-	-	(0.2)	(0.2)
At 31 December 2012	**6.7**	**12.2**	**28.5**	**47.4**
Accumulated depreciation				
At 1 January 2012	0.7	2.8	18.5	22.0
Charge for the year	0.1	0.2	2.3	2.6
Disposals	-	-	(0.2)	(0.2)
At 31 December 2012	**0.8**	**3.0**	**20.6**	**24.4**
Net book amount at 31 December 2012	**5.9**	**9.2**	**7.9**	**23.0**

GROUP

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Total £m
Cost				
At 1 January 2011	6.8	12.2	26.3	45.3
Additions	-	-	1.0	1.0
Disposals	(0.1)	-	(0.3)	(0.4)
At 31 December 2011	**6.7**	**12.2**	**27.0**	**45.9**
Accumulated depreciation				
At 1 January 2011	0.6	2.6	16.0	19.2
Charge for the year	0.1	0.2	2.6	2.9
Disposals	-	-	(0.1)	(0.1)
At 31 December 2011	**0.7**	**2.8**	**18.5**	**22.0**
Net book amount at 31 December 2011	**6.0**	**9.4**	**8.5**	**23.9**

17 Property, plant and equipment Continued

SOCIETY

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Total £m
Cost				
At 1 January 2012	6.7	0.9	24.9	32.5
Additions	-	-	1.7	1.7
Disposals	-	-	(0.2)	(0.2)
At 31 December 2012	**6.7**	**0.9**	**26.4**	**34.0**
Accumulated depreciation				
At 1 January 2012	0.7	0.1	16.4	17.2
Charge for the year	0.1	-	2.3	2.4
Disposals	-	-	(0.2)	(0.2)
At 31 December 2012	**0.8**	**0.1**	**18.5**	**19.4**
Net book amount at 31 December 2012	**5.9**	**0.8**	**7.9**	**14.6**

SOCIETY

	Freehold buildings £m	Leasehold land and buildings £m	Equipment, fixtures, fittings and motor vehicles £m	Total £m
Cost				
At 1 January 2011	6.8	0.9	24.0	31.7
Additions	-	-	1.0	1.0
Disposals	(0.1)	-	(0.1)	(0.2)
At 31 December 2011	**6.7**	**0.9**	**24.9**	**32.5**
Accumulated depreciation				
At 1 January 2011	0.6	0.1	13.9	14.6
Charge for the year	0.1	-	2.6	2.7
Disposals	-	-	(0.1)	(0.1)
At 31 December 2011	**0.7**	**0.1**	**16.4**	**17.2**
Net book amount at 31 December 2011	**6.0**	**0.8**	**8.5**	**15.3**

Included within Equipment, fixtures, fittings and motor vehicles are assets under finance leases, which comprise motor vehicles and a long lease hold property that have the following net book amounts.

	GROUP and SOCIETY **2012** £m	2011 £m
Cost		
At 1 January	**1.0**	1.1
Accumulated depreciation	**(0.1)**	(0.1)
Net book amount at 31 December	**0.9**	1.0

18 Investment properties held for sale

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Fair value				
At 1 January	15.9	14.3	-	-
Additions	-	1.7	-	-
Net losses from fair value adjustments	(1.0)	(0.1)	-	-
Disposals	(0.9)	-	-	-
At 31 December	14.0	15.9	0.0	0.0

The investment property business does not fall into the Group's simplified building society model and the decision has been taken to dispose of this portfolio of assets on a piecemeal basis in the 12 months to 31 December 2013. Further details are given in the Cheif Executive's Review on page 6.

The Group has classified the assets of its investment property business as held for sale at 31 December 2012 in accordance with the key requirements of IFRS 5; i.e. all assets in the portfolio are saleable in their present condition and the sale is considered highly probable.

The Group has valued all of its investment property as at December 2012 at fair value in accordance with IAS40, the valuation referencing open market prices for similar properties, as estimated by management and reviewed by the Directors.

A revaluation deficit of £1m has arisen on revaluation of held for sale investment properties to fair value as at December 2012 (2011: £0.1m) and this has been taken to the Income Statements.

The historical cost of the Group's investment property as at 31 December 2012 is £15.6m (2011: £16.5m).

Investment property rental income (included within other income) and direct operating expenses (included within administrative expenses) for the Group are shown below:

	GROUP 2012 £m	GROUP 2011 £m
Income from rental properties	0.7	0.7
Operating expenses relating to rental properties	(0.2)	(0.2)
Net rental income from rented properties	0.5	0.5

The Group leases investment properties to non-commercial individuals under non-cancellable operating leases for a contract period of up to 6 months.

Notes to the Accounts for the year ended 31 December 2012

19 Deferred tax

Deferred tax is calculated on all temporary differences under the liability method using a tax rate of **23%** (2011: 25%).
The movement on the deferred tax account is shown below.

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
At 1 January	12.9	12.6	13.5	13.2
Income Statements expense	(1.5)	(0.8)	(1.8)	(0.9)
Over provision in respect of prior years	(0.3)	-	(0.6)	0.1
(Debited) / credited on items taken directly through reserves	(0.1)	1.1	(0.1)	1.1
At 31 December	11.0	12.9	11.0	13.5

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

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Deferred tax assets				
Short term timing differences	2.1	2.4	1.7	2.3
Fair value adjustments on adoption of IAS 32 and IAS 39	0.3	0.5	0.3	0.5
Trading losses	7.6	10.1	7.4	10.1
Depreciation in excess of capital allowances	1.6	0.6	1.6	0.6
	11.6	13.6	11.0	13.5
Deferred tax liabilities				
Accelerated capital allowances	(0.6)	(0.7)	-	-
	(0.6)	(0.7)	-	-
Deferred tax assets				
Deferred tax asset to be recovered in less than 12 months	1.5	0.8	0.9	0.7
Deferred tax asset to be recovered in more than 12 months	10.1	12.8	10.1	12.8
	11.6	13.6	11.0	13.5
Deferred tax liabilities				
Deferred tax liability to be recovered in less than 12 months	-	-	-	-
Deferred tax liability to be recovered in more than 12 months	(0.6)	(0.7)	-	-
	(0.6)	(0.7)	-	-

The deferred tax expense in the Income Statements comprises the following temporary differences:

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Accelerated capital allowances	1.1	0.6	0.9	0.6
Short term timing differences	(0.8)	(0.9)	(1.0)	(0.9)
Pensions and other post retirement benefits	0.3	-	0.3	-
Trading losses	(2.4)	(0.5)	(2.6)	(0.5)
Other	-	-	-	-
	(1.8)	(0.8)	(2.4)	(0.8)

Deferred tax assets are recognised for tax losses carried forward only to the extent that realisation of the related tax benefit is probable.

20 Other assets

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Receivable from subsidiary undertakings	-	-	7.6	3.8
Interest receivable on financial instruments	5.8	7.6	5.8	7.6
Prepayments and accrued income	9.4	8.1	15.8	14.9
Other	2.5	4.6	2.1	4.5
	17.7	20.3	31.3	30.8

21 Due to members

	GROUP and SOCIETY 2012 £m	GROUP and SOCIETY 2011 £m
Held by individuals	3,445.3	3,761.2
Other shares	0.1	0.2
	3,445.4	3,761.4

Repayable from the date of the Balance Sheets in the ordinary course of business as follows:

	2012 £m	2011 £m
Accrued interest	40.4	39.0
On demand	1,686.9	1,541.1
In not more than three months	1,008.2	1,402.1
In more than three months but not more than one year	569.7	582.3
In more than one year but not more than five years	140.1	196.3
In more than five years	0.1	0.6
	3,445.4	3,761.4

Included within due to member balances above is **£159.6m** (2011: £226.1m) of Capital Protection Bonds. The fair value includes adjustments of **£20.4m** (2011: £16.9m) which are attributable to changes in benchmark equity and interest rates. The Society is contractually required to pay only the par value of the shares on maturity.

22 Due to other customers

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Amounts owed to subsidiary undertakings	-	-	3.1	3.1
Other	160.8	157.2	160.8	157.2
	160.8	157.2	163.9	160.3

Repayable from the date of the Balance Sheet in the ordinary course of business as follows:

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Accrued interest	0.7	1.1	0.7	1.1
On demand	4.4	5.2	4.4	5.2
In not more than three months	67.2	98.5	70.3	101.6
In more than three months but not more than one year	88.4	51.3	88.4	51.3
In more than one year but not more than five years	0.1	1.1	0.1	1.1
	160.8	157.2	163.9	160.3

23 Deposits from banks

Repayable from the date of the Balance Sheets in the ordinary course of business as follows:

	GROUP and SOCIETY 2012 £m	GROUP and SOCIETY 2011 £m
Accrued interest	0.1	0.3
In not more than three months	17.4	66.0
In more than three months but not more than one year	59.7	41.3
	77.2	107.6

24 Debt securities in issue

	GROUP and SOCIETY 2012 £m	GROUP and SOCIETY 2011 £m
Certificates of deposit	8.0	16.0

Debt securities have remaining maturities as follows:

	2012 £m	2011 £m
In not more than three months	3.0	13.0
In more than three months but not more than one year	5.0	3.0
	8.0	16.0

25 Other liabilities

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Amounts payable to subsidiary undertakings	-	-	9.5	4.7
Third party income tax withheld	1.3	0.7	1.3	0.7
Obligations under finance leases	1.1	1.1	1.1	1.1
Other creditors	8.6	9.2	8.5	9.1
Accruals and deferred income	8.0	8.0	6.9	7.7
	19.0	19.0	27.3	23.3

Obligations under finance leases fall due as follows:

	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Within one year	0.1	0.1	0.1	0.1
In one to two years	0.1	0.1	0.1	0.1
In two to five years	0.1	0.1	0.1	0.1
In more than five years	0.8	0.8	0.8	0.8
	1.1	1.1	1.1	1.1

These liabilities are secured by charges over the assets to which they relate.

There is not a material difference between the minimum lease payment at the balance sheet date and their present value.

26 Provisions for liabilities and charges

GROUP and SOCIETY

	Repositioning Programme £m	FSCS Levy £m	Other Provisions £m	Total £m
Opening Provision at 1 January 2012	**1.1**	**3.1**	**4.2**	**8.4**
New Provisions during the year	**-**	**2.1**	**-**	**2.1**
Amounts utilised during the year	**(0.3)**	**(1.4)**	**(3.8)**	**(5.5)**
Closing Provision at 31 December 2012	**0.8**	**3.8**	**0.4**	**5.0**

GROUP and SOCIETY

	Repositioning Programme £m	FSCS Levy Provision £m	Other Provisions £m	Total £m
Opening Provision at 1 January 2011	1.7	3.0	1.6	6.3
New Provisions during the year	-	1.4	3.1	4.5
Amounts utilised during the year	(0.6)	(1.3)	(0.5)	(2.4)
Closing Provision at 31 December 2011	1.1	3.1	4.2	8.4

Provision for Financial Services Compensation Scheme Levy

In common with all regulated UK deposit takers, the Society pays a levy to the Financial Services Compensation Scheme (FSCS) which covers a management expenses levy and a compensation levy. The management expenses levy covers the costs of running the scheme and the compensation levy covers the amount of compensation the scheme pays, net of any recoveries it makes, using the rights that have been assigned to it. During the latter part of 2008 claims against the FSCS were triggered by the transfer of Bradford and Bingley's retail deposit business to Abbey National (now Santander) and the defaults of Kaupthing Singer and Friedlander, Heritable Bank and Landsbanki (Icesave). Further defaults arose in relation to London Scottish Bank and Dunfermline Building Society. The FSCS has met these claims by way of loans received from HM Treasury.

The FSCS is liable to pay interest on the loans from HM Treasury and has a further liability where there are insufficient funds available from the realisation of the assets of the relevant institutions to repay fully the respective HM Treasury loans.

The Society has recognised a provision of £3.8m at 31 December 2012 for the scheme years 2012/13 and 2013/14 which is calculated with reference to the eligible deposits the Society held at 31 December 2011 and 31 December 2012, and the likely interest payable on the Society's share of overall eligible UK deposits. Interest payable has been calculated using the latest available information published by the FSCS and with reference to the expected 12 month LIBOR rates over the relevant period. In addition, the FSCS published its latest plan and budget in February 2013 which clarified the amount of capital compensation being levied in relation to the 2013/14 Scheme year based on eligible deposits at 31 December 2012. The Society has provided for its share of the capital levy at 31 December 2012 based on the latest FSCS information.

As further information is provided by the FSCS the Society will continue to update its estimate of the amount of FSCS levies it will ultimately be required to pay.

Provision for Repositioning costs

The Society established a £4m provision in 2010 to cover costs and fees associated with its programme of cost reduction, business simplification and property rationalisation. At 31 December 2012 £0.8m (2011: £1.1m) of the provision remained, relating to vacant properties that the Society is currently marketing with property agents.

Other provisions

Other provisions include amounts provided for on Prepaid Card debtors and settlement liabilities for Prepaid Card programmes, which remain with the Society following the disposal of the Prepaid Cards Division.

Mortgage Payment Protection Insurance (MPPI)

The Society has established a small provision of £23k (2011: £25k) against MPPI mis-selling claims. The provision covers costs of dealing with claims rather than any compensation payable. The Society has never sold single premium policies with charges loaded up front and the Society has no issues with regard to systemic mis-selling of MPPI.

27 Subordinated liabilities

	GROUP and SOCIETY 2012 £m	2011 £m
7.375% fixed rate subordinated notes 2015	**9.6**	9.6
8.190% fixed rate subordinated notes 2017	**25.0**	25.0
6.625% fixed rate subordinated notes 2019	**25.0**	25.0
Less: unamortised issue costs	**(0.1)**	(0.1)
Less: unamortised capital exchange costs	**(0.6)**	(0.8)
	58.9	58.7

On a winding up, the subordinated notes rank behind the claims against the Society of all depositors, creditors and investing members (other than holders of deferred shares i.e. permanent interest bearing shares) of the Society. The notes are repayable at the Society's option and with the prior consent of the Financial Services Authority, on any interest date within five years of the maturity date.

On 10 May 2010 the Society announced that a Capital Agreement had been approved by holders of certain classes of the Society's existing subordinated debt and permanent interest bearing shares. The Capital Agreement involved adding a conversion feature such that the relevant instruments would convert into profit participating deferred shares (PPDS) should the Society's core tier 1 capital ratio fall below 5%. In return for this feature an increase in coupon was agreed as follows:

£11 million 6.375% fixed rate subordinated notes due 2015 (increase in coupon of 1%);

£25 million 7.19% fixed rate subordinated loan due 2017 (increase in coupon of 1%); and

£10 million 12% permanent interest bearing shares (increase in coupon of 0.25%)

The relevant instruments cease to be convertible and the coupon uplift falls away if the Society's core tier 1 capital ratio exceeds 12%.

In the event of conversion, the PPDS would qualify as core tier 1 capital of the Society and be eligible for a dividend payment based on a percentage of the Society's annual post-tax profits. This percentage, which would be determined at the time of conversion, would be equivalent to that proportion of the Society's core tier 1 capital which the PPDS represent immediately after conversion (the "Participation Percentage"). Any such dividend would be at the sole discretion of the Society's board of directors and any dividends would be non-cumulative. The PPDS would be deferred shares for the purposes of Section 119 of the Building Societies Act 1986, as amended, and would be perpetual instruments with no maturity date or right to repayment other than on a winding-up. The PPDS would also absorb the Participation Percentage of any consolidated post-tax losses recorded by the Society, any such amount being debited to a reserve account maintained by the Society for the purpose of the PPDS (the PPDS Reserve Account). Any net profits which are eligible to be paid to holders of PPDS as dividends but which are not so paid would be credited to the PPDS Reserve Account. No dividends may be paid on the PPDS in years where the Society incurs consolidated post-tax losses or where the PPDS Reserve Account is in deficit as a result of previous years' losses.

The conversion feature is considered to be an embedded derivative requiring separate recognition. There was a gain arising on the recognition of the embedded derivative in May 2010 of £0.1m although as this is based on an internal cashflow model with no observable market data, this gain was not recognised in accordance with IAS 39. The fair value of the embedded derivative has not changed materially as at 31 December 2012 and therefore a market value of £nil has been recorded.

On 2 October 2012 the coupon on the £25m 2017 subordinated debt increased by 1% to 8.19%

28 Subscribed capital

	GROUP and SOCIETY 2012 £m	2011 £m
12.625% permanent interest bearing shares	**10.0**	10.0
10.750% permanent interest bearing shares	**10.0**	10.0
12.250% permanent interest bearing shares	**10.0**	10.0
	30.0	30.0
Less: unamortised issue costs	**(0.1)**	(0.1)
Less: unamortised capital exchange costs	**(0.2)**	(0.3)
	29.7	29.6

The subscribed capital was issued for an indeterminate period and is only repayable in the event of the winding up of the Society.

The £10.0m 12.25% permanent interest bearing shares were included in the Capital Agreement as described in Note 27.

29 Note to the Cash Flow Statements

Reconciliation of profit / (loss) before taxation to net cash (outflow) / inflow from operating activities	GROUP 2012 £m	GROUP 2011 £m	SOCIETY 2012 £m	SOCIETY 2011 £m
Profit / (loss) before taxation and dividends	1.5	0.1	3.0	(3.3)
Depreciation and amortisation	2.6	2.9	2.4	2.7
Interest on subordinated liabilities	2.6	2.2	2.6	2.2
Interest on subscribed capital	3.6	3.6	3.6	3.6
Decrease in derivative financial instruments	(11.1)	(6.9)	(11.1)	(3.9)
Increase / (decrease) in other financial liabilities at fair value through profit or loss	6.8	0.8	6.8	(2.0)
Changes in retirement benefit obligations	5.2	3.0	5.2	3.0
Gain on disposal of properties	-	(0.4)	-	(0.4)
Other non-cash movements	30.2	(38.0)	29.4	(38.1)
Net cash inflow / (outflow) before changes in operating assets and liabilities	41.4	(32.7)	41.9	(36.2)
Decrease in loans and advances to customers	238.6	353.8	233.3	276.2
(Decrease) / increase in shares	(316.0)	168.4	(316.0)	168.4
Decrease in amounts due to other customers and deposits from banks	(26.8)	(106.1)	(26.8)	(106.8)
(Decrease) / increase in debt securities in issue	(8.0)	(70.5)	(8.0)	0.5
Increase / (decrease) in other assets, prepayments and accrued income	3.4	2.1	(0.8)	14.1
(Decrease) / increase in other liabilities	(3.9)	(0.3)	0.2	2.2
Net cash (outflow) / inflow from operating activities	(71.3)	314.7	(76.2)	318.4
Cash and cash equivalents				
Cash and balances with the Bank of England	364.4	162.3	364.4	162.3
Loans and advances to banks repayable on demand	1.1	0.8	1.0	0.7
Investment securities	162.5	214.9	162.5	214.9
At 31 December	528.0	378.0	527.9	377.9

Cash and cash equivalents comprise cash in hand, balances with the Bank of England, loans and advances to banks available on demand or with original maturities of three months or less and investment securities with a maturity period of three months or less i.e. highly liquid assets readily convertible into cash.

30 Guarantees, contingent liabilities and commitments

(i) Until 11 June 1996, under Section 22 of the Building Societies Act 1986, the Society had an obligation to discharge the liabilities of its subsidiary undertakings insofar as they were unable to discharge the liabilities out of their own assets. Subsequently, the Society has voluntarily agreed to provide continued support to all of its subsidiary undertakings, insofar as any liabilities are not covered by legislation.

(ii) In common with other financial institutions, the Society has a contingent liability in respect of contributions to the Financial Services Compensation Scheme established under the Financial Services and Markets Act 2000. Details are given in Note 26.

(iii) In 2008, the Society received grant aid of £0.3 million in relation to the premises at Cobalt Business Park. In certain circumstances this grant could become repayable.

(iv) Commitments

The Society has no capital commitments for the acquisition of property, plant and equipment at 31 December.

	GROUP and SOCIETY 2012 £m	GROUP and SOCIETY 2011 £m
Irrevocable undrawn committed loan facilities	56.3	33.5

Payments under non-cancellable operating lease agreements

Total minimum lease payments:

	GROUP and SOCIETY 2012 £m	GROUP and SOCIETY 2011 £m
Within one year	1.5	1.6
In one to five years	5.1	5.6
Over five years	4.2	5.6
	10.8	12.8

31 Retirement benefit obligations

Group and Society Pension schemes

The Group operates a Final Salary 'defined benefit' scheme, the Newcastle Building Society Pension and Assurance Scheme ("the Scheme"). The Scheme was closed to future benefit accrual with effect from 30 November 2010. Pension benefits for deferred members are based on the members' final pensionable salaries and service at the date accrual ceased (or date of leaving if earlier).

The Group has applied IAS 19 (Revised 2004) to the scheme and the following disclosures relate to this Standard. Any accumulated gains and losses in each period are recognised in the Statements of Comprehensive Income, unless recognised in the Income Statements.

The pension scheme assets do not include assets from Newcastle Building Society.

The amounts recognised in the Balance Sheets are as follows:	2012 £m	2011 £m
Present value of pension obligation	82.4	74.5
Fair value of scheme assets	(76.7)	(73.3)
Net pension liability	5.7	1.2

The amounts recognised in the Income Statements are as follows:		
Interest on obligation	3.6	3.8
Expected return on scheme assets	(3.7)	(4.2)
Total included in staff costs	(0.1)	(0.4)
Actual return on scheme assets	3.5	1.3

Changes in the present value of the defined benefit obligation are as follows:		
Opening defined benefit obligation	74.5	71.5
Interest cost	3.6	3.8
Actuarial losses	6.4	1.1
Benefits paid	(2.1)	(1.9)
Closing defined benefit obligation	82.4	74.5

Changes in the fair value of scheme assets are as follows:		
Opening fair value of scheme assets	73.3	71.5
Expected return	3.7	4.2
Actuarial losses	(0.3)	(2.9)
Contributions by employer	2.1	2.4
Benefits paid	(2.1)	(1.9)
Closing fair value of scheme assets	76.7	73.3

31 Retirement benefit obligations Continued

The major categories of Scheme assets as a percentage of total Scheme assets are as follows:	2012	2011
Equities	47.3%	53.3%
Corporate Bonds	13.3%	7.5%
Government Bonds	35.5%	36.3%
Cash	3.9%	2.9%

Principal actuarial assumptions at the Balance Sheet date (expressed as weighted averages)		
Discount rate	4.50%	4.95%
Future salary increases	-	-
Future pension increases in line with RPI to 5% per annum	2.90%	3.10%
Inflation assumptions - RPI	3.00%	3.20%
- CPI	2.35%	2.10%
Mortality - current pensioners		
Life expectancy at age 62		
Males	24.6 years	24.6 years
Females	27.1 years	26.9 years
Mortality - future pensioners		
Life expectancy at age 62 (aged 42 now):		
Males	26.1 years	26.1 years
Females	28.7 years	28.5 years

At 31 December, the pre and post retirement mortality is assumed based on S1PA CMI_2011_M/F (year of birth) tables with a 1% improvement (2011: S1PA CMI_2010_M/F (year of birth) tables with a 1% improvement)

100% of members are assumed to commute to maximum pension possible for cash at retirement, in line with current cash commutations.

The overall expected return on assets is assumed to be 5.00% pa as at 31 December 2012, and has been derived by calculating the weighted average of the expected weight of return for each asset class. The following approach has been used to determine the expected rate of return for each asset class:

- fixed interest and index-linked securities, current market yields
- equities, current dividend yield plus RPI inflation plus an allowance for dividend growth of 1% pa
- cash, FTSE 15-year all coupon gilt yield less 0.5% pa

Where investments are held in bonds and cash, the expected long-term rate of return is taken to be the yields generally prevailing on such assets at the Balance Sheet date. A higher rate of return is expected on equity investments, which is based more on realistic future expectations than on the returns that have been available historically. The overall expected long term rate of return on assets is then the average of these rates, taking into account the underlying asset portfolio of the pension scheme.

The expected rates of return for each asset class, gross of Scheme expenses, were:	2012	2011
Equities	7.60%	7.70%
Corporate Bonds	4.10%	4.70%
Government Bonds	2.30%	2.50%
Cash	1.80%	2.00%

Amounts for the current and previous four periods are as follows:	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Defined benefit obligation	82.4	74.5	71.5	68.8	57.3
Scheme assets	(76.7)	(73.3)	(71.5)	(66.6)	(49.5)
Deficit	5.7	1.2	-	2.2	7.8
Experience adjustments on plan liabilities	-	-	-	(2.2)	0.7
Experience adjustments on plan assets	(0.2)	(2.9)	3.2	5.2	(18.2)

Analysis of amounts recognised in Statements of Comprehensive Income:

	2012 £m	2011 £m
Total amount of actuarial losses recognised in the Statements of Comprehensive Income for the year:	(6.7)	(3.9)
Cumulative amount of actuarial losses recognised in the Statements of Comprehensive Income at the year end:	(24.9)	(18.2)

Future funding obligation

Following the valuation as at 30 June 2010, the Society has agreed to pay annual contributions of £2.0m increasing at 5.0% pa for 10 years with a final payment of £1.65m in 2021. The Society will also contribute 20% of annual profits in excess of £8.5m. The Society expects to pay £2.2m into the Scheme during the accounting year beginning 1 January 2013.

32 Related parties

The Group is controlled by Newcastle Building Society which is registered in England and Wales and operates in the United Kingdom. Further details of subsidiary undertakings are disclosed in Note 16 to these Accounts. The Directors are considered to be the only key management personnel as defined by IAS 24.

Transactions with directors and their close family members

Directors and their close family members have entered into the following transactions with Newcastle Building Society in the normal course of business.

Loans outstanding to directors and their close family members

	2012 £000	2011 £000
At 31 December	-	200

These loans were made on normal commercial terms and a register of them is available for inspection at the Principal Office for a period of 15 days up to and including the Annual General Meeting.

Deposits and investments held by directors and their close family members

	2012 £000	2011 £000
At 31 December	485	491

Amounts deposited by Directors and members of their close families earn interest on the same terms and conditions applicable to other customers.

Other transactions

Mrs CRR Vine-Lott is Chairman of Openwork Holdings Limited. During 2012, commission of £6.8m (2011: £5.9m) was received by one of the Society's subsidiary companies, Newcastle Financial Services Limited from Openwork. During the same period Newcastle Financial Services paid £36,461 (2011: £45,102) to Openwork in respect of a franchise fee/regulatory support charges. All transactions are on an arm's length basis.

32 Related parties Continued

Year ended 31 December 2012

	Interest paid to Society £000	Interest received from Society £000	Rent received from Society £000	Other amounts paid to Society £000	Other amounts received from Society £000
Kings Manor Properties Limited	590	-	-	1,325	-
Newcastle Financial Services Limited	-	1	-	-	-
Newcastle Mortgage Loans (Jersey) Limited	1,402	-	-	6,630	-
Newcastle Portland House Limited	-	10	66	-	-
Newton Facilities Management Limited	-	-	-	1	2

Year ended 31 December 2011

	Interest paid to Society £000	Interest received from Society £000	Rent received from Society £000	Other amounts paid to Society £000	Other amounts received from Society £000
Kings Manor Properties Limited	544	-	-	1,126	-
Newcastle Financial Services Limited	-	-	-	3,000	-
Newcastle Mortgage Loans (Jersey) Limited	1,721	-	-	8,050	-
Newcastle Portland House Limited	-	11	66	-	-
Newton Facilities Management Limited	-	-	-	333	335

At the year end the following unsecured balances were outstanding.

	Amounts owed by Society 2012 £000	Amounts owed to Society 2012 £000	Amounts owed by Society 2011 £000	Amounts owed to Society 2011 £000
Kings Manor Properties Limited	188	16,569	222	16,857
Newcastle Financial Services Limited	9,116	6,740	4,394	3,467
Newcastle Mortgage Loans (Jersey) Limited	-	20,286	-	25,465
Newcastle Portland House Limited	2,928	3	2,922	4
Newton Facilities Management Limited	73	60	129	71
Newcastle Strategic Solutions Limited	505	487	505	487

33 Financial instruments

These disclosures are given on a Group basis, unless otherwise stated, as the risks of the organisation are managed on a Group basis. Society disclosures are given where management information is also reported on that basis.

Categories of financial instruments

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 table analyses 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.

Group as at 31 December 2012	Note	Amortised cost £m	Available for sale £m	Held to maturity £m	Fair value through income statements £m	Total £m
Financial assets						
Cash in hand and balances with Bank of England		364.4	-	-	-	364.4
Loans and advances to banks	11	175.4	-	-	-	175.4
Debt securities	12	-	569.6	4.7	-	574.3
Derivative financial instruments	33	-	-	-	38.1	38.1
Fair value adjustments for hedged risk	15	-	-	-	40.0	40.0
Loans and advances to customers	14	2,727.6	-	-	-	2,727.6
Assets pledged as collateral	13	54.0	-	-	-	54.0
Total financial assets		**3,321.4**	**569.6**	**4.7**	**78.1**	**3,973.8**
Financial liabilities						
Due to members - shares	21	3,425.0	-	-	20.4	3,445.4
Fair value adjustments for hedged risk	15	-	-	-	17.5	17.5
Due to other customers	22	160.8	-	-	-	160.8
Deposits from banks	23	77.2	-	-	-	77.2
Debt securities in issue	24	8.0	-	-	-	8.0
Derivative financial instruments	33	-	-	-	40.0	40.0
Subordinated liabilities	27	58.9	-	-	-	58.9
Subscribed capital	28	29.7	-	-	-	29.7
Total financial liabilities		**3,759.6**	**-**	**-**	**77.9**	**3,837.5**

33 Financial instruments Continued

Group as at 31 December 2011	Note	Amortised cost £m	Available for sale £m	Held to maturity £m	Fair value through income statements £m	Total £m
Financial assets						
Cash in hand and balances with Bank of England		162.3	-	-	-	162.3
Loans and advances to banks	11	254.1	-	-	-	254.1
Debt securities	12	-	749.7	14.8	-	764.5
Derivative financial instruments	33	-	-	-	44.3	44.3
Fair value adjustments for hedged risk	15	-	-	-	57.9	57.9
Loans and advances to customers	14	2,976.6	-	-	-	2,976.6
Assets pledged as collateral	13	85.1	-	-	-	85.1
Total financial assets		**3,478.1**	**749.7**	**14.8**	**102.2**	**4,344.8**
Financial liabilities						
Due to members - shares	21	3,744.5	-	-	16.9	3,761.4
Fair value adjustments for hedged risk	15	-	-	-	28.7	28.7
Due to other customers	22	157.2	-	-	-	157.2
Deposits from banks	23	107.6	-	-	-	107.6
Debt securities in issue	24	16.0	-	-	-	16.0
Derivative financial instruments	33	-	-	-	57.4	57.4
Subordinated liabilities	27	58.7	-	-	-	58.7
Subscribed capital	28	29.6	-	-	-	29.6
Total financial liabilities		**4,113.6**	**-**	**-**	**103.0**	**4,216.6**

33 Financial instruments Continued

Fair values of financial assets and liabilities

The following table summarises the carrying amounts and fair values of those financial assets and liabilities not presented on the Group's or Society's Balance Sheet at their fair value.

GROUP

	Note	Carrying value 2012 £m	Carrying value 2011 £m	Fair value 2012 £m	Fair value 2011 £m
Financial assets					
Cash and balances with the Bank of England		364.4	162.3	364.4	162.3
Loans and advances to banks	11	175.4	254.1	175.5	254.2
Debt securities held to maturity	12	4.7	14.8	3.4	12.9
Loans and advances to customers	14	2,727.6	2,976.6	3,126.3	3,354.4
Assets pledged as collateral	13	54.0	85.1	54.0	85.1
Financial liabilities					
Due to members - shares	21	3,445.4	3,761.4	3,527.0	3,876.1
Due to other customers	22	160.8	157.2	161.1	157.6
Deposits from banks	23	77.2	107.6	77.2	107.6
Debt securities in issue	24	8.0	16.0	8.3	16.3
Subordinated liabilities	27	58.9	58.7	67.5	67.3
Subscribed capital	28	29.7	29.6	39.4	31.6

SOCIETY

	Note	Carrying value 2012 £m	Carrying value 2011 £m	Fair value 2012 £m	Fair value 2011 £m
Financial assets					
Cash and balances with the Bank of England		364.4	162.3	364.4	162.3
Loans and advances to banks	11	175.3	254.1	175.4	254.2
Debt securities held to maturity	12	4.7	14.8	3.4	12.9
Loans and advances to customers	14	2,707.2	2,951.0	3,078.2	3,322.5
Assets pledged as collateral	13	54.0	85.1	54.0	85.1
Financial liabilities					
Due to members - shares	21	3,445.4	3,761.4	3,527.0	3,876.1
Due to other customers	22	163.9	160.3	164.2	160.6
Deposits from banks	23	77.2	107.6	77.2	107.6
Debt securities in issue	24	8.0	16.0	8.3	16.3
Subordinated liabilities	27	58.9	58.7	67.5	67.3
Subscribed capital	28	29.7	29.6	39.4	31.6

Loans and advances to banks

The fair value of floating rate and overnight deposits is their carrying amount. The fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money-market interest rates for debts with similar credit risk and remaining maturity.

Loans and advances to customers

Loans and advances to customers are net of provisions for impairment. The estimated fair value of loans and advances represents the discounted amount of estimated future cash flows expected to be received. Expected cash flows are discounted at current market rates to determine fair value.

Due to customers

The fair value of shares represents the discounted amount of estimated future cash flows paid to share holders.

Deposits due to other banks

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest bearing deposits and other borrowings without market price, is based on discounted cash flows using interest rates for new debts with similar remaining maturity.

Debt securities in issue

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity.

33 Financial instruments Continued

Fair value measurement

The following table summarises the fair value measurement basis used for assets and liabilities held on the Balance Sheet at fair value:

2012
GROUP and SOCIETY

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets				
Debt securities - available for sale	569.6	-	-	569.6
Derivative financial instruments	-	38.1	-	38.1
Financial liabilities				
Derivative financial instruments	-	40.0	-	40.0

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability either directly (i.e. as price) or indirectly (i.e. derived from prices)

Level 3: Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

These definitions have been taken from March 2009 amendment to IFRS 7 'Improving Disclosures Financial Instruments'.

Derivatives held for hedging

Derivative financial instruments used by the Group have been described previously in the Risk Management Report.
The fair values of the derivative instruments held are set out below:

	2012 Notional Amount £m	2012 Fair Value Assets £m	2012 Fair Value Liabilities £m	2011 Notional Amount £m	2011 Fair Value Assets £m	2011 Fair Value Liabilities £m
At 31 December						
Interest rate swaps designated as fair value hedges	2,383.0	38.0	(39.6)	3,057.0	44.1	(56.4)
Interest rate swaps designated as cash flow hedges	100.0	0.1	-	-	-	-
Interest rate swaps	24.4	-	(0.4)	145.3	0.2	(1.0)
		38.1	(40.0)		44.3	(57.4)

Hedge Ineffectiveness

	2012 £m	2011 £m
Gains on hedging instruments	10.9	6.1
Losses on hedged items attributable to the hedge risk	(10.2)	(5.3)
Net gains representing ineffective portions of the fair value hedges	0.7	0.8

33 Financial instruments Continued

Liquidity risk

For each material category of financial liability a maturity analysis is provided in Notes 21 to 24, which represents the contractual maturities.

The table below analyses the Group's financial liabilities, which will be settled on a net basis, into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows.

GROUP and SOCIETY

At 31 December 2012	Repayable on demand	Up to 3 months	Between 3 and 12 months	Between 1 and 5 years	Over 5 years	Total
Due to members - shares	1,727.3	1,008.2	569.7	140.1	0.1	3,445.4
Due to other customers	5.1	67.2	88.4	0.1	-	160.8
Deposits from banks	0.1	17.4	59.7	-	-	77.2
Debt securities in issue	-	3.0	5.0	-	-	8.0
Derivative financial instruments	-	-	0.5	4.0	35.5	40.0
Fair value adjustments for hedged risk	-	-	(0.3)	17.8	-	17.5

At 31 December 2011	Repayable on demand	Up to 3 months	Between 3 and 12 months	Between 1 and 5 years	Over 5 years	Total
Due to members - shares	1,580.1	1,402.1	582.3	196.3	0.6	3,761.4
Due to other customers	6.3	98.5	51.3	1.1	-	157.2
Deposits from banks	0.3	66.0	41.3	-	-	107.6
Debt securities in issue	-	-	16.0	-	-	16.0
Derivative financial instruments	-	-	0.9	7.1	49.4	57.4
Fair value adjustments for hedged risk	-	-	1.5	27.2	-	28.7

Equity risk

The Group has no material direct exposure to equity risk. The Group has a number of structured products which have an embedded derivative attached to them i.e. the return payable is derived from the performance of an underlying index. Under IAS 39 both the underlying product and the derivative are fair value accounted through the Income Statements. The fair value amounts are approximately equal and offsetting so there is no material charge or credit in the accounts.

33 Financial instruments Continued

Credit risk

Note 14 of the Accounts on page 44 contains details of total mortgage assets.

The average loan to value (LTV) ratio of the Group's loans and advances to customers is estimated to be **65.1%** (2011: 66.3%). Further LTV and payment performance information is shown below:

GROUP and SOCIETY prime residential mortgage book

The Prime residential mortgage book consists of traditional residential loans. No sub-prime or self-certification lending has been undertaken.

Loan to value (indexed)	2012 £m	2012 %	2011 £m	2011 %
<70%	1,011.3	71.0	1,115.6	74.9
70% - <80%	173.0	12.2	175.1	11.8
80% - <90%	112.0	7.9	121.0	8.1
>90%	126.1	8.9	77.3	5.2
	1,422.4	100.0	1,489.0	100.0

The table below provides further information by payment due status:

	2012 £m	2012 %	2011 £m	2011 %
Neither past due nor impaired	1,395.6	98.1	1,456.5	97.8
Past due up to 3 months but not impaired	15.8	1.1	19.6	1.3
Impaired and past due 3 to 6 months	5.0	0.3	7.3	0.5
Impaired and past due over 6 months	5.7	0.4	4.9	0.3
In possession	0.3	0.1	0.7	0.1
	1,422.4	100.0	1,489.0	100.0

Against past due and possession cases, **£72.0m** (2011: £79.3m) of collateral is held.

No loans that would be past due or impaired have had terms renegotiated.

Specialist residential mortgage book

The Specialist residential mortgage book consists of buy-to-let and residential investment loans.

Loan to value (indexed)	2012 £m	2012 %	2011 £m	2011 %
<70%	24.9	12.2	22.1	9.8
70% - <80%	53.2	26.0	57.2	25.3
80% - <90%	65.1	31.9	57.5	25.4
>90%	61.1	29.9	89.4	39.5
	204.3	100.0	226.2	100.0

The table below provides further information by payment due status:

	2012 £m	2012 %	2011 £m	2011 %
Neither past due nor impaired	138.2	67.6	200.0	88.4
Past due up to 3 months but not impaired	39.4	19.3	5.0	2.2
Not past due but impaired	3.0	1.5	3.1	1.4
Impaired and past due 3 to 6 months	-	-	0.1	0.1
Impaired and past due over 6 months	2.6	1.3	1.0	0.4
LPA receivership	10.8	5.3	6.1	2.7
In possession	10.3	5.0	10.9	4.8
	204.3	100.0	226.2	100.0

Against past due, LPA receivership and possession cases, **£70.6m** (2011: £27.0m) collateral is held.

No loans that would be past due or impaired have had terms renegotiated.

33 Financial instruments Continued

Commercial lending book

The commercial lending book comprises:

GROUP and SOCIETY	2012 £m	2012 %	2011 £m	2011 %
Loans secured on commercial property	318.0	28.7	393.3	31.4
Loans to Housing Associations	791.0	71.3	858.8	68.6
	1,109.0	100.0	1,252.1	100.0

Loans secured on commercial property **Loan to value**	2012 £m	2012 %	2011 £m	2011 %
<70%	45.7	14.4	68.2	17.3
70% - <80%	102.1	32.1	95.1	24.2
80% - <90%	68.2	21.4	104.9	26.7
>90%	102.0	32.1	125.1	31.8
	318.0	100.0	393.3	100.0

Valuations are carried out on a regular basis and movements into higher LTV bands represent latest valuations, consistent with falls in commercial property values since loan origination.

The table below provides further information by payment due status:

	2012 £m	2012 %	2011 £m	2011 %
Neither past due nor impaired	252.1	79.3	343.6	87.4
Past due up to 3 months but not impaired	0.4	0.1	4.3	1.1
Not past due but impaired	33.0	10.4	25.3	6.4
Impaired and past due up to 3 months	-	-	11.2	2.8
Impaired and past due 3 to 6 months	-	-	2.7	0.7
Impaired and past due over 6 months	10.1	3.2	2.7	0.7
Impaired LPA receivership	22.4	7.0	3.1	0.8
Impaired In possession	-	-	0.4	0.1
	318.0	100.0	393.3	100.0

During 2012 two loans had arrears capitalised which is considered to be forbearance. Total balances on loans where arrears have been capitalised was £24.0m with provisions against these loans amounting to £5.4m. The Society extended the loan term on seven loans maturing in 2012 with total balances of £45.0m, on original commercial terms and conditions. Such extensions are granted to give the borrower more time to sell the security property or to aid amortisation of the debt prior to sale of the security property. There are no specific provisions against these loans but they are covered by the collective provision. In addition, the Society extended the loan terms on two impaired loans that matured in 2012 totalling £11.8m The loans are being serviced and are not in arrears but a short fall may arise at the revised maturity date for which provisons of £1.6m have been made.

Loans secured on commercial property are diversified by industry type and an analysis is shown below:

	2012 £m	2012 %	2011 £m	2011 %
Retail	160.5	50.5	187.8	47.7
Office	42.6	13.4	56.9	14.5
Industrial	56.5	17.8	57.6	14.6
Hotel / Leisure	19.9	6.3	22.3	5.7
Student Accommodation	12.7	4.0	16.6	4.2
Serviced Apartments	24.2	7.6	51.9	13.2
Other	1.6	0.4	0.2	0.1
	318.0	100.0	393.3	100.0

Loans to Housing Associations **Loan to value (unindexed)**	2012 £m	2012 %	2011 £m	2011 %
<70%	329.4	41.6	325.8	37.9
70% - <80%	164.6	20.8	158.9	18.5
80% - <90%	226.9	28.7	273.9	31.9
>90%	70.1	8.9	100.2	11.7
	791.0	100.0	858.8	100.0

Loans to Housing Associations are secured on residential property.

No Housing Associations Loans are past due or impaired.

Notes to the Accounts for the year ended 31 December 2012

33 Financial instruments Continued

Interest Rate Risk

Interest rate risk is the exposure of the Group's net interest income to movement in interest rates. This is managed using a combination of limits set by the Board and by use of derivative instruments. The sensitivity to interest rate movements is measured using dynamic stress tests for a series of parallel rate shifts over various time periods.

The table below shows the impact of various interest rate scenarios on Group profit before tax, against the Society's current interest rate view. A positive item is an increase in margin and a negative item is a reduction.

	+1% £m	+2% £m	-1% £m	-2% £m
At 31 December 2012				
Next 12 months	1.9	3.8	-	-
Next 2 years	1.1	3.2	-	-
Next 3 years	1.4	2.8	-	-
At 31 December 2011				
Next 12 months	-	0.1	-	-
Next 2 years	(0.3)	(0.6)	-	-
Next 3 years	(0.9)	(1.8)	-	-

The main risk measure used by ALCO is an immediate 200 basis points parallel shift in rates. However, due to the low interest rate environment experienced over the last year, the rate shocks for interest rate reductions have been amended to -0.10% and -0.20%.

Due to the low interest rate environment, the interest rate shifts for -1% and -2% are not currently reported to ALCO.

An immediate 2% upward movement in interest rates would increase Members' Interests by **£1.7m** (2011: £5.7m increase).

The derivative gains less losses for the year in respect of fair value hedges comprise gains on derivatives of **£10.9m** (2011: £6.1m gain) and associated losses on hedged items of **£10.2m** (2011: £5.3m loss).

Interest rate risk in the pension schemes

A reduction of 0.1% in the discount rate would increase the pension deficit by approximately **£1.5m**.

Currency risk

The Group has no exposure to currency risk.

1 Statutory percentages

	2012 %	Statutory %
Lending limit	**15.69**	25.00
Funding limit	**6.66**	50.00

The above percentages have been calculated in accordance with the provisions of the Building Societies Act 1986 as amended by the Building Societies Act 1997.

The lending limit measures the proportion of business assets not in the form of loans secured on residential property. Business assets are the total assets of the Group plus allowances for losses on loans and advances less liquid assets, investment properties and property, plant and equipment as shown in the Group balance sheet.

	2012 %	2011 %
Lending limit excluding all IAS39 adjustments for derivative financial instruments and fair value adjustments for hedged risk	**13.59**	15.21

The funding limit measures the proportion of shares and borrowings not in the form of shares held by individuals.

The statutory limits are as laid down under the Building Societies Act 1986, as amended by the Building Societies Act 1997, and ensure that the principal purpose of a building society is that of making loans which are fully secured on residential property and are funded substantially by its members.

2 Other percentages

As a percentage of shares and borrowings:	2012 %	2011 %
Gross capital	**7.05**	6.44
Free capital	**6.20**	5.49
Liquid assets	**30.18**	29.18
Result / (loss) for the year as a percentage of mean total assets	**-**	(0.02)
Management expenses as a percentage of mean total assets	**0.88**	0.80

The above percentages have been prepared from the Annual Accounts.

Gross capital represents the aggregate of the general reserve, available for sale reserve, subordinated liabilities and subscribed capital.

Free capital represents gross capital less property, plant and equipment, investment property and non-current assets held for sale.

Liquid assets are as shown in the Group Balance Sheets plus any other liquid assets which qualify as prudential liquidity, but exclude liquid assets pledged under repo agreements.

Shares and borrowings represent the total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue.

Management expenses represent the aggregate of administrative expenses and depreciation.

Mean total assets is the average of the 2012 and 2011 total assets.

Annual Business Statement for the year ended 31 December 2012

Directors at 31 December 2012

	Date of Birth	Date of Appointment	Business Occupation
DJ Buffham	**13.08.59**	**24.05.10**	**Company Director**
	Directorships: Zytronic PLC; William Leech (Investments) Limited; William Leech Foundation.		
FD Holborn FCIB	**26.05.47**	**01.01.03**	**Company Director**
	Directorships: Newcastle Portland House Limited; Rothley Trust (Vice Chairman).		
RJ McCormick FCA, FCIIA	**09.05.49**	**16.08.07**	**Business Consultant**
	Directorships: Newcastle Strategic Solutions Limited; Grassington Hub Limited; Threshfield Quarry Development Trust Limited.		
RD Mayland FCA	**22.05.53**	**27.06.05**	**Company Director**
	Directorships: Norprime Limited; Community Services North East Limited.		
PJ Moorhouse FCCA	**18.01.53**	**31.10.11**	**Company Director**
	Directorships: Cumbria NHS Partnership Foundation Trust; Molins PLC; Newcastle Strategic Solutions Limited.		
J Morris BA, FCA	**13.09.56**	**31.10.11**	**Chartered Accountant**
	Directorships: Weston Park Hospital Cancer Care and Research Fund (Trustee).		
AM Russell BA, FCA, CPA	**18.03.67**	**01.07.10**	**Building Society Finance Director**
	Directorships: Newcastle Card Solutions Limited; Newcastle Financial Services Limited; Newcastle Mortgage Loans (Jersey) Limited; Newcastle Portland House Limited; Newton Facilities Management Limited; St Cuthberts Care Limited.		
G Tiplady LLB	**30.09.65**	**11.01.11**	**Building Society Business Services Director**
	Directorships: Kings Manor Properties Limited; Newcastle Card Solutions Limited; Newcastle Strategic Solutions Limited; Newton Facilities Management Limited.		
CRR Vine-Lott MBA, FCISI, FCIM, ACIB	**30.01.60**	**01.01.10**	**Director in Financial Services**
	Directorships: Openwork Holdings Limited; Openwork Services Limited; Rathbone Brothers PLC.		
JH Willens MBA, ACIB	**07.06.56**	**04.01.10**	**Building Society Chief Executive**
	Directorships: Brown Shipley and Company Limited (ceased 31st December 2012); Kings Manor Properties Limited; Buildings Societies Association (Nominations Committee and Remuneration Committee).		

Documents may be served on any of the above named Directors: "Newcastle Building Society" c/o Addleshaw Goddard LLP (Ref. GAB), at the following address: Sovereign House, PO Box 8, Sovereign Street, Leeds LS1 1HQ. The Executive Directors have service contracts which are terminable at any time by the Society on six months notice. There are no contracts for Non Executive Directors and no compensatory terms for loss of office.

Other Officers at 31 December 2012

	Business Occupation
K Anderson Assoc CIPD	**Building Society Executive**
P Ferguson BSc, CA	**Building Society Executive**
	Directorships: Newcastle Building Society Pension & Assurance Scheme (Trustee).
PG Grand MCMI, DMS, MBA	**Building Society Executive**
	Directorships: Newcastle Strategic Solutions Limited.
PJ Green BA (Hons)	**Building Society Executive**
	Directorships: Newcastle Building Society Pension & Assurance Scheme (Trustee).
S Marks ACIBS, DMS	**Building Society Executive**
SA Urwin BSc, DipM	**Building Society Executive**
	Directorships: Newcastle Financial Services Limited, Newcastle Mortgage Loans (Jersey) Limited.
S Watchman BSc	**Building Society Executive**
I Good FMAAT	**Group Secretary**

Glossary

Set out below are the definitions of the terms used within the Annual Report and Accounts to assist the reader and to facilitate comparison with other financial institutions:

Arrears - A customer is in arrears when they are behind in their mortgage payments.

Administrative expenses - Expenses incurred in running the day to day activities of the Society including staff, property, marketing and technology costs.

Basel II - The second of the Basel Accords, issued by the Basel Committee on Banking supervision, which defines the methods by which firms should calculate their regulatory capital requirements to retain enough capital to protect the financial system against unexpected losses. Basel II became law in the EU Capital Requirements Directive, and was implemented in the UK via the FSA Handbook.

Basel III - The third of the Basel Accords, issued by the Basel Committee on Banking supervision, which are a long-term package of changes that will strengthen regulatory requirements for capital and liquidity.

Commercial lending / mortgage - Loans secured on commercial property.

Contractual maturity - The final payment date of a loan or other financial instrument, at which point all the remaining outstanding principal and interest is due to be paid.

Core Tier 1 capital - Defined by the FSA as general reserves or qualifying capital instruments which for the Society is the accumulation of retained profits.

Covered bonds - Debt securities backed by a portfolio of mortgages that is segregated from the issuer's other on-balance sheet assets solely for the benefit of the holders of the covered bonds.

Credit risk - The risk that a customer or counterparty is unable to honour their repayment obligations as they fall due.

Debt securities - Assets representing certificates of indebtedness of credit institutions, public bodies or other undertakings excluding central banks.

Derivative financial instruments - A derivative financial instrument is a type of financial instrument (or an agreement between two parties) that has a value based on the underlying asset, index or reference rate it is linked to. The Group uses derivative financial instruments to hedge its exposures to interest rate risk.

Effective interest rate method (EIR) - The method used to measure the carrying value of a financial asset or a liability and to allocate associated interest income or expense over the relevant period.

Fair value - Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial Services Compensation Scheme (FSCS) - The UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation to customers if a firm is unable, or likely to be unable, to pay claims against it, usually because it has stopped trading or has been declared in default. The FSCS is funded by the financial services industry. Every firm authorised by the FSA is obliged to pay an annual levy, which goes towards running costs and compensation payments.

Forbearance - A term generally applied to arrangements which are provided to support mortgage customers experiencing financial difficulties. An example of this would be a temporary reduction in mortgage payments.

Free capital - Represents gross capital less property, plant and equipment and investment property.

Funding for Lending Scheme (FLS) - The Scheme to boost the incentive for banks and building societies to lend to UK households and non-financial companies. The Scheme is designed to reduce lending rates and increase availability by making available cheaper Bank of England funding.

Funding limit - Measures the proportion of shares and borrowings not in the form of shares held by individuals.

Gilts - Gilt-edged securities are bonds issued by certain national governments. The Group only classifies debt securities issued by the Bank of England as Gilts.

Gross capital - The aggregate of general reserve, available-for-sale reserve, subscribed capital and subordinated liabilities.

Icelandic treasury investments - Treasury investments in Icelandic banks purchased prior to the collapse of the Icelandic banking system in October 2008, including Glitnir, Landsbanki, Heritable and Kaupthing Singer and Friedlander.

Impaired loans - Loans where an event has occurred which indicates the Group does not expect to collect all the contractual cash flows due, or expects to collect them later than they are contractually due.

Individual Capital Guidance (ICG): - Guidance from the FSA on the minimum level of capital that must be held.

Individual Liquidity Adequacy Assessment (ILAA): - The Group's internal assessment of the liquidity levels needed to meet its regulatory liquidity requirements.

Individual Liquidity Guidance (ILG): - Guidance from the FSA on the minimum quantity of a firm's liquidity resources and the firm's funding profile.

Individually / collectively assessed - Individual assessments are made of all mortgage loans where objective evidence indicates losses are likely or the property is in possession. A collective impairment provision is made against the remaining group of loans and advances where objective evidence indicates that it is likely that losses may be incured.

Internal Capital Adequacy Assessment Process (ICAAP) - The Group's own assessment of the levels of capital that it needs to hold in respect of the risks it faces under a business as usual scenario and a variety of stress scenarios.

Legacy mortgage portfolios - Mortgage loan books where the Group has ceased new lending and is winding down exposures.

Lending limit - Measures the proportion of business assets not in the form of loans fully secured on residential property.

Liquid assets - The total of cash in hand and balances with the Bank of England, loans and advances to credit institutions and debt securities.

Liquidity risk - The risk that the Group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash inflows and outflows.

Loan-to-value ratio (LTV) - A ratio which expresses the amount of a mortgage as a percentage of the value of the property. The Group calculates UK residential mortgage LTV on an indexed basis (the value of the property is updated on a quarterly basis) to reflect changes in house prices.

Loans and advances to banks - Treasury investments purchased with banking institutions.

Management expenses - Management expenses represent administrative expense and depreciation. The management expense ratio is management expenses expressed as a percentage of mean total assets.

Market risk - The risk that movements in market risk factors, including re-pricing of assets and liabilities and the imperfect matching of interest rates between different asset and liability types, may adversely impact the Society.

Mean total assets - Represents the amount produced by halving the aggregate of total assets at the beginning and end of the financial year.

Member - A person who has a qualifying share investment or a mortgage loan with the Society.

Mortgage Market Review (MMR) - An FSA Issued policy statement on reform of the lending market designed to deliver a better market for consumers that is sustainable for all participants.

Net interest income - The difference between interest received on assets and interest paid on liabilities.

Non Executive Director - A member of the Society's Board who does not form part of the executive management team. He or she is not an employee of the Society.

Operational risk - The risk of loss arising from inadequate or failed internal processes, people and systems or from external events.

Other lending - loans and advances secured on traded endowment policies.

Past due - Loans on which payments are overdue including those on which partial payments are being made.

Permanent Interest Bearing Shares (PIBS) - Unsecured, deferred shares that are a form of Tier 1 capital. PIBS rank behind the claims of all subordinated debt holders, depositors, payables and investing members of Newcastle Building Society.

Prepaid Cards business - The division of the Society licensed to issue cards loaded with electronic money which was sold in December 2011.

Prime - Prime mortgages are those granted to the most credit worthy category of residential borrowers.

Recovery and Resolution Plan (RRP) - In response to the latest financial crisis, the FSA now requires all financial institutions to prepare recovery and resolution plans, or living wills. The purpose of these plans is to mitigate the likelihood and impact of a future failure.

Renegotiated loans - Loans are classed as renegotiated with the customer's consent, when their terms have changed during the year. Loans and advances are generally renegotiated either as part of an on-going customer relationship or in response to an adverse change in the circumstances of the borrower.

Repo - Short to medium-term funding agreements which allow a borrower to sell a financial asset, such as Government bonds, as security for cash. As part of the agreement the borrower agrees to repurchase the security at a later date. For the party selling the security (and agreeing to repurchase it in the future) it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future), it is a reverse repurchase agreement or reverse repo.

Residential mortgage backed securities (RMBS) - Asset backed securities that represent interests in residential mortgages. Investors in these securities have the right to cash received from future mortgage payments (interest and principal).

Residential loans - Residential loans are secured against residential property.

Retail Distribution Review (RDR) - A process carried out by the FSA to change the way recommendations about investment products and pensions are made to investors. This also includes changing the way fees are charged for these services.

Risk appetite - The articulation of the level of risk that the Group is willing to take (or not take) in order to safeguard the interests of the Society's members whilst achieving business objectives.

Risk-weighted asset (RWA) - The value of assets, after adjustment under Basel II rules, to reflect the degree of risk they represent. The Society measures RWA using the standardised approach.

Shares - Funds deposited by a person in a retail savings account with the Society. Such funds are recorded as liabilities for the Society.

Shares and borrowings - The total of shares, amounts owed to credit institutions, amounts owed to other customers and debt securities in issue, including accrued interest.

Solutions - a division of the Society that offers business to business services through people, process and innovative application of technology. Services include complete systems for smaller societies and white-labelled savings management for a range of banks and building societies.

Solvency ratio - the ratio of total capital to total risk weighted assets.

Specialist lending - Aggregate of the Group's residential investment and buy to let mortgage portfolios. No lending has taken place on this book since 2008 and the exposure to portfolio Investors is being reduced.

Subordinated debt / liabilities - A form of Tier 2 capital that is unsecured and ranks behind the claims of all depositors, creditors, and investing members (other than holders of PIBS).

Tier 1 capital - Tier 1 capital is divided into Core Tier 1 and other Tier 1 capital. Core Tier 1 capital comprises general reserves from retained profits. Other regulatory adjustments may be made for the purposes of capital adequacy. Qualifying capital instruments such as PIBS are included in other Tier 1 capital (i.e. not Core Tier 1).

Tier 2 capital - Comprises the Group's qualifying subordinated debt and collective impairment allowance (for exposures treated on a Basel II standardised basis).

Wholesale funding - The total of amounts owed to credit institutions, amounts owed to other customers and debt securities in issue less.